Thursday, October 9, 2025
10:30 AM – 11:30 AM

Workshop 10

Strategic Options in Bankruptcy When the Anchor Goes Under: Mayday, Mayday!

Presented to

2025 ICSC+U.S. LAW
Marriott Marquis San Diego Marina, San Diego, CA
October 8-10, 2025

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While unfortunate, bankruptcy filings of anchor tenants at shopping centers are all too common. Sometimes, they can have a long-term detrimental impact on a center and, at other times, landlords may welcome having a chance to redevelop the space. Prevention is often impossible; therefore, preparation is critical. As a landlord, it is important to know your options before and after a bankruptcy filing to protect your interests. Below we discuss strategies to employ in both situations.

I. Pre-Bankruptcy Strategies

A. Financial Due Diligence

The most important strategy is to be proactive, especially as it relates to a tenant's credit. This is as important in initial leasing as it is during the lease term. Because of the outsized impact that an anchor has on a shopping center, landlords must be focused on the creditworthiness of an anchor tenant. At initial leasing, this means that, in addition to their normal due diligence, landlords should be focused on exactly how the anchor tenant makes money and how they are financed. Some questions to consider are: (i) do they obtain their greatest profits during fourth quarter like many retail tenants or do their sales peak during a different season?, (ii) is the tenant operating in a growing or dying industry?, (iii) is the tenant's revenue sustainable?, (iv) does the tenant have a history of not paying its contractors and being subject to numerous mechanic's liens?, (v) is the tenant's use untraditional and untested for an anchor space?, and (vi) does the tenant have traditional bank lenders or is it funded by private equity? With fewer options in the modern day for anchor tenants given the decline of the department store, it is particularly important to perform enhanced due diligence.

However, analysis of a tenant's creditworthiness and financial stability should not stop once a lease is executed. While it is important that rent checks are received timely and not returned for insufficient funds, the impact of an anchor tenant on a shopping center is too important to hope and pray that payments will continue. Landlords should monitor the creditworthiness of anchor tenants (and other tenants for that matter) throughout the term of the lease.

First and foremost, before the lease is signed, negotiate for the tenant to provide frequent sales and financial reporting and, after the lease is signed, enforce those rights throughout the term. Be specific about the reports. Request audited versions if possible. If sales are down, ask questions. Do not assume things will improve. Bring in financial experts if necessary.

Second, as a society, we now have innumerable ways of capturing data about a company. There are well-known services that track the creditworthiness of tenants, even smaller ones, through analysis of public filings, press reports, news stories, industry trends, and conversations with management. These services also track the timeliness of vendor payments, which is important to understand a tenant's ability to meet its obligations. Not paying vendors translates to not stocking shelves, which leads to decreased sales, missed projections, and, often, bankruptcy. It is also important to pay attention to your anchor tenant's upcoming debt maturities as that can be an indicator of when its lender may draw a line in the sand and force them into bankruptcy.

Third, there are services that track consumer traffic at shopping centers, which allows a landlord not only to track the traffic at its anchor tenant's location, but also the traffic at all of the anchor tenant's other locations throughout the country and traffic at the stores of your anchor tenant's competitors. Keeping on top of this information is critical to ensure the success of a shopping center. As the landlord, you want to be the first to know of any trouble before you read it in the news. If you have bankruptcy counsel, it is also worthwhile to check in with them every so often to see which tenants they are watching for potential bankruptcy filings. While some of these credit monitoring services can be very costly, often bankruptcy counsel are already subscribed and may be able to share information with you.

B. Lease Negotiations and Renegotiations

The second strategy landlords should employ is to approach lease negotiations and renegotiations with an eye towards a potential future tenant bankruptcy.

After the landlord has done its financial due diligence, it should consider whether security is necessary to enter into a lease with the anchor tenant. While anchor tenants may refuse in light of their strong financial performance, if the landlord has any doubt about the tenant's long-term viability, security is key. Note that not all security is equal in the eyes of the Bankruptcy Court. Security deposits will be treated as property of the estate, while letters of credit and guarantees from non-debtors are the best options to increase the likelihood that you will be able to obtain a recovery outside of the Bankruptcy Court.

When drafting a lease, the landlord should also consider its impact on a hypothetical future assignment of that lease in bankruptcy. A provision that prevents a landlord from assigning its lease will not be enforceable in bankruptcy. However, if the lease contains specific parameters for permitted assignees, including with detailed financial requirements, that could be persuasive for a Bankruptcy Court in considering whether to approve assignment of a lease. Also, in connection with a hypothetical lease assignment, part of a landlord's pecuniary loss (*see* discussion below) may include the costs and expenses, including attorney's fees, incurred in connection with curing defaults under the lease. The Bankruptcy Court will look to the language of the lease to determine whether attorneys' fees are compensable; therefore, the landlord should avoid using boilerplate language.

Finally, a word about co-tenancy. The bankruptcy of an anchor tenant in a shopping center can cause numerous co-tenancy implications for other tenants of the center. Therefore, during initial lease negotiations and renegotiations throughout the term, the landlord should be laser-focused on modifying troubling co-tenancy provisions or striking them completely.

C. Vigilant Enforcement of Landlord's Rights Under the Lease

Aside from monitoring a tenant's creditworthiness during the lease term, the landlord should also pay close attention to the tenant's compliance with all lease provisions and should enforce its rights when possible if it fears a potential bankruptcy filing by the tenant. Landlords are often hopeful that a tenant will right the ship and sales will improve. Sometimes, there are valid reasons for believing that and for partnering with a tenant to help make their business viable. However, absent compelling circumstances, landlords should be diligent in enforcing their rights under the lease. This means knowing the terms of each lease closely, sending out default letters immediately, being mindful of the timing requirements under the lease and state law, and pursuing eviction when possible. Once the tenant is in bankruptcy, the landlord may completely lose control over the space. The best strategy when confronted with a tenant heading towards bankruptcy is often to determine whether terminating the lease under its own terms or state law is possible. Consult with knowledgeable counsel both pre- and post-bankruptcy about how to cautiously take back possession given the automatic stay, as discussed below.

II. Post-Bankruptcy Strategies

A. The Automatic Stay

The overall goal of the Bankruptcy Code is to provide the debtor with a fresh start. Critical to achieving that fresh start is the imposition of the automatic stay. As the name implies, it automatically enjoins actions by creditors to, among other things, collect pre-petition debt and initiate or continue actions to recover property of the estate (*e.g.*, eviction actions). *See* 11 U.S.C. § 362.

If a lease was terminated pre-petition (*i.e.*, before the bankruptcy filing), the automatic stay should not apply to it. However, be cautioned that merely sending a termination notice is insufficient to fully terminate a lease and keep it outside the scope of the debtor's bankruptcy case. Further, even if a landlord terminated a lease pre-petition, the facts may prevent a landlord from obtaining possession immediately. For example, if the debtor left personal property at the premises, then the landlord may need relief from the automatic stay to dispose of that property.

Violators of the automatic stay are subject to potentially severe penalties; therefore, after a bankruptcy filing, it is important for landlords to consult with counsel to create a strategy for any collection efforts and communications with a debtor tenant.

B. Post-Petition Payments

During the bankruptcy, landlords should pay close attention to lease obligations coming due or accruing – as applicable and explained below – with particular emphasis on any expected non-recurring charges such as real estate taxes and common area maintenance reconciliations. Depending on the Bankruptcy Court the case is pending in, lease obligations may be measured based on when they come due (a "performance date" jurisdiction such as Delaware, Texas, or New Jersey) or when they accrue (a "proration" jurisdiction such as New York, Florida, or Virginia).

Bankruptcy Code section 365(d)(3) requires debtor-tenants to "timely perform" under unexpired leases of nonresidential real property (*i.e.*, retail store leases). *See* 11 U.S.C. § 365(d)(3). In a performance date jurisdiction, this means lease obligations that *come due* post-bankruptcy but prior to assumption, assignment, or rejection must be paid and are entitled to administrative (*i.e.*, high) priority to the extent they are not paid, whereas, in a proration jurisdiction, the same would be true for lease obligations that *accrue* during that period. If a lease may be rejected – which is especially likely when a store closing sale has already commenced – and the landlord is in a performance

date jurisdiction, it may look to bill charges as soon as possible to increase the likelihood they come due prior to rejection; in a proration jurisdiction, there is no need to consider that, but landlords should keep in mind that even if something is invoiced post-rejection, it would still need to be paid – whether in part or in full – to the extent it accrued during the post-bankruptcy/pre-rejection period.

C. Lease Dispositions

When deciding how to treat its leases in bankruptcy, a debtor tenant has three options: (i) assumption, (ii) assumption and assignment, and (iii) rejection. The Bankruptcy Code limits the amount of time the debtor has to make this decision to 120 days, which can be extended up to 210 days upon a minimal showing of cause by the debtor. *See* 11 U.S.C. § 365(d)(4). If the debtor wants more than 210 days to decide, then it will reach out to the landlord for consent, which can be withheld. If a landlord prefers to relet, redevelop, or sell the premises, it has the option to oppose such extension. However, note that in large chapter 11 bankruptcy cases, counsel to the debtor is not going to allow its client to risk getting close to the 210-day deadline since the leases are such a valuable asset to the estate and the risk of losing them to automatic rejection could be disastrous for the success of the case.

The debtor's first option is to assume a lease, which usually occurs in connection with a plan of reorganization. Its second option is to assume and assign the lease to a third-party, which typically occurs in connection with a section 363 sale of substantially all of the debtor's assets or individual lease sales. Bankruptcy court approval is required for both.

If there has been a default under a lease, then, before assuming or assuming and assigning it, the debtor must: (i) cure all defaults under the lease or provide adequate assurance of prompt cure, (ii) compensate, or provide adequate assurance that it will promptly compensate, landlord for any actual pecuniary loss resulting from such default, and (iii) provide adequate assurance of future performance of all lease terms. *See* 11 U.S.C. § 365(b)(1). It is important for a landlord to be proactive in responding to a motion to assume or assume and assign its lease. The deadline to file an objection to the debtor's proposed cure amount will not be extended and the failure to respond could result in the landlord being forced to waive the debtor's arrears. Further, the requirement that the debtor or its assignee provide adequate assurance of future performance can be amorphous. To protect its interests, the landlord must file an objection in the bankruptcy case and seek detailed, specific information from the debtor or its assignee to ensure any assumption or assignment will comply with the heightened shopping center protections. Contested lease assignments are some of the most complicated and expensive fights landlords can be impacted by in a bankruptcy case; therefore, it is critical to discuss your goals with your counsel at the beginning of the case to ensure decisions are made in advance of the fast-moving lease assumption or assumption and assignment process.

The debtor's third option is to reject the lease. There is typically not much a landlord can do if the debtor decides to reject its lease. For the Court to approve debtor's rejection of the lease, it only has to find that the debtor used its "business judgment" in making the decision. Opposing a lease rejection is an uphill battle. However, there are still a few pitfalls to avoid in lease rejection. First, ensure that the rejection of the lease is not effective before the debtor actually vacates the space. Second, rent must be paid unless and until the debtor vacates and how much is due will be dependent on whether the case filed in an accrual or performance date jurisdiction. Third, be cautious about what the proposed rejection order permits the debtor to leave in the space. Finally, the order should provide sufficient time for the landlord to file rejection damage claims. While rejection is often not the result that a landlord would prefer, it is important not to miss the opportunity to maximize your rejection damages claim and prevent an inadequate rejection order from being entered by the Court.

D. Lease Modifications

In many cases, a landlord and debtor will negotiate a lease amendment in connection with the debtor's potential assumption or assignment of a lease. The debtor will likely prioritize financial issues such as forgiving and reducing rent and other lease costs, extending or reducing the lease term, and perhaps eliminating or delaying required renovations to the premises. A landlord may have to concede on enough of the debtor's demands to keep the debtor from rejecting the lease; however, the landlord may be able to obtain valuable lease concessions as well such as co-tenancy or exclusive use waivers. In a case that contemplates a large-scale sale of assets or the disposition of leases through an auction process, for example, these negotiations may not take place with the debtor itself; instead, there could be a purchaser of lease "designation rights" – a party that steps into the debtor's shoes with the right to designate leases for assignment or rejection – that is looking to take assignment of leases to itself or assign leases to third parties.

Generally speaking, most debtors in larger cases will engage a real estate consultant to negotiate lease amendments. These real estate consultants are very well versed in the negotiation process, but they have a well-

known playbook that frequently includes impossibly tight timetables, a demand that all lease amendments must be "on their form," further demands that no other lease terms are to be negotiated, and threats that the lease will be rejected unless the terms presented are agreeable. A landlord should be able to confirm, through counsel, the actual level of urgency, and a landlord should have confidence that it does not have to use the debtor's form of lease amendment and that any lease terms may be negotiable.

A release is the most obvious thing that a landlord should secure in connection with any lease amendment. Whether it is a general release or one limited to specific matters, a landlord forgiving accrued rents or granting prospective rent relief should, at a minimum, receive a corresponding release of a debtor's claims for any prior overpayments, refunds, or adjustments to variable lease charges such as percentage rent, taxes, and common-area maintenance charges. If the debtor insists on mutual releases, the landlord must ensure that it excludes the debtor's indemnity obligations, especially in a lease assignment scenario—this exclusion will keep the debtor and, more importantly, the debtor's insurance carrier, obligated with respect to any premises liability claims.

Many other tenant-favorable lease provisions could be targeted by a landlord in these negotiations, including exclusive use rights, "no-build" zones, and pylon sign rights. A landlord also may want to shorten the term of the lease and eliminate or reduce extension options. Another provision that a landlord may want to add or address is percentage rent, which could be adjusted to have a lower "unnatural" breakpoint and a higher percentage rent rate so that percentage rent will be more likely to be paid by the debtor and thus help to mitigate some of the landlord's financial losses.

A landlord may consider adding new lease provisions, including relocation rights and termination rights exercisable by the landlord, to allow for more flexibility. These rights may be conditioned so that the debtor can prevent relocation or termination by agreeing to restore full rents under the original lease provisions. Finally, a landlord may want to address subsequent defaults and the measure of damages by conditioning the ongoing rent relief on the debtor's full performance of the modified lease terms and reinstating the original lease rates if the debtor subsequently defaults.

A landlord should keep in mind that a lease amendment and the resulting lease assumption is not final until there is a bankruptcy court order approving the assumption of the lease as modified by the amendment; thus, there is always the possibility of an attempt to re-trade the deal. Sometimes this occurs when the parties' assumptions prove to be incorrect—for example, a standalone plan of reorganization may turn into a sale of the company, or a debtor may underperform projections to such an extent that its lenders require further lease concessions as a condition of additional lending.

Furthermore, negotiations may involve some gamesmanship by the debtor and/or its real estate consultants. They may attempt to take a fully negotiated—but not yet executed—lease amendment and seek additional concessions by blaming demands from the debtor's real estate committee or board of directors or from third parties, such as the creditors' committee or lenders. Real estate consultants have also been known to change negotiators to reopen discussions or even to claim that previously agreed-upon terms were not properly authorized all in an effort to extract more value from landlords.

If a lease amendment negotiation is unsuccessful, the debtor may decide to reject the lease, leaving the landlord with "claims" for pre-bankruptcy rent and capped rejection damages.