I Lease Real Estate to Bon Ton—Now What?

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In this tenuous retail market, the loss of a Bon Ton department store tenant is a significant economic jolt to a landlord. The author of this article discusses the Bon Ton bankruptcy and its impact on the real estate market.

Bon Ton Inc., which operates department stores around the country under the Boston Store, Carson's, Bon Ton, Bergner's, Elder-Beerman, and Herberger's flags, has been a retail mainstay in Wisconsin and the Midwest. On February 4, 2018, Bon Ton filed a Chapter 11 bankruptcy in a failed attempt to locate a going concern buyer. In early April 2018, its assets were purchased in a bankruptcy auction by a consortium of liquidators, which almost immediately commenced going out of business sales that are expected to be completed by August 31.

Creditor Rights

Bon Ton's creditors are trying to determine what their rights will be and, more importantly, what they may recover from the bankruptcy process. Bon Ton was burdened with a huge of amount of debt. The first lien and the second lien creditors held pre-petition claims totaling approximately $850 million. Bon Ton borrowed $725 million in post-petition financing to operate during the Chapter 11 process, and the total pre-petition priority and unsecured claims totaled almost $118 million. The unsecured claims will likely be increased significantly by the claims of landlords whose leases will be rejected following the going out of business sales. Consequently, the prospects of unsecured creditors receiving much, if anything, on account of their pre-petition claims, are slim indeed.

Avoidable Preferences

In addition to having to write off as uncollectable pre-petition amounts due from Bon Ton, many unsecured creditors may suffer an even more disappointing set back—having to give back payments which they have already received. In virtually every Chapter 11 case, either the debtor, or a liquidating trust created by the debtor, will pursue avoidance actions to recover certain amounts paid by the debtor prior to the bankruptcy. Chief among these are avoidable preferences recoverable under Sec-

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tion 547 of the U.S. Bankruptcy Code. The theory behind recovering these payments, which were entirely legal and appropriate when made, is to ensure that all creditors of the debtor are treated equally, rather than favoring some creditors who were paid at the expense of others who were not.

Under Section 547, pre-petition payments by the debtor are avoidable if made:

(1) to or for the benefit of a creditor;

(2) on account of an antecedent debt;

(3) within the 90 days preceding the bankruptcy petition (or within one year if the payment is to an insider);

(4) while the debtor was insolvent; and

(5) which result in the creditor receiving more than it would have received in a Chapter 7 liquidation had the payment had not been made.

Given Bon Ton's financial circumstances, each of these elements will likely be met.

Although meeting the above definition of an avoidable preference, certain payments may be exempt from avoidance if they fit within the provisions of Section 547(c), which sets forth nine defenses to avoidance. For unsecured creditors, the two most common defenses are the ordinary course of business defense, described in Section 547(c)(2), and the new value defense, described in Section 547(c)(4).

The ordinary course of business defense exempts from avoidance payments of debts incurred in the ordinary course of business of the debtor and the creditor, which payments are made in the ordinary course of business or financial affairs of the debtor and the creditor, and which are made according to ordinary business terms. While an alteration to the historical terms of payment (such as requiring a cashier's or certified check instead of a regular company check) will make the defense inapplicable, this defense most often turns on comparing the historical payment history between the debtor and the creditor, and, specifically, how the payments received during the preference period compare to the payments received during the entire historical relationship of the debtor and creditor.

In a recent decision, *The Unsecured Creditors Committee of Sparrer Sausage Co. v. Jason's Food's, Inc.*,[1] the U.S. Court of Appeals for the Seventh Circuit discussed the ordinary course of business defense and noted that there are two principal tests used by courts when analyzing the payment history to determine an ordinary course range. Some courts use the total-range method, which uses the minimum and maximum invoice ages during the historical period to establish the range. While this method provides a complete picture of the parties' relationship, it has been criticized because it has a tendency to skew the range by payments that are outliers. As an alternative, other courts use the average-lateness method, which uses the average invoice payment date during the pre-petition historical period to determine which payments made during the preference period were outside the ordinary course of business, and therefore avoidable. This method may provide a more accurate depiction of ordinary course because it compensates for outlier payments. The total payments are grouped into buckets to determine the percentage of payments which are made later than the historical average time of payment. For example, if 85 percent of the payments made during the historical relationship of the debtor are made within 20 days from the due date, payments made during the preference period within 20 days of the due date would be deemed to be in the ordinary course of business, and payments made more than 20 days of the due date would not and would be recoverable

The other defense which is commonly available to unsecured creditors is the new value defense under Code Section 547(c)(4). Under this Section, the creditor receives a dollar for dollar credit against payments which are otherwise avoidable for goods shipped to the debtor after such payments have been made. The theory behind this defense is to encourage creditors to continue to ship goods to a struggling debtor. Note that unlike the law under the prior Bankruptcy Act, shipments which are delivered before a preferential payment is made do not qualify for the defense. Additionally, there is significant litigation over whether shipments made and subsequently paid for by the debtor, because of a critical vendor motions, for example, are eligible for the defense.

While an unsecured creditor who received no payments during the preference period may benefit by the debtor's or liquidating trustee's aggressive pursuit of preferences, creditors who have been paid within the period suffer the cost of defending against the preference claims and the risk of having to repay amounts received if their defenses are not allowed by the court. Moreover, preference recoveries go first to pay any unpaid administrative expenses, including the cost of the preference litigation, further reducing the net benefit to all unsecured creditors. Bon Ton creditors would be well advised to discuss with their legal advisors all payments which they received during the preference period, identifying which defenses may apply and gathering records to support the defenses. Doing this now will prevent a creditor who may not receive any distribution on its pre-petition claim from subsequently receiving another unexpected and unwelcomed surprise.

Landlords

Landlords in particular are assessing rights under their respective leases. The Bankruptcy Code has special rules relating to leases, some of which benefit a landlord, but others that significantly limit a landlord's rights. In many liquidating Chapter 11 retail bankruptcies, the debtor retains a lease broker to try to maximize the value of their leased property while at the same time limiting landlord's claims arising from the breach of the lease caused by store closures. However, Bon Ton does not appear to have retained a real estate broker.

Under Bankruptcy Code Section 365, a liquidating debtor has the right to assume the executory lease and assign it to a third party. To assume and assign the lease, any amounts past due under the lease must be cured by prompt payment, any other pecuniary damages must be satisfied and the assignee of the leased premises must provide the lessor with adequate assurance of the ability to perform the lease in the future. There are special rules set forth in Section 365(b)(3) relating to shopping centers which require the assignee to show that the financial condition of the assignee will be similar to that of the debtor, that any percentage rent will not decline substantially, and that the new lessee will not violate any radius, location or exclusivity provision in the lease or disrupt the tenant mix.

The other alternative available to the debtor is to reject the lease. Rejection is deemed to be a breach immediately prior to the bankruptcy. The question is what are the damages arising from the lease rejection by the debtor? Because damages arising from a long term breach can swamp a bankruptcy case, Congress limited, or capped, damages arising from rejected leases. Under Section 502(b)(6) of the Bankruptcy Code, a landlord's claims from damages under a lease rejected during the bankruptcy proceeding is capped at the greater of rent reserved under the lease for (a) one year; or (b) 15 percent of the remaining lease term, not to exceed three years. Under that calculation, a lease with a remaining term of 81 months or more would be entitled to claim greater than one year's rent.

Landlord's often take letters of credit instead of cash security deposits for leases. It is well established that a cash security deposit will be applied to the landlord's capped claim. However, the law is uncertain regarding whether the proceeds of a letter of credit must be applied to the capped portion of the claim thereby reducing the amount the landlord can recover from the bankruptcy estate, or, instead can be applied to the landlord's damages in excess of the cap, allowing the landlord to also recover in addition on the full capped claim allowed under Code Section 502.

This issue has addressed by three circuit courts of appeals. The U.S. Court of Appeals for the Third Circuit in *Solow v. PPI Enterprises (US), Inc. (In re PPI Enterprises (US), Inc.)*,[2] and the U.S. Court of Appeals for the Ninth Circuit in *AMB Property, LP v. Official Creditors ex rel. Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*,[3] held that proceeds of a letter of credit must be applied to the capped claim. By contrast, the U.S. Court of Appeals for the Fifth Circuit in *EOP-Colonade of Dallas Ltd. Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*,[4] ruled that landlord did not have to return to the bankruptcy estate proceeds of a letter of credit which exceeded the Bankruptcy Code Section 502(b)(6) capped amount. However, in that case the landlord did not file a proof of claim, making it factually different from the other two circuit court opinions, and leaving open the question of whether the result would have been different if a proof of claim had been filed.

Conclusion

In this tenuous retail market, the loss of a Bon Ton department store tenant is a significant economic jolt to a landlord. They should carefully assess their rights and discuss with their legal advisors the implications of filing a proof of claim and the impact of a letter of credit, if they were fortunate enough to procure one. Taking the appropriate steps to maximize a landlord's recovery, will make a bad situation a little less so.

NOTES:

[1] *Unsecured Creditors Committee of Sparrer Sausage Company, Inc. v. Jason's Foods, Inc.*, 826 F.3d 388, 62 Bankr. Ct. Dec. (CRR) 196, 75 Collier Bankr. Cas. 2d (MB) 1528, Bankr. L. Rep. (CCH) P 82971 (7th Cir. 2016).

[2] *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 41 Bankr. Ct. Dec. (CRR) 16, 49 Collier Bankr. Cas. 2d (MB) 1749, Bankr. L. Rep. (CCH) P 78824 (3d Cir. 2003).

[3] *In re AB Liquidating Corp.*, 416 F.3d 961, 44 Bankr. Ct. Dec. (CRR) 278, 54 Collier Bankr. Cas. 2d (MB) 955, Bankr. L. Rep. (CCH) P 80321 (9th Cir. 2005).

[4] *In re Stonebridge Technologies, Inc.*, 430 F.3d 260, 45 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 80389 (5th Cir. 2005).