

# RENT ARREARS

TENANTS BEHIND ON THEIR PAYMENTS ARE A HEADACHE FOR SOME LANDLORDS

By Steve McLinden

**A**S THE YEAR DRAWS TO A CLOSE, RETAIL CENTER owners continue to bleed the red ink of bad debt from tenant defaults. And just about the time earnings reports began showing some improvement, along came the Blockbuster Video bankruptcy filing.

Uncollectible rent from financially distressed tenants cuts into shopping center owners' operating income, forcing them to boost reserves to compensate. Until three or four years ago, such debt was at a minimum, because landlords could quickly re-lease

an abandoned space. Things have changed. "Now these landlords have huge damages from so many tenant bankruptcies," said Jason Binford, an attorney with Dallas-based Kane Russell Coleman & Logan. The Blockbuster filing "is certainly going to affect a large number of landlords."

Bad-debt volume reports at mid-year were mixed. At CBL & Associates Properties, bad debt for the second

quarter declined by \$1.4 million year on year, CFO John N. Foy told investors. Developers Diversified Realty debt, meanwhile, remained above normal levels, CFO David J. Oakes said in an earnings call. "While we have seen the fundamentals for most of our tenants improve, we are still seeing heightened levels of bad debt amongst some smaller tenants," Oakes told investors.

Bad debt at Inland Real Estate Corp. caused operating expenses to rise to \$10.3 million in the first quarter, from \$9 million a year before. Inland had to raise its bad-debt reserve during the quarter "to reflect a conservative estimate of collectible receivables from certain tenants impacted by the economic downturn," said CFO Brett Brown in an earnings call. Inland Real Estate's bad debt has since gotten smaller, and the firm decreased the reserves accordingly.

Other REITs, too, saw some improvement. Macerich second-quarter net operating income was up 2 percent year on year, thanks largely to lower

**BLOCKBUSTER'S BANKRUPTCY FILING WILL PROBABLY LOAD LANDLORDS' BALANCE SHEETS WITH MORE BAD DEBT.**



bad-debt expenses and gains in occupancy. Simon Property Group saw a 2.3 percent operating-income increase for the first half, thanks to fewer bankruptcies and a rise in percentage rents. A drop in bad debt helped push second-quarter operating income at Weingarten Realty Investors into positive territory for the first time in seven quarters.

Filing for Chapter 11 enables retailers to terminate leases and cap debt owed to landlords, but the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 makes that a less effective tool than before. Previously, courts had discretion to grant lengthy time extensions to debtors mulling over which leases to terminate, but the maximum allowable period for doing so now is 210 days.

“With locations all over the nation, it’s very difficult to decide which ones are dogs and which ones are the good ones in that period,” Binford said. “This requires an army of professionals, and it’s a huge, expensive endeavor.” Some retailers have been unable to secure the funding needed to bankroll the reorganization process, he says. “As odd as it sounds, the economy is so bad that a lot of companies can’t afford to file for bankruptcy.”

Smaller landlords have the same remedies available outside of bankruptcy, such as eviction, but the owners of large numbers of properties typically wield greater negotiating leverage, says Binford. The smaller landlords also have the same protections inside of bankruptcy, including the right to refuse rent concessions and to receive payment of unpaid back rent. “But in the rough-and-tumble of negotiation, it’s certainly better on the landlord side to have more to hold over the head of the debtor tenant,” Binford said.

On the international side, U.K. retail landlords are seeing some abatement in bankruptcies and related bad-debt issues.

In Britain the number of retailers going into administration (the U.K. term for bankruptcy) has fallen significantly this year. Deloitte reports that first-quarter administrations were down 65 percent from the previous year.

In the U.K. landlords take the bad-debt hit unless the administrator or liquidator can continue leasing the unit. Otherwise, administrators will adopt some of the obligations of the lease contract and pay a rates tax

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equivalent to 40 percent of the rental rate, based on rents as of April 2008. “Those [rents] are pre-recession,” said Catherine Lambert, U.K. head of retail management at Jones Lang LaSalle. In that scenario landlords absorb certain costs, including the assumption of the tenant’s outstanding utility bills.

The U.S., meanwhile, is seeing fewer retailers go belly-up this year, but the bad-debt problem shows no signs of disappearing, as evidenced by the Blockbuster filing. “Right now vacancies are up and rents are down, and that’s the core issue,” said Howard Davidowitz, head of Davidowitz & Associates, a New York City-based retail consulting and investment banking firm. “Most of that bad debt is never going to be collected; it’s going to be written off.”

One area landlords can often control in a tenant bankruptcy is the collection of “stub rents” — so named for the part of the month that remains following the filing date. Because rent is typically due on the first of the month,

the landlord can contend in court that a full month’s rent is due regardless of the protections granted to the tenant that same month, says attorney Eric Snyder, a partner at New York City-based Willk Auslander. “In smaller bankruptcies, when you just have a couple leases, stub rent doesn’t mean much,” Snyder said. “But when you have these big bankruptcies by Movie Gallery, Bally’s and others, it means millions.”

Some courts, including those in Delaware and Virginia, typically do not require payment of stub rent, at least not immediately, so the likes of Movie Gallery, Circuit City, Gottschalks, KB Toys and Linens ‘n Things have filed for bankruptcy there at the urging of lenders, Snyder says.

The avalanche of bad debt that many in the industry had feared never materialized, because banks started stretching out maturity dates and reducing rates to slow down defaults. This helped banks classify questionable loans as “performing” and minimized the cash they had to keep in reserves for future losses.

“We are seeing fewer bankruptcies of large national and regional tenants now than a year or two ago,” said Thomas Leanse, a partner at the Los Angeles law offices of Katten Muchin Rosenman. “On the other hand, we are seeing more mom-and-pop tenants at risk. And it’s become rarer and rarer for those small tenants to work their way out once they’ve fallen behind in rent.”

In the end, it makes little difference, if any, whether bad debt is written off or resolved through the courts, Leanse says. “If it is uncollectible, it is uncollectible. We are still seeing a lot of regional and national tenants trying to figure out how to reduce their number of stores. I have been doing this for 30 years and gone through a variety of cycles, but none of them quite like this.”

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