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Landlords, Loan Documents and Tenant Bankruptcies: Commercial Real Estate Finance COVID-19 Impact Series

This is part of our Commercial Real Estate Finance COVID-19 Impact Series, which is aimed at providing informed and real-time guidance tailored to various sectors of commercial real estate owners. In the context of recent bankruptcy filings by national shopping center tenants, this article examines the interplay between a tenant bankruptcy and a landlord's obligations under its loan documents. For broader analysis of common loan document provisions that may be implicated by the strains of the pandemic on shopping center landlords and recommendations for how to avoid recourse and events of default and communicating with the lender, see [Commercial Real Estate Finance COVID-19 Impact Series: Retail and Shopping Center Landlords](#).

On Monday, May 4, 2020, J.Crew and Gold's Gym became the latest major shopping center tenants to take the drastic step as the COVID-19 pandemic continues to severely disrupt the cash flow of many businesses when each filed for bankruptcy protection under chapter 11 of the U.S. Bankruptcy Code. Neiman Marcus' and JCPenney's chapter 11 filings followed shortly thereafter. Many states are preparing for phased or limited re-openings of non-essential businesses, but uncertainty abounds. The extent to which shoppers will return in the near term is unknown. Some retail and shopping center industry stakeholders and observers have predicted the above-mentioned tenants will not be the last national tenants to file bankruptcy, [as Barron's does here](#). The International Council of Shopping Centers (ICSC) [notes here](#) what steps some retailers and shopping center tenants are taking to shore up finances and prepare to reopen as and to the extent local governments permit.

Many shopping center landlords have recently experienced one or more tenants filing for bankruptcy protection and many more will face that challenge in the coming months. Certainly, these landlords should be careful not to violate the automatic stay from the bankruptcy court and should engage competent counsel to file claims and appropriate motions in the bankruptcy case to protect their interests in the bankruptcy proceedings. These landlords also should carefully understand what is permitted and required under any mortgage loan documents secured by the affected shopping centers.

Tenant's Bankruptcy and the Loan Documents

As discussed in a previous article, ["Retail Tenant Bankruptcy and Restructuring in the COVID-19 Era, by our Bankruptcy & Restructuring and Shopping Center & Retail Development Practice Groups, a lease may be assumed, assumed and assigned, or rejected in a bankruptcy. Landlords will need to closely monitor bankruptcy proceedings and perform in-depth lease reviews to ensure compliance with any lease\(s\) and to proactively protect its interest in such lease\(s\) with a tenant which has filed for bankruptcy under either chapter 7 or chapter 11 of the US Bankruptcy Code.](#)

While protecting its interest in the bankruptcy case, the landlord should simultaneously be carefully fulfilling its obligations under any mortgage loan documents. As with all loan document questions, the specific loan documents in question will govern and should be reviewed, but below are some common ramifications of a retail tenant bankruptcy.

Cash Management

If the shopping center is financed through a commercial mortgage backed securities (CMBS) loan or certain other non-recourse capital markets financing, cash management will likely be contemplated in the loan documents. Cash management generally requires a "lockbox account", a lender-controlled account into which rents from the property must be deposited, to be established either on the closing date or upon the occurrence of some specified

event during the loan term. Regardless of whether the lockbox was established at closing or springs into existence upon a trigger event, loans with cash management will also have triggers upon which excess cash, rents from the property after the debt service, reserves deposits and operating expenses, are held by the lender until a cure outlined in the loan documents occurs.

A tenant bankruptcy might cause the lockbox account and an excess cash trap to activate directly or indirectly. One of the most common cash management triggers is a threshold for either the debt yield or debt service coverage ratio, below which cash management activates. Both metrics factor in cash flow from the property to make the relevant calculation. Not only might actual collections from the property decline, possibly resulting in a trigger, but even where the tenant in bankruptcy is still paying rent that rent might not count when calculating debt yield or debt service coverage ratio. This is due to underwriting adjustments many loan documents apply to tenants in bankruptcy, excluding any rents from such tenants for purposes of the calculation. The loan documents may specify that the act of filing for bankruptcy by the tenant automatically triggers cash management depending on the tenant's importance to the underwriting (often called a "major tenant trigger" or similar terminology).

Solely for illustration purposes, the act of filing for bankruptcy by J.Crew, for example, which is typically an inline tenant, might not automatically trigger cash management. The bankruptcy might nonetheless cause a debt yield or debt service coverage ratio trigger if the rent paid by J.Crew during the pendency of the bankruptcy case is excluded from the calculation, the bankruptcy case endures long enough and excluding the rent paid by J.Crew lowers the relevant metric enough to cause it to dip below the trigger threshold in the loan documents. J.Crew has announced it intends to reorganize and reopen its stores. Once it emerges from bankruptcy, its rent should again be included in the debt yield or debt service coverage ratio calculations.

On the other hand, Neiman Marcus, JCPenney and other similarly situated anchor tenants would likely be categorized as "major tenants" under any mortgage loan documents. Such categorization

will often mean that cash management will be triggered by a default under, or termination of, the related lease. In some instances, it may specifically include bankruptcy of a major tenant (or its parent company) as a trigger. Regardless of whether bankruptcy is specifically included as a cash management trigger, the bankruptcy of a major tenant will likely still result in a trigger by causing such tenant to default under its lease.

Lease approvals

A separate landlord consideration raised when a tenant files for bankruptcy is compliance with the landlord's loan document requirements for lease approvals, which requirements will likely vary depending on whether a lease constitutes a "major lease." In the event a lease for such a tenant is neither assumed nor rejected, an impacted landlord should closely review the loan documents before agreeing to any modifications to the lease – including an assignment or sublease not expressly permitted by the lease – to determine whether lender consent is required. Often a breach of the landlord's leasing covenants under the loan documents results in severe consequences, including an event of default and recourse depending on the terms of the loan documents and the nature of the breach. The same analysis would apply for any potential replacement lease should the original lease be rejected in the bankruptcy proceedings. Further analysis of the common leasing covenants and other important loan documents provisions can be found in another Commercial Real Estate Finance COVID-19 Impact Series publication, [Retail and Shopping Center Landlords](#).

Liens on Leases

Landlords should also take into consideration any provisions in their mortgage loan documents prohibiting the imposition of liens, and specifically, liens on leases. In conjunction with their review of the loan documents, landlords will likely want to confirm that, as is typical, the applicable lease also prohibits any liens being imposed or granted on such lease. Early bankruptcy filings will establish the collateral to be included in the bankruptcy estate which, unless properly objected to, will sometimes include lien rights on leases.

Unless specifically permitted by their mortgage loan documents and the applicable lease, and to avoid any defaults thereunder, landlords should take care to review the relevant pleadings to ensure no liens are granted on leases. It is generally acceptable, however, for the collateral to include liens granted on the resultant proceeds under any leases.

While landlords are under increasing strain from the COVID-19 pandemic more tenant bankruptcies can be expected. To the extent landlords do not already have a keen understanding of how such events may interact with their loan documents, landlords facing a tenant bankruptcy will need to develop or refresh their understanding without delay to help guide decision making.

Read additional articles regarding [hospitality property owners](#) and the [current state of hospitality owner requests for relief from lenders, multifamily properties subject to loans backed by Fannie Mae and Freddie Mac](#), analysis focused on [HUD-insured loans](#), and other topics on our [website](#).

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To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus Response Team](#). Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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