

New Jersey Law Journal

VOL. CLXIII – NO. 6 – INDEX 512

FEBRUARY 5, 2001

ESTABLISHED 1878

Bankruptcy Law

Retail Debtors Aggressively Attempt To Realize the Value of Shopping Center Leases

These efforts, however, often spur contentious litigation with landlords trying to protect their tenant mix with restrictive-use provisions

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Perhaps the most visible indicator of the changing economic climate is the recent wave of Chapter 11 filings by some of the nation's largest retailers. During boom economic times, retailers expand and consume real estate with a ferocious appetite. As the economy slows, however, so does retail consumption. The result is fierce competition among retailers and the inevitable failure of once profitable retail chains.

In the past few years alone, the bankruptcy courts of Delaware, New York and New Jersey have hosted the bankruptcies of such recognizable retailers as Caldor, Jamesway, Rickel Home Centers, Grand Union, Pathmark, Bradlees, Tops Appliances,

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Hit or Miss and Montgomery Ward. Many others are teetering on the edge of bankruptcy.

Several of these retailers have filed multiple bankruptcy proceedings. While their initial Chapter 11 filings were designed to reorganize operations and restructure their debts, subsequent filings have been used to liquidate their assets.

Aside from inventory, a retailer's most valuable asset often is its interest in favorable shopping or "strip" center leases. Retail debtors aggressively attempt to realize the value of these leases for their bankruptcy estates and avoid substantial administration expenses and "rejection" claims.

Their efforts, however, have spurred contentious litigation with landlords who desire to protect their tenant mix with restrictive-use provisions and, in many cases, recapture the space for new tenants at market rent. These conflicting objectives and the unresolved legal issues raised — (1) the extent to which bankruptcy courts may excise lease provisions that, on their face, present serious obstacles to debtors seeking to assign their leasehold interests to third-party tenants, and (2) issues raised by the recent phenomena of debtors attempting to sell so-called designation rights, which allow a nondebtor third-party purchaser to subsequently assign the leases to end-users — will become

paramount as the current economic trend continues.

Use Restrictions and Other Anti-Assignment Provisions

Section 365(a) of the Bankruptcy Code provides that, subject to certain restrictions and court approval, debtors-in-possession may assume or reject unexpired leases. Among the conditions a debtor must satisfy are (1) curing existing defaults, and (2) providing adequate assurance of the proposed assignee's future performance under the lease.

For defaults attributable solely to the insolvency or commencement of a bankruptcy proceeding by the tenant, the Bankruptcy Code excuses the requirement that such defaults must be cured to assume and assign a lease to a third party.

In the context of shopping center leases, however, landlords often insist on provisions that restrict a tenant's ability to assign its interest in the lease. Among these common provisions are requirements that the tenant operate continuously and share the proceeds of any assignment with the landlord.

To ensure the desired tenant mix, shopping center leases also commonly include "use clause" provisions describing the permitted uses of the premises. Provisions of this nature are especially common in leases between a landlord and the shopping center's anchor tenants.

By narrowing the universe of prospective assignees, restrictions such as a narrow-use clause could severely

hampers a debtor's ability to realize the value of a leasehold through the assumption and assignment process in bankruptcy.

Bankruptcy Code §365(b)(3), which defines what a debtor must demonstrate to establish adequate assurance in the context of shopping center leases, represents Congress' attempt to balance the goals of debtors with the goals of landlords and non-debtor, shopping center tenants.

The language of § 365(b)(3)(c), on its face, suggests that debtors are powerless to assign leases to third parties who desire to use the debtor's former space for purposes that differ from those contemplated by the use clause in the subject lease. In practice, however, these provisions have not been interpreted as strictly as the statutory language suggests. The Third Circuit, in *In re Joshua Slocum Ltd.*, 922 F.2d 1081 (3d Cir. 1990), held:

Even under the tightly drawn definition of "adequate assurance" in the shopping center context, Congress did not envision literal compliance with all lease provisions; insubstantial disruptions in, inter alia, tenant mix, and insubstantial breaches in other leases or agreements were contemplated and allowed.

Moreover, in *In re Rickel Home Centers, Inc.*, 240 B.R. 826, (D.Del. 1998), the U.S. District Court for the District of Delaware, considering § 365(b)(3)(C) in conjunction with § 365(f)(1), observed:

... [C]ourts and commentators alike have construed the terms to not only render unenforceable lease provisions which prohibit assignment outright, but also lease provisions that are so restrictive that they constitute de facto anti-assignment provisions.

Thus, the battle over whether use clauses and similar restrictions should be enforced under § 365(b)(3) and (f)(1) is waged by the presentation of evidence as to whether the restrictions are akin to prohibitions on assignment by the debtor.

In *Rickel Home Centers*, the debtor,

who wanted to assign the stores to Staples, a major office supply chain, requested that the court excise use clauses requiring the premises to be used "for the purposes of typical Channel Home Improvements Centers and for no other purpose."

In support of its motions, the debtor proffered testimony that the typical Channel Home Centers referenced in the leases had become either obsolete or was struggling to remain in existence as a result competition from warehouse-type home improvement stores. The debtor further proffered that none of its stores was suitable for a warehouse-style home center and that no such retailers had shown an interest in any of the debtor's locations.

The court found the market for the centers described in the use clauses was "either non-existent or in dire straits," making it impossible for the debtor to assign the subject leases. Accordingly, the court held the use clauses were "de facto anti-assignment clauses," which should be permanently struck from the leases.

Recently, however, other retailers have had less success in convincing courts to excise restrictive lease provisions as de facto anti-assignment clauses. In *In re The J. Peterman Co.*, 232 B.R. 366 (Bankr. E.D. Ky. 1999), the debtor, a retailer of upscale clothing and household items, sought to assign its lease in the Woodbury Common in Central Valley, N.Y. to The Children's Place Retail Stores, Inc.

The lease included a radius restriction precluding the tenant from operating additional stores within 60 miles of Woodbury Common, and required that gross sales — from additional stores opened in violation of the restriction — be included in the tenant's percentage rent calculation.

The Children's Place argued the radius restriction was unreasonable and akin to an anti-assignment clause in violation of §365. The landlord argued the restriction was reasonable when viewed in conjunction with the lease's percentage rent provision and that it was a bargained for benefit that could not be excised. Based on the nature and location of the shopping center, the court concluded the radius

restriction was reasonable and denied the debtor's motion to assign the lease to The Children's Place.

Similarly, in *In re Sun TV and Appliances, Inc.*, 234 B.R. 356 (Bankr. D. Del. 1999), the debtor argued that a use restriction, which limited the use of the premises to the sale of "televisions, electronics, home appliances, computers, and home office products and all related products," should be stricken as a de facto anti-assignment clause.

The court held the landlord "presented enough evidence of the need for the use restriction and its effect on the existing tenant mix to convince us that the elimination of the clause may had an adverse effect of the volume of shoppers at the mall." Accordingly, the court held it was inappropriate to excise the use provision. It should be noted that the motion in *Sun TV* contemplated a sale of the debtor's leases to a liquidator who was not the proposed end-user. Thus, the court could not determine whether the ultimate use of the premises would have a substantial impact on the tenant mix under the guidelines established by *Joshua Slocum*.

Designation Rights

In Chapter 11 proceedings involving large retail entities, the debtor often is confronted with the task of maximizing the value of the estate's interest in several leasehold interests spread over a large geographic area.

Often, debtors cannot sustain the carrying costs associated with these leases while they are marketed to potential assignees and, accordingly, could be forced to prematurely reject or hurriedly sell potentially valuable leases. To realize value for these leases and avoid the expense associated with a prolonged marketing process, creative retail debtors have proposed bulk sales of their lease assumption and rejection rights to a liquidator or an entity interested in many locations with a desire to exercise some control over the process.

In exchange for a guaranteed return to the estate and an assumption of certain carrying and fit-up costs, the acquiror receives an assignment of the estate's designation rights or the right to market and assign the estate's leasehold

interests to third-party end-users.

By selling the right to assume and assign leases — rather than actually assuming and assigning the leases — debtors avoid immediate compliance with the requirements of §§363 and 365 and, most important, the adequate assurance provisions.

After the sale of designation rights is approved, landlords are usually left only with streamlined procedures to challenge the ultimate assignment to the end-user. Those procedures, which usually are promoted by the debtor, may not always resemble the protections afforded by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure.

The issue of whether the Bankruptcy Code contemplates a debtor's ability to sell designation rights is certain to receive attention from bankruptcy appellate panels, District Courts and circuit courts of appeal in coming years. Very few courts have addressed the issue to date. For example, in *Sun TV*, the debtor proposed a sale of its designation rights to a liquidator. The Bankruptcy Court never addressed the issue of whether the Bankruptcy Code allowed for such a sale

In *In re G Survivor Corp.*, 171 B.R. 755 (Bankr. S.D.N.Y. 1994), the court addressed the issue of the extent to which the Bankruptcy Code permits a debtor-in-possession to sell its right to reject executory contracts in the context of a larger asset sale. Gitano, a large, publicly held apparel designer and manufacturer, sold substantially all its assets to Fruit of The Loom, Inc. for \$100 million.

The agreement provided that Fruit of The Loom had the right to designate executory contracts to be rejected by Gitano. Pursuant to the sale agreement, Fruit of The Loom designated for rejection an agreement between Gitano and the John Forsyth Company for the licensing of Gitano merchandise in Canada.

The Bankruptcy Court approved the sale to Fruit of The Loom, including the condition regarding Fruit of The Loom's ability to designate contracts for rejection. When Gitano moved to

reject the license agreement, however, Forsyth objected. The Bankruptcy Court overruled Forsyth's objection, holding that the ability to designate which contracts it wished to have rejected was a valuable right, for which Fruit of The Loom had bargained.

The designation concept was extended to the context of the liquidation of the debtor's leasehold interests in *In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997). Ernst, a leading home improvement, hardware and garden retailer, determined shortly after its Chapter 11 filing to liquidate its assets and cease operations. To realize the significant value of its leases and to avoid paying the ongoing occupancy costs, which were approximately \$1.6 million per month, Ernst sought approval of an agreement with a liquidator called FADCO.

Under the FADCO agreement, Ernst proposed, among other things, to sell FADCO 59 leasehold interests and grant FADCO the right to direct Ernst to reject leases or assume and assign leases to a FADCO designee. The FADCO agreement established a 14-month time frame for the liquidation and provided that FADCO would pay all monthly occupancy fees associated with the leases pending their assumption or rejection. The purchase price was \$16 million, subject to a downward adjustment of no more than \$4 million if any lease became excluded under the FADCO agreement.

Ernst moved for approval of the FADCO agreement and for the required 14-month extension of time to assume or reject the leases at issue. The Bankruptcy Court granted the motions, finding that Ernst had made a sound and justified business decision by entering into the FADCO agreement. The court also determined that a 14-month extension under §365(d)(4) was appropriate due to the anticipated difficulty in marketing the leases, but carved out mechanisms to adjust the applicable period for four landlords who claimed their leases contained continuous operation clauses.

In *Ernst*, the court discussed only briefly the issue of whether a sale of the

debtor's designation rights was permissible under the Bankruptcy Code. The debtor and FADCO argued the FADCO agreement was a transaction under §363(b), which should enjoy the protection from subsequent attack afforded by §363(m). The landlords argued that the bonus value of Ernst's leases was not a property right that could be sold pursuant to §363(b).

The Bankruptcy Court held the FADCO agreement was a sale under §363(b) entitled to the protections of §363(m), stating that "The debtor's power under §365 to assume and assign a lease creates value for the bankruptcy estate where no value would be present under state law."

In *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198 (1983), the Supreme Court held that the intent of §541(a)(1) is to include any property made available to the estate, by other provisions of the Bankruptcy Code, in the estate. The court concluded that the bonus value of the FADCO leases constituted property for purposes of §363(b).

The issues addressed in these cases will arise again and again as the retail bankruptcy epidemic continues to spread. Debtors will continue to request that courts excise unfavorable lease provisions by claiming they operate as de facto anti-assignment clauses that undermine the policies of the Bankruptcy Code.

To thwart aggressive debtors' attempts to rewrite their leases through the liquidation process, landlords must be armed with evidence that their use clauses and other restrictions are designed to preserve the tenant mix of their shopping centers and the economic bargain originally struck with the debtor.

Retail debtors also will likely continue to seek Bankruptcy Court authority to sell lease designation rights. This process minimizes the debtor's administrative obligations, potentially maximizes asset values and temporarily excuses the debtor from making the "adequate assurance" showing required by §365. The propriety of this process, however, is uncertain and open for serious debate. ■