

Selected Issues of Lease Assumption and Rejection in Chapter 11 Cases

Joseph Zagraniczny, Esq.^{*}
Sara Temes, Esq.^{**}

I. Introduction

- A. Debtors with multiple operating business locations under leases, such as retailers, have historically used the lease assumption and rejection provisions of the Bankruptcy Code as a powerful tool to monetize the value of underperforming locations for the ultimate benefit of creditors and to achieve the result of a more streamlined organization.
- B. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) was enacted on April 30, 2005. A majority of the provisions of BAPCPA became effective on October 17, 2005. Many changes to the Bankruptcy Code provisions concerning the assumption and rejection of non-residential real property leases were made pursuant to BAPCPA.

II. Fixed Time Period for Debtor’s Determination of Assumption or Rejection of Nonresidential Real Property Leases

- A. Under BAPCPA, section 365(d)(4) has been amended to require a debtor to determine whether to assume or reject nonresidential real property leases within 120 days, with a possible 90 day extension, without prior written consent of the landlord. If the debtor fails to act within this time period, the lease is deemed rejected.
- B. Prior to BAPCPA, a debtor was given an initial 60 day period to determine whether to assume or reject, and could request extensions for cause. In many large retail bankruptcy cases prior to BAPCPA, debtors such as Service Merchandise, Kmart, Footstar and others were given unlimited extensions to the 365(d)(4) period, which allowed such debtors to take whatever time was required to dispose of retail leases for the greatest value to creditors.
- C. With an outside limit of 210 days to assume or reject without landlord consent, retail debtors have lost significant leverage in postpetition dealings with landlords

^{*} Joseph Zagraniczny, Esq. is a member of Bond, Schoeneck & King, PLLC and is the Co-Chair of the firm’s Business Restructuring, Creditors’ Rights and Bankruptcy practice group and Chair of the firm’s Real Estate, Environmental and Finance practice group.

^{**} Sara Temes, Esq. is an associate in Bond, Schoeneck & King’s Business Restructuring, Creditors’ Rights and Bankruptcy practice group.

III. Performance of Lease Obligations Prior to Assumption or Rejection

- A. Pursuant to revised section 365(d)(3), a debtor must timely perform lease obligations prior to assuming or rejecting such lease, including obligations other than payment of rent. *In re In re Pacific-Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994).
- B. However, any attempt by a landlord to “recapture” prepetition amounts due from a debtor tenant as postpetition obligations will likely be met by resistance from courts. *In re Pac-West Telecomm*, Case No. 07-10562 (BLS), 2007 WL 2910093 (Bankr. D. Del. Oct. 5, 2007).

IV. Assumption and Cure of Non-Monetary Defaults

- A. Prior to 2005, a debtor was obligated to cure any defaults before assuming an executory contract or unexpired lease. The amendments to section 365 provide that a debtor no longer must cure a non-monetary default if it is impossible to do so, but the assignee must be able to comply with the terms of the lease “at and after” the time of assumption. Prior to BAPCPA there was a great deal of confusion regarding the ability of a debtor to cure in impossible situations, such as going back and rectifying the violation of a “go-dark” provision in the past.
- B. BAPCPA also amended section 365(b)(2)(D) of the Bankruptcy Code. That section now expressly provides that a debtor is not required to cure by satisfying a “penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the ... lease.” This provision codifies the holding of the Ninth Circuit in *Claremont Acquisition Corp. v. General Motors Corp.* (*In re Claremont Acquisition Corp.*), 113 F.3d 1029, 1034 (9th Cir. 1997) and rejects the First Circuit’s view in *Eagle Insurance Co. v. BankVest Capital Corp.* (*In re BankVest Capital Corp.*), 360 F.3d 291 (1st Cir. 2004).
- C. Courts have held that certain lease provisions are unenforceable because they have the direct effect of prohibiting the debtor tenant from realizing its equity in a lease that may be below market or otherwise benefit the debtor in assignment. Lease provisions which are invalid as anti-assignment under sections 363(f)(1) and (3) include:
 - 1. those which expressly prohibit or condition the right of the tenant to assign the lease;
 - 2. those which so narrowly limit use of the premises that they are a de-facto anti-assignment provision, which would in effect prohibit any assignment;

3. those which require the debtor share proceeds of an assignment with the landlord; and
4. those which require the assignee to pay an increased rent amount or a fee for the assignment.

V. Assignment and Adequate Assurance

- A. For assumption of a non-residential real property lease, a debtor must give adequate assurance of ability to comply with lease provisions. In order to assign such a lease, the debtor must show that the assignee will be able to perform the obligations under the lease.
- B. Section 365(b) requires the proposed assignee to provide adequate assurance of future performance under the lease. Information such as the financial condition of the assignee, intended use, and operating history is relevant to the analysis.

VI. Enforceability of Anti-Assignment Clauses in Leases

- A. A debtor must also cure all monetary and all ongoing non-monetary defaults under a lease prior to assumption and/or assignment of such lease.
- B. Non-monetary clauses of a lease may include:
 1. a provision requiring that the identity of the tenant remain constant;
 2. prohibitions on “going dark” for any period of time;
 3. restrictions on assignment or sublet or a requirement that the tenant share any rent received from assignment or sublet with the landlord;
 4. restrictions on use of the property;
 5. restrictions on competing stores operated by tenant within a certain geographical radius;
 6. a calculation of additional rent to be paid as a function of sales; and
 7. financial covenants.
- C. Courts have in the past treated some non-monetary provisions as de facto anti-assignment provisions, however the revisions under BAPCPA will alter this balance significantly.
- D. *In re Three A's Holding, LLC*, 364 B.R. 550 (Bankr. D. Del. 2007) – In a recent decision, the U.S. Bankruptcy Court for the District of Delaware denied the debtors’ request to assume and assign a lease of property

located in a shopping center, reasoning that use restriction provisions, which include restrictions on the type of business permitted on the leased premises, may not be ignored under BAPCPA.

- E. The shopping center lease at issue in *Three A's* contained restrictions imposed by a local planning board, which contained a list of permitted businesses within the shopping center. The proposed assignee, Walgreen's, planned to operate a pharmacy on the site, which was an unauthorized use pursuant to the planning board restrictions.
- F. The court in *Three A's* noted that BAPCPA limited a court's discretion to override shopping center lease restrictions as "de facto anti-assignment" provisions. The court stated that BAPCPA "further constrained the Court's ability to authorize assumption or assignment of shopping center leases in violation of the terms of such leases by expressly subjecting section 365(f)(1) to the provisions of 365(b)(3)."
- G. In light of the 2005 amendment and the *Three A's Holdings* decision, it now appears that courts may not have the discretion to override radius, use, location and other similar restrictions as de-facto anti-assignment provisions pursuant to §365(f)(1) and that such provisions may be strictly enforced despite a debtor's attempt to monetize the value of its shopping center lease.
- H. It remains to be seen whether BAPCPA also will limit a court's power to limit as "de facto anti-assignment" other provisions such as continuous use or "go dark" provisions in shopping center leases, which would make assignment nearly impossible without the ability to transition the space to a new use. Such provisions are not really relevant to a shopping center "mix" of tenants, and would tend to be intended to prevent, rather than limit, assignment. Before BAPCPA, courts frequently declined to enforce provisions that had the effect of precluding or inhibiting assignments.

VII. Sale of Designation Rights

- A. A debtor may sell its right to assign leases to another party, usually a real estate expert in the business of selling leases. This tactic was used in retail bankruptcies historically in cases such as *Montgomery Ward*, *Service Merchandise*, *Kmart* and *Ames*. Many courts have held that designation rights are property of a debtor's estate. See *In re Ames Dep't Stores, Inc.*, 287 B.R. 112, 1118-25 (Bankr. S.D.N.Y. 2002); *In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997).
- B. This method is especially helpful to debtors in large retail bankruptcies to permit the debtor to quickly monetize the value of the leases prior to the

assumption/assignment procedure. Real estate liquidators will also assist in many cases as consultants to help debtors determine which leases should be sold.

- C. Non-monetary defaults and anti-assignment provisions become particularly relevant when the direct assignee of the debtor will not be the ultimate tenant.
- D. Prior to the BAPCPA revisions, the court in *In re Montgomery Ward* allowed sale of designation rights over the objections of landlords and without regard for provisions limiting use, prohibiting going dark, prohibiting store closing sales, imposing minimum sales requirements, asserting that the lease was “personal” to the debtor, requiring profit sharing on assignment or sublet and restricting changes in signage. The Court held that such provisions “would materially diminish the value of the leases ... and the ability to assign and sell such leases ... for value.” *In re Montgomery Ward, LLC*, Case No. 00-4667 (Bankr. D. Del, March 1, 2001).
- E. In *In re Service Merchandise Co., Inc.*, Case No. 99-02649 (Bankr. M.D. Tenn. Mar. 10, 2002), the Court permitted sales of designation rights but made a distinction between non-monetary provisions that have the “effect” of restricting assignment, which are enforceable, and those that have the “intent” of restricting assignment, which are unenforceable. *Ramsco-Gershenson Props., L.P. v. Service Merchandise Co., Inc.*, 293 B.R. 169 (M.D. Tenn. 2003)
- F. Limitations on the period for a debtor to determine whether to assume or reject non-residential real property leases may have a negative effect on future sales of designation rights.
- G. Typical features of a designation rights agreement include:
 - 1. Payment of a large sum in cash to debtor tenant as consideration for the assignment of the designation rights;
 - 2. An exclusive period for the purchaser to market the leases, assign or terminate the existing leases;
 - 3. Purchaser may pay amounts due under leases during marketing period;
 - 4. Purchaser may elect to remove leases from agreement;

5. Debtor must request court approval for assumption and assignment of leases once purchaser is able to line up an ultimate purchaser/tenant;
 6. Purchaser may have to pay all amounts necessary to cure defaults in anticipation of assumption and assignment;
 7. Purchaser keeps proceeds of sale of leases; and
 8. Debtor may remain liable for rejection damages for those leases not assumed and assigned under designation rights agreement.
- H. *In re Ames Department Stores, Inc.*, 348 B.R. 91 (Bankr. S.D.N.Y. 2006) – Judge Gerber held that “the sale of designation rights is fully permissible in bankruptcy cases, and...there is nothing in either bankruptcy or non-bankruptcy law that prohibits this plainly salutary means for making available for the benefit of creditors the underlying economic value in a debtor's leases.” The *Ames* court defined designation rights as “the right to direct the debtors to assume and assign unexpired leases...to third parties qualifying under the Bankruptcy Code, after such non-end users locate ultimate purchasers of the unexpired leases.” Judge Gerber noted that the subsequent assumption or assignment is subject to the applicable provisions of section 365.

VIII. Special Issues with Shopping Centers

- A. Prior to BAPCPA, it was unclear whether section 365(f) applied to override other provisions of section 365, including the section 365(b)(3) provisions limiting assignment of shopping center leases.
- B. BAPCPA amended section 365(f)(1) of the Bankruptcy Code to clarify that section 365(f) does not override the other specific provisions of section 365, including the limitations on assignment of shopping center leases in section 365(b)(3). Now, if a debtor seeks to assign a shopping center lease, the debtor and any proposed assignee must, without a doubt, comply with use and other clauses contained in such leases.
- C. Even prior to BAPCPA, the United States Court of Appeals for the Fourth Circuit upheld a landlord’s rights to enforce lease restrictions on use, alterations and other issues in the context of shopping center leases in a designation rights transaction. The Court concluded that the more specific provision of the shopping center lease trumped the anti-assignment provision and noted that a shopping center was “a carefully planned enterprise ... [and] the tenant mix ... may be as important to the lessor as the actual promised rental payments, because certain mixes will attract

higher patronage of the stores in the center.” *In re Trak Auto Corp. v. West Town Center, LLC*, 367 F.3d 237, 242 (4th Cir. 2004).

IX. Rejection of Leases Under 365(a)

- A. Rejection damages are calculated under section 502(b)(6) as rent without acceleration for the greater of one year or 15% not to exceed three years or the remaining term of the lease plus any unpaid rent without acceleration.
- B. “Change of Heart” rejection after a decision to assume a lease is made allows landlords greater rights. Under this situation, pursuant to section 503(b)(7), a landlord is entitled to administrative priority for the amount of the monetary obligations accrued prior to rejection plus an administrative claim of two years of non-penal monetary obligations plus an unsecured rejection claim under section 502(b)(6), reduced by funds received from other sources (such as through a letter of credit).
- C. “Stub Rent” – courts have held that debtors must pay only the portion of rent due for the portion of the month prior to the rejection of a lease. See attached decision in *In re Footstar*, Case No. 04-22350 (ASH) (Bankr. S.D.N.Y. 2005) (attached).

X. Landlord Tactics to Improve Bargaining Power With Large Retail Chains

- A. Add non-monetary default provisions such as use restrictions.
- B. List in lease factors to be considered in determining whether to consent to an assignment or sublet and request payments or profit sharing for assignment or sublet.
- C. Specify what adequate assurance should be provided.
- D. Apply cross-default provisions across multiple leases.
- E. Use a master lease to cover multiple leases.
- F. Apply restrictive covenants.

XI. Recent Retail Bankruptcy Cases

- A. *Linens ‘n Things* – Filed May 2, 2008 in Delaware – reported a lose in the fiscal year of 2007 of \$242.1 million and announced that it would close 120 of its 590 stores as part of its chapter 11 process. Linens has received an extension to its 120 day period to assume or reject non-residential real property leases to November 28, 2008, 210 days after its

petition date. On May 30, 2008, the Delaware Bankruptcy Court approved an agency agreement with Tiger/SP Capital JV to conduct store closing/liquidation sales, presumably in anticipation of the disposition of leases for those affected stores. The Debtors filed a motion on June 2, 2008 seeking expedited procedures for rejection or assumption and assignment of leases (attached).

- B. *Sharper Image* – Filed February 19, 2008 in Delaware – with plans to close 90 of 184 stores Hilco Merchant Resources LLC and Gordon Brothers Retail Partners LLC, leading members of a joint venture that purchased the San Francisco-based chain for \$49 million at a May 30 bankruptcy auction, are shutting the stores as part of a plan to reformulate Sharper Image.
- C. *Movie Gallery and Hollywood Video* – Filed October 16, 2007 in Virginia – already closed 520 of 6849 Movie Gallery and Hollywood Video stores in fall of 2007 and will close another 400.
- D. *The Bombay Company* – Filed September 20, 2007 in Texas – with plans to sell all 335 of US leases and keep its Canadian operations, engaged in store closing sales. The Bankruptcy Court approved an expedited procedure for selling leases through an ongoing auction (attached).