

SHOPPING CENTERS: USE CLAUSES MUST BE HONORED IN TENANTS' BANKRUPTCIES

By: Harris Ominsky*

After twenty years of fighting tenant-favorable bankruptcy decisions on lease assignments, landlords have won a major victory. The case of In re Trak Auto Corporation v. West Town Center, LLC, 2004 WL 856859 (4th Cir.), decided April 22, 2004, should go down in legal history as a turning point in upholding a landlord's rights to enforce lease restrictions on use, alterations and other operating issues in shopping center leases.

The Trak decision is one of the first at the circuit court level to support these rights in bankruptcy. The issue revolved around a limitation in the Trak lease that permitted only the retail sale of automobile parts and accessories and such other items as are customarily sold by Trak at its other auto stores. Trak also agreed to use the leased property only as a Trak Auto Store.

When Trak Auto went into bankruptcy and tried to assign the lease, it did not receive any interest from auto parts retailers. Perhaps because there were then seven auto parts stores within three miles of the center. Instead, it found an apparel merchandiser who offered \$80,000 to buy the lease, and use the store to sell brand-name family apparel at discount prices. Over objection from the landlord, the bankruptcy court approved that assignment which, of course, would make the bankruptcy estate \$80,000 richer, and leave the landlord with a discount clothing store it did not want. On appeal the bankruptcy court's

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decision was affirmed by the federal district court, and the landlord appealed to the United States Court of Appeals, which reversed the lower courts and agreed with the landlord in a well-reasoned opinion that should send a message to bankruptcy courts and bankruptcy and real estate lawyers throughout the country.

Bankruptcy Code Analysis

This is not a local issue involving only the Fourth Circuit. The issue involves an interpretation of two apparently contradictory sections of the Bankruptcy Code. Under one section, Section 365(b)(3), “a debtor may assign a lease if the assignee provides adequate assurance of future performance.” When you are dealing with a shopping center, that adequate assurance must include specific assurances that are spelled out in the Code. Most importantly to this case, there must be adequate assurance that the assignment “is subject to all the provisions of the lease including (but not limited to) provisions such as a radius, location, use or exclusivity provision,” and will not breach any such provision contained in any other lease or agreement relating to the shopping center.

On the surface that seems pretty clear, but the conflict occurs because another section of the Code, Section 365(f)(1), contains a general provision that prohibits the enforcement of “anti-assignment” clauses in leases. This section allows a debtor to assign a lease “notwithstanding a provision . . . that prohibits, restricts or conditions . . . assignment.” That simple provision has been the basis over the years for millions of dollars of value in shopping center leases winding up in the hands of tenants’ creditors, over the objections of numerous shopping center owners. Judge Michael, speaking for the three judge circuit court, analyzed the legislative history and concluded that the more specific provision,

intended to protect shopping center owners, trumped the more general legislative provision intended to prohibit anti-assignment clauses.

Congressional Intent

In reviewing the legislative history, Judge Michael pointed out that the House Judiciary Committee was concerned about a shopping center being a “carefully planned enterprise” where “the tenant mix in the shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher percentage of the stores in the center.”

Pursuant to Congressional hearings in 1984, Congress concluded that the practice of avoiding use restrictions in bankruptcy was creating problems with tenant mix and adversely affecting shopping centers. This was being done to facilitate assignments by debtor-tenants. “These locations were losing their balance-of-merchandise drawing card which was a threat to overall sales revenues in the shopping center sector of the economy.” Therefore, Congress responded in 1984 by amending the shopping center provisions in the Bankruptcy Code.

As stated by the court: “Among other things, Section 365(b)(3) (C) was amended to delete the word ‘substantially’ from the provision previously requiring that assignment of the shopping center lease must not ‘breach substantially’ certain restrictions. This section was also amended to provide that any assigned shopping center lease would remain subject to all of the provisions of the lease and not just the provisions of ‘any other lease’ relating to the center. Again, the amended provision that we interpret today provides: ‘adequate assurance of future performance of a lease of real property in a shopping center includes adequate

assurance . . . that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision.’”

It is noteworthy that the landlord sought only to enforce the use provision concerning the sale of automobile parts and accessories. It wisely did not attempt to enforce the restriction that the store could be used only as a “Trak Auto Store.” That provision would have presented a more difficult issue for the landlord because it would have forbidden assignments even to other companies in the auto supply business. As Judge Michael pointed out, Senator Hatch, in explaining the 1984 amendment to Section 365(b)(3)(C) said that it was not intended to enforce requirements to operate under a specified trade name.

In reaching its decision, the court weighed the potential advantages to the bankruptcy estate of permitting freer assignability of leases against the advantages of honoring Congressional intent and deferring to shopping-center owners’ judgments about what is good for their shopping centers. In criticizing the bankruptcy court’s decision, the circuit court held: “This analysis overlooks the fact that West Town, the shopping center landlord, made the judgment that an auto parts retailer is important to a successful mix of stores in the center. And, in its lease with Trak Auto, West Town successfully negotiated to have the leased space dedicated to the sale of auto parts. West Town insists that this use restriction be honored by any assignee of Trak Auto, and that is West Town’s right under Section 365(b)(3)(C), regardless of market conditions. Section 365 (b)(3)(C) simply does not allow the bankruptcy court or us to modify West Town’s ‘*original* bargain with the debtor.’ ”

Leading Case

The Trak Auto case will undoubtedly become a leading case and will frequently be cited in future battles between bankrupt tenants and shopping center owners. There have been a host of recent major bankruptcies involving such companies as Rickel Home Centers, Bradley Stores, Montgomery Ward, Service Merchandise and Kmart. Many of the issues in those cases would have been decided differently by the Fourth Circuit Court of Appeals.

This case will also be cited by landlords to enforce other common restrictions and obligations which appear in retail leases, such as provisions forbidding alterations or closing of a store without the landlord's consent, and provisions requiring tenants to share profits they may receive on assignment or subleasing. However, tenants will undoubtedly respond that none of those clauses are specifically protected in 365(b) as "a radius, location, use or exclusivity provision."

The case will also undercut a recent trend to commerce in what are sometimes called "designation rights" in shopping center bankruptcy cases. Those sales, often involving tenants with dozens of shopping center sites, are often structured as auction sales of rights to a number of retail stores.

When a debtor sells these designation rights, sometimes for millions of dollars, it typically transfers to the purchaser of these rights the exclusive right to select and designate which of the leases may be assumed and assigned and to whom, and which ones are to be excluded from these transactions. The successful bidder is usually given a period of time within which to market these leases to other buyers, and the profits are then split based on some negotiated arrangement between the debtor and the bidder. Obviously, these rights become more valuable if the leases can be assigned free of the lease restrictions and other

limits that have often been carefully negotiated in the leases by the shopping center owners. While the Trak decision will undoubtedly please landlords, it will strike a blow against those companies that deal in these designation rights.

While some of the opinions in the bankruptcies listed earlier may be distinguishable in their facts, the Trak opinion presents a different perspective on Congressional intent than these other cases. For example, in the often-cited case of Rickel Home Centers, Inc., 240 B.R. 826 (D.C. Del. 1998), the bankruptcy court overrode a use requirement for a “Rickel’s type home improvement store,” and permitted the assignee, Staples, to subdivide the space and use it for retail sale of office supplies. The court characterized the restriction as a “de facto anti-assignment clause,” because market conditions were such that these type centers would become “obsolete,” or at least would struggle to compete against stores like Home Depot. Essentially, the court bought Rickel’s argument that its type of operation was no longer feasible. It appears that the Fourth Circuit Court of Appeals would have come to the opposite conclusion on those facts.

The message of Trak is clear. Bankruptcy courts cannot invalidate use restrictions merely because another use will be more valuable, or even if the court determines that the tenant has not been able to find anyone interested in occupying the space for the required use. It seems that the landlord’s choice of tenant mix in a shopping center lease must be honored, whether or not it is a wise choice by the owner, or even whether it is presently feasible because of changes in market conditions.