Debtor-Tenants Located in Shopping Centers Must Satisfy Heightened Requirements When Assuming and Assigning Their Unexpired Lease in Bankruptcy

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INTRODUCTION

Under title 11 of the United States Code (the “Bankruptcy Code”), a debtor filing for bankruptcy with an executory contract or unexpired lease will be relieved of their obligation under that contract or lease when it is properly assumed and assigned to a third party with court approval.\(^1\) Section 365(b) mandates that the debtor meet certain requirements to assume a contract or lease, which includes providing adequate assurance of future performance.\(^2\)

Section 365(b)(3) governs the assumption and assignment for debtor-tenants located in shopping centers. Section 365(b)(3) enumerates heightened requirements in providing adequate assurance in order for the debtor-tenant in a shopping center to be released from their obligations and avoid breach of the lease; these include:

- (A) adequate assurance of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease; (B) that any percentage rent due under such lease will not decline substantially; (C) that assumption or assignment of such lease is subject to all the provisions

\(^1\) 11 U.S.C. § 365(b).
\(^2\) Id.
thereof, 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, financing agreement, or master agreement relating to such shopping center; and (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.³

Assignment is impermissible if any of the subsections of 365(b)(3) are not met.⁴

This memorandum will examine section 365(b)(3) of the Bankruptcy Code and its implications. Part I will briefly examine the term “adequate assurance.” Part II will focus on the requirement of adequate financial condition and rent stabilization under section 365(b)(3)(A), (B). Part III will evaluate the requirement of compliance with lease provisions and agreements within shopping centers and the overt tension between section 365(b)(3)(C) and section 365(f)(1). Part IV will assess the requirement of avoiding disruption of the tenant mix and balance in the shopping center in section 365(b)(3)(D).

DISCUSSION

I. Assessing Adequate Assurance

The cornerstone of section 365(b) of the Bankruptcy Code is “adequate assurance.” Congress adopted the term “adequate assurance” from section 2-609 of the Uniform Commercial Code.⁵ An official comment to section 2-609 of the Uniform Commercial Code attempts to provide some guidance on the interpretation of adequate assurance, stating that “‘adequate’ assurance is to be ‘defined by commercial rather than legal standards.’”⁶ Further, “[w]hat constitutes “adequate assurance” is to be determined by factual conditions; the seller must

⁶ U.C.C. § 2-609 cmt. 3.
exercise good faith and observe commercial standards; his satisfaction must be based upon reason and must not be arbitrary or capricious.”

Although the meaning of adequate assurance is vague, there is a general consensus among the courts that adequate assurance is intended to allow “practical, pragmatic construction,” which is to be “determined by consideration of the facts of the proposed assumption.” Thus, satisfaction of adequate assurance of future performance can range from a simple promise to pay to guaranteed performance.

Section 365(b)(3) provides special protections for shopping centers through the specific provisions concerning adequate assurance. Section 365(b)(3) requires adequate assurance of future performance for unexpired shopping center leases and requires the non-debtor party be provided with the full benefit of the bargain, eliminating any potential leeway in changing that bargain. Adequate assurance is directed at protecting the financial well-being of landlords. The legislative intent rests on the prospect of protecting the economic expectations of shopping center landlords from the potentially tragic ripple effect of the debtor’s bankruptcy.

II. The Requirement to Maintain Financial Stability

The general requirement of providing adequate assurance of future performance in assuming and assigning an unexpired lease or contract under section 365(b) omits specific language as to what sufficiently satisfies the provision. This is distinguishable from section 365(b)(3), which delineates specific requirements a debtor must satisfy in providing adequate assurance.
assurance for assignments in shopping centers.\textsuperscript{13} Section 365(b)(3)(A) requires adequate assurance of the source of rent and other consideration under such lease and if the lease is assigned, the assignee must have a financial condition and operating performance similar to the original tenant when the lease was executed.\textsuperscript{14} In addition, section 365(b)(3)(B) requires adequate assurance that the percentage of rent under a lease will not substantially decline.\textsuperscript{15} The legislative history indicates that the purpose of this specific language was “to ensure that the assignee itself will not soon go into bankruptcy and will provide operating and advertising benefits to the other tenants similar to those provided by the original tenant when its lease was executed.”\textsuperscript{16}

It is widely accepted that the burden of proving such adequate assurance of future performance is on the debtor. However, debtors need not prove a profit will be made by assignment or provide an absolute guarantee of performance.\textsuperscript{17} “Section 365(b)(3)(A) requires that ‘the financial condition and operating performance’ of [the assignee] ‘be similar’ to that of the Debtors at the time the lease was executed.\textsuperscript{18} The statute's main purpose is to provide adequate assurance for the payment of future rent, “[the court] interpret[s] this to mean that the financial condition and operating performance of [the assignee] must be at least as strong as was the Debtors’.”\textsuperscript{19}

Moreover, in regard to section 365(b)(3)(B), Congress does not require all leases to have percentage rent clauses.\textsuperscript{20} “It must simply appear that the rent will be paid and other lease

\textsuperscript{13} See 11 U.S.C. § 365(b)(3).
\textsuperscript{14} Id. § 365(b)(3)(A).
\textsuperscript{15} Id. § 365(b)(3)(B).
\textsuperscript{18} In re Casual Male Corp., 120 B.R. at 264.
\textsuperscript{19} Id.
obligations will be met.” Accordingly, courts will consider things such as “the debtor’s payment history, presence of guarantee, presence of a security deposit, evidence of profitability, a plan that would earmark money exclusively for the landlord, the general outlook on the debtor’s industry, and whether the unexpired lease is at, or below, the prevailing rate.”

The Bankruptcy Court for the Eastern District of New York evaluated the heightened requirements in providing adequate assurance of future performance for shopping centers in In re Sapolin Paints. There, the debtor, Sapolin, filed a liquidating plan under chapter 11 of the Bankruptcy Code. Three years before voluntarily filing for bankruptcy, Sapolin acquired a California leasehold. The lease payments under that lease were significantly below the market rate at the time the petition was filed. Thereafter, Sapolin asked bankruptcy court approval to assign the lease to Metropolitan Greetings (“Metropolitan”). Metropolitan provided the court with satisfactory financial information, but the landlord argued that Metropolitan could not satisfy the provision in the lease requiring the tenant to ensure the property would not be vacant or abandoned. However, the court stated that the landlord “should not be permitted to work the forfeiture of a valuable asset of the debtor on the basis of chimerical possibilities.” The court emphasized the fact that the under-market lease was very valuable and held that the “economic

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21 In re M. Fine Lumber Co., 383 B.R. at 573.
23 In re Sapolin Paints, Inc., 5 B.R. at 414.
24 Id.
25 Id.
26 Id. at 421.
27 Id. at 415.
28 Id. at 418.
29 Id. at 421.
condition . . . [provided] protection against the possibility that [the] property [would] be vacated and abandoned sometime in the indefinite future. . . .”

III. Mandated Adherence to Applicable Restrictive Provisions

Section 365(b)(3)(C) of the Bankruptcy Code requires a debtor to provide adequate assurance that the assumption or assignment of an unexpired lease within a shopping center is subject to provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement in such shopping center. This imposes restrictions on the types of lessees to whom a debtor may assign an unexpired lease.

In In re Heilig-Meyers Co., the Bankruptcy Court for the Eastern District of Virginia denied the proposed sale, assumption and assignment to Hanrick Fabric store because the debtor did not satisfy the requirements of section 365(b)(3)(C). The proposed assignee, Hanrick Fabric, was in the business of selling fabrics. However, there was another fabric store ("Fabric") within the shopping center that had an exclusivity provision in its lease, which prohibited the assignment to a store that would be in direct competition with Fabric. Because Hanrick Fabric would be direct competition with Fabric, the proposed lease would have violated the exclusivity provision and therefore was denied.

In contrast, certain circumstances allow an assignment or assumption of an unexpired lease within a shopping center notwithstanding its prohibition by another stores lease or master agreement. This was the case in In re Toys “R” Us. There, the Bankruptcy Court for the

30 Id.
33 Id. at 662.
34 Id.
35 Id. at 663.
Eastern District of Virginia held that the assumption and assignment of the unexpired subject lease did not violate section 365(b)(3)(C), although the lease was subsumed in the exclusive use provision of another store’s lease in the shopping center. The debtor, Toys “R” Us, proposed to assume and assign its unexpired lease to Burlington Coat Factory (“Burlington”), an off-price retail store. Another off-price retail store had an exclusivity provision in its lease prohibiting assignment to any other off-price retail stores within the shopping center. However, the court ruled that such an exclusivity provision is only applicable when the relevant party has sufficient legal capacity to require performance. The court-approved assumption and assignment to Burlington rendered the landlord without capacity to prevent the assignment. Therefore, the court upheld the assumption and assignment.

The language in section 365(b)(3)(C), which requires compliance with other lease provisions, conflicts with section 365(f)(1). Section 365(f)(1) provides that notwithstanding a provision in an executory contract or lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease so long as adequate assurance is provided. In the past, courts have disagreed about which provision is paramount in regard to shopping center leases, but case law has attempted to reconcile these provisions.

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37 Id. at 310–11.
38 Id. at 307.
39 Id. at 308.
40 Id. at 310.
41 Id.
42 Id. at 311.
45 See Binford, supra note, at 5.
Many courts have held that section 365(b)(3)(C) trumps 365(f)(1).\textsuperscript{46} For example, the Fourth Circuit adopted this view in \textit{Trak Auto Corp. v. West Town Center}.\textsuperscript{47} The Fourth Circuit ruled that section 365(f)(1) doesn’t authorize a court to modify the original bargain between a landlord of a shopping center by invalidating a restrictive use provision.\textsuperscript{48} The debtor-tenant, Trak Auto Corporation, sought to assume and assign its shopping center lease to a non-auto part retailer, which was prohibited by a restrictive use provision in its lease.\textsuperscript{49} The Fourth Circuit denied the motion to assume and assign on the basis it would violate the restrictive use provision, emphasizing the saliency in adhering to the heightened requirements for shopping centers.\textsuperscript{50}

Several other courts also follow this policy of preserving the special interests of shopping center landlords.\textsuperscript{51} However, other courts adopt a different position. In \textit{In re Rickel Home Centers, Inc.}, the district court noted that section 365(b)(3)(C) and 365(f)(1) must be read together.\textsuperscript{52} In \textit{In re Rickel Home}, the court considered whether a debtor operating a home improvement store in a shopping center could assume and assign a lease to Staples for the operation of an office supply store.\textsuperscript{53} The proposed assumption and assignment was prohibited by two restrictive use provisions, which mandated the premises to be maintained solely for the purposes of a home improvement store.\textsuperscript{54} The court ruled the restrictive use provisions unenforceable, stating that “courts and commentators alike have construed the terms to not only render unenforceable lease provisions which prohibit assignment outright, but also lease

\textsuperscript{46} Id.
\textsuperscript{47} Trak Auto Corp. v. West Town Center (\textit{In re} Trak Auto Corp.), 367 F.3d 237 (4th Cir. 2004).
\textsuperscript{48} Id. at 244.
\textsuperscript{49} Id. at 239–40.
\textsuperscript{50} Id. at 245.
\textsuperscript{51} See, e.g., \textit{In re} Sun TV Appliances, Inc., 234 B.R. 356 (Bankr. D. Del. 1999) (holding shopping center use provisions are accorded important significance by Congress in section 365(b)(3)).
\textsuperscript{52} \textit{In re Rickel Home Centers, Inc.}, 240 B.R. 826, 832 (Bankr. D. Del. 1998).
\textsuperscript{53} Id. at 829.
\textsuperscript{54} Id. at 830.
provisions that are so restrictive that they constitute de facto anti-assignment provisions.”
Testimony from the debtor’s president revealed that no home improvement store was looking to assume the subject lease; the court used this as a basis to conclude the use provision would prohibit any assignment, acting as an anti-assignment clause. Thus, the court held the use provision null under section 365(f)(1).

IV. Avoiding Disruption of Tenant Mix and Balance

The final provision of section 365(b)(3), paragraph (d), provides that an assignment must not disrupt the tenant mix or balance of the shopping center. A proposed assignment may be allowed under the aforementioned subsections of section 365(b)(3), but if a substantial disruption of tenant mix or balance is probable then a court will be unwilling to grant the proposed assignment. “[T]he tenant mix in a shopping center 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.”

A majority of courts use a flexible approach in the enforcement of tenant mix clauses and typically approve assignment if the disruption is insignificant. In In re Ames Dept. Stores, Inc., the Bankruptcy Court for the Southern District of New York approved the assignment of a department store lease to a lessee that intended to use the premises to operate a furniture store and sublet a portion of the property. The debtor, Zayre Illinois Corporation (“Zayre”), sought to assign their unexpired lease of non-residential property in The Thatcher Woods Shopping Center.

55 Id. at 832.
56 Id. at 831–32.
57 Id. at 832.
59 In re Joshua Slocum Ltd., 922 F.2d at 1089.
(the “Lease”) to Schottenstein Stores Corporation (“Schottenstein”). The Lease did not restrict use of the premises in any way, nor did any of the other existing leases in the shopping center. The court relying on its own precedent reiterated that “[t]he statute itself thus directs tenant mix inquiry to contractual provisions rather than general notions of tenant mix.” Thus, because the lease permitted the premises to be used for any purpose and there was nothing in the record that indicated the landlord bargained for the right to preserve tenant mix, the assumption and assignment was allowed. The “construction of section 365(b)(3)(D) is consistent with the notion that a court should avoid infringement of property rights.” Without sufficient evidence to show a contractual provision will be violated, a court will likely be reluctant to prohibit an assumption or assigned pursuant to section 365(b)(3)(D).

CONCLUSION

A debtor-tenant located in a shopping center that files for bankruptcy may assume and assign their unexpired lease but must satisfy the requirements of section 365(b)(3). The Bankruptcy Code incorporated adequate assurance of future performance to ensure the non-debtor party of the agreement receives the benefit of its bargain. “Shopping center landlords are given greater protection through the more specific provisions of section 365(b)(3), but these provisions are additional means to the same end—the preservation of that bargain.” If a debtor satisfies the heightened requirements of section 365(b)(3), courts are likely to approve the

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62 Id. at 745.
63 Id. at 746.
64 Id. at 752.
65 Id. at 753–54.
67 Id.
69 See id.
70 Id.
assumption and assumption based on the clear congressional policy favoring assumption and assignment.\(^71\)

Under section 365(b)(3) of the Bankruptcy Code, adequate assurance of future performance requires an examination based on the facts at hand and the lease at issue.\(^72\) Courts may, however, perceive similar facts differently.\(^73\)


\(^{72}\) See In re Sapolin Paints, Inc., 5 B.R. at 420.

\(^{73}\) See Binford, supra note, at 5 (“This discussion of adequate assurance of future performance case law makes it clear that determining whether the standards set out in section 365 have been met requires a fact-intensive inquiry. No two cases are ever exactly alike, and different courts may view similar facts differently.”).