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## Solvent Shopping Center Tenants

### Reexamination in Light of *In re Trak Auto Corp.*: Part I

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Approximately half of all U.S. retail trade is conducted in shopping centers. The International Council of Shopping Centers estimated shopping center sales at \$1.98 trillion last year.



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The success of shopping centers depends on the operation of a carefully chosen mix of stores. A shopping center has been described as similar to a small town, with “a delicate balance of merchants.”<sup>2</sup> Eliminate one merchant from the mix, and the effect may ripple through the entire town.

Congress had the well-being of shopping center lease tenants in mind—as well as owners, developers and landlords—when it built specific provisions into the U.S. Bankruptcy Code to ensure that the delicate balance of retail stores within shopping centers is preserved, even when an individual tenant goes bankrupt.

With this context in mind, we consider *In re Trak Auto Corp.*,<sup>3</sup> a decision issued on April 22, 2004, by the U.S. Fourth Circuit Court of Appeals. *Trak Auto* is a victory for

shopping center landlords—and, by implication, non-bankrupt tenants—in recognizing the limits imposed by law upon a debtor-tenant’s efforts to assign its leasehold interests in a manner contrary to the terms of its lease. *Trak Auto* also invites a reexamination of other tools Congress made available to landlords and solvent tenants in a shopping center to ensure that the rights they bargained for when they signed their leases are preserved.



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In particular, solvent tenants—as well as shopping center owners, developers and landlords—should give serious consideration to §365(b)(3)(D) of the Bankruptcy Code<sup>4</sup> as a tool for preserving tenant mix and category exclusivity within a shopping center that has lost a fellow tenant to bankruptcy.

This article also examines the implications of the *Trak Auto* decision regarding an increasingly prevalent phenomenon: the sale of so-called “designation rights” in bankruptcy.

### Historical Background to Landlords’ Victory in *Trak Auto*

Shopping center tenants are not randomly chosen and assigned to available stores, but carefully selected, often in accordance with a master plan. When a master plan has been created, it is typically preserved through a series of restrictive clauses included in each lease as well as constant monitoring designed to ensure that the balance within the shopping center community is preserved.

Both tenants and landlords have a reasonable expectation that their relationships will be governed by carefully drafted executed leases and painstakingly negotiated restrictions on the use of leased premises. But what if one of those tenants seeks bankruptcy protection?

On the date of a bankruptcy filing, those lease clauses and restrictions become subject

to the provisions of the Code and to courts’ interpretations of the meaning of those provisions. Following enactment of the Bankruptcy Reform Act of 1978, however, some bankruptcy courts interpreted the statute to invalidate such restrictive-use clauses contained in leases, which led to permanent modifications of lease terms.

Older leases with contractually fixed below-market rent are a valuable asset. The debtor frequently wishes to sell or assign his lease to the highest bidder to maximize value for the estate. This goal may or may not be aligned with promoting the overall well-being of the shopping center. The landlord and its non-debtor tenants, however, have a vested interest in the continuing success of the center. For this reason, they hope to preserve bargained-for clauses in their leases along with the overall tenant mix and balance in the center.

Congress was receptive to the concerns of landlords and their non-debtor tenants regarding the negative impact that a lease assignment may have on tenant mix and balance in shopping centers. The Bankruptcy Reform Act of 1984 (1984 Amendments) ensured that the delicate balance bargained for by the original parties would not be disturbed by one or more insolvent tenants. To achieve this purpose, the 1984 Amendments required that the assignee honor the restrictions bargained for by the landlord and non-debtor tenants.

The Code provides that a trustee or debtor-in-possession (DIP)<sup>5</sup> may assign an unexpired lease only if the new tenant gives adequate assurance of future performance.<sup>6</sup> Section 365(b)(3) provides that assignment of a shopping center lease requires adequate assurance that such assignment:

- is subject to all lease provisions, including restrictions as to radius, location, use or exclusivity;<sup>7</sup>
- will not breach any such provision contained in any other lease, financing agreement or master agreement relating to such shopping center;<sup>8</sup> and

<sup>5</sup> In the present context, the terms “trustee” and “debtor-in-possession (DIP)” may be used interchangeably. See 11 U.S.C. §1107(a) (a DIP is accorded the rights of a trustee pursuant to 11 U.S.C. §1108).

<sup>6</sup> 11 U.S.C. §365(f)(2)(B).

<sup>7</sup> 11 U.S.C. §365(b)(3)(C).

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<sup>2</sup> *In re Federated Dep’t. Stores Inc.*, 135 B.R. 941, 943-46 (Bankr. S.D. Ohio 1991).

<sup>3</sup> *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004).

<sup>4</sup> 11 U.S.C. 101 *et seq.*

- will not disrupt any tenant mix or balance in the shopping center.<sup>9</sup>

Though Congress's intent seems clear, the Code contains a seeming contradiction between two sections: §365(b)(3), which conditions the assignment of a shopping center lease on rigid adherence to the requirements of restrictive use clauses and tenant mix and balance, and §365(f)(1), which permits the assignment of a lease notwithstanding any provision of the lease that prohibits, restricts or conditions such assignment. In *Trak Auto*, the Fourth Circuit confronted this apparent contradiction.

### Permitted Uses Only, Please

The debtor, Trak Auto Corp., was a retailer of auto parts and accessories. In a bid to reorganize following a bankruptcy filing, it sought to assume one of its leases and assign it to a new tenant. Provisions of the lease restricted the use of the premises to the retail sale of automobile parts and accessories.<sup>10</sup>

When none of the bids for the store lease came from an auto parts chain, *Trak Auto* sought to assign the lease to the highest bidder: a discount clothing store.

The landlord objected on two grounds. First, the landlord argued that the proposed assignment was inconsistent with the use clause contained in the lease. Additionally, the landlord claimed that a change in use would disrupt the tenant mix in violation of §365(b)(3)(D). Trak Auto countered that those lease restrictions were unenforceable anti-assignment provisions under §365(f)(1) and that, on the facts of the case, assigning the lease to a clothing store would not disrupt the tenant mix.

### Lease Restriction Denied

The bankruptcy court found that the area where the shopping center was located was saturated with auto stores to the point that no prospective assignee would bid on the store for that use. The court noted that the use provision permitted only auto stores named "Trak Auto" and that this limitation had the effect of prohibiting leasing to anyone but the original tenant. According to the bankruptcy court, such restrictions constitute *de facto* anti-assignment provisions. In reaching its decision, the court relied heavily on the oft-cited *In re Rickel Home Centers Inc.*, which held that where compliance with a use clause is impossible or where a use restriction has been so broadly drafted as to constitute a *de facto* anti-assignment clause, the clause may be stricken from the lease in its entirety.<sup>11</sup>

<sup>8</sup> *Id.*  
<sup>9</sup> 11 U.S.C. §365(b)(3)(D).

<sup>10</sup> Section 1.1(L) of the lease limited "permitted uses" to the "[s]ale at retail of automobile parts and accessories and such other items as are customarily sold by tenant at its other Trak Auto stores." In §8.1 of the lease, Trak Auto agreed to "use the leased premises only as a Trak Auto store and for the uses provided in §1.1(L)." *In re Trak Auto*, 367 F.3d at 240.

The bankruptcy court in *Trak Auto* concluded that the landlord did not present sufficient evidence to support a finding that the proposed assignment of the lease would disrupt the tenant mix or that "the alleged tenant mix was part of the bargained-for exchange of its lease and the leases of the other tenants."<sup>12</sup> In the court's view, the fact that there were many stores in the area that the landlord did not control did not help its plea that protection of the use clause was essential to preserve the bargained-for tenant mix. Accordingly, the court allowed the assignment.

On appeal, the district court affirmed. Relying on *Rickel*, that court held that the lease clause limiting use of the premises to a "Trak Auto" store was unenforceable. The court found the clause to be inconsistent with the underlying policies of the Bankruptcy Code, as it had the effect of prohibiting assignment of the lease to anyone other than the original tenant. Even though the landlord did not rely on the lease restriction mandating that the premises be used "only as a Trak Auto Store," the court focused on the language of the lease itself.

### Reversed on Appeal

The Fourth Circuit Court of Appeals reversed. Resolving the conflict between §365(f)(1) and §365(b)(3)(C), the court reasoned that §365(b)(3)(C) controls as the more specific provision, and accordingly held that the original agreement between tenant and landlord cannot be modified by the courts when a tenant seeks protection under the Code.

The Fourth Circuit found the legislative history of §365(b)(3) to be highly relevant in determining how to resolve the conflict between §§365(b)(3)(C) and 365(f)(1). According to the court, this history reflects congressional efforts to protect shopping center interests.

Both prior to and after the passage of the 1978 Act, one way in which shopping center landlords have maintained the desired tenant mix and balance is by placing use restrictions in their leases. Prior to the passage of the 1978 Act, a tenant's leasehold interest did not automatically become property of its bankruptcy estate. Moreover, the typical lease was likely to contain a provision giving the landlord an option to terminate the lease in the event that the tenant filed for bankruptcy protection.

With the passage of the 1978 Act, landlords were no longer able to regain control of leased property in the event of

<sup>11</sup> 240 B.R. 826, 831 (D. Del. 1998), *appeal dismissed*, 209 F.3d 291 (3d Cir.), *cert. denied sub nom.*, *L.R.S.C. v. Rickel Home Ctrs. Inc.*, 531 U.S. 873 (2000).

<sup>12</sup> *In re LaSalle Nat'l Trust*, 288 B.R. 114, 125 (E.D. Va. 2003), *citing In re Ames Dep't. Stores Inc.*, 121 B.R. 160, 165 (Bankr. S.D.N.Y. 1990).

bankruptcy, as leasehold interests routinely became part of the debtor-tenant's estate. Congress was persuaded, however, that shopping center interests needed special protection. The 1978 Act provided that a debtor-tenant could not assign its lease unless there was adequate assurance that "assignment of [the] lease [would] not breach *substantially* any provision, such as radius, location, use or exclusivity provision *in any other lease*, financing agreement or master agreement relating to such shopping center."<sup>13</sup>

Such protection of the interests of landlords and non-debtor tenants proved to be illusory. Debtors were able to convince the courts that even though an assignment would breach a use provision in the lease sought to be assigned, the assignment could proceed because the 1978 Act only prevented assignment if *some other* lease or agreement relating to the shopping center would be breached. Effectively, these debtors nullified §365(b)(3).

With the enactment of the 1984 Amendments, Congress responded to the pleas of shopping center interests that the practice of avoiding use restrictions was creating problems with tenant mix and balance in affected shopping centers. Specifically, "affected centers...were losing their balance of merchandise drawing card, which was a threat to overall sales revenues in the shopping center sector of the economy."<sup>14</sup> Accordingly, Congress amended subsections (C) and (D) of §365(b)(3) by deleting the word "substantially" from the provisions requiring that an assignment of a shopping center lease not violate use restriction or disrupt tenant mix. Second, subsection (C) was amended to provide that any assigned shopping center lease would remain subject to all provisions of the lease and not just the provisions of "any other lease" relating to the shopping center.

### Section 365(b)(3)(C) Controls over §365(f)(1)

The Fourth Circuit resolved the apparent conflict between §365(f)(1) and §365(b)(3)(C) by relying on the canon of statutory construction that holds that a more specific provision applicable to the issue at hand controls over a more generalized provision. Section 365(b)(3)(C) is more specific in that it directly addresses whether a debtor-tenant assigning a shopping center lease must honor a straightforward use restriction.

This conclusion is supported by the legislative history, which demonstrates that Congress's purpose in enacting the 1984

<sup>13</sup> *In re Trak Auto Corp.*, 367 F.3d 237, 243 (4th Cir. 2004), *citing* 11 U.S.C. §365(b)(3) (1982) (emphasis added).

<sup>14</sup> *Id.*

Amendments was to preserve bargained-for protections with respect to the use of premises and other matters spelled out in the debtor-tenant's lease. Congress has effectively put shopping center leases in a special category, making it more difficult for debtor-tenants to assign these leases in chapter 11.

The court concluded that because the intended assignee of the Trak Auto lease did not plan to take the lease subject to restrictions limiting use of the premises to an auto parts and accessories store, Trak Auto's motion to assume and assign the lease must be denied.

### What's Left of §365(f)(1)

The court then turned to an analysis of what is left of §365(f)(1) in light of its ground-breaking opinion. First, the court noted that its decision does not mean that §365(f)(1) can never be used to invalidate a clause prohibiting or restricting assignment in a shopping center lease. The court explained that a shopping center lease provision designed to prevent any assignment whatsoever might be a candidate for the application of §365(f)(1). In support of such reasoning, the court referred to the legislative history, quoting a statement by Sen. Orrin Hatch (R-Utah), who, in explaining the 1984 Amendments, said that the "amendment is not intended to enforce requirements to operate under a specified trade name."<sup>15</sup> The court concluded that Sen. Hatch's comment suggests that Congress did not intend to make §365(f)(1) completely inapplicable to shopping center leases. The issue as to when §361(f)(1) applies was left "for some future case."<sup>16</sup>

Clearly, this decision marks a turning point in the way many bankruptcy courts will approach the specific use restriction provisions included in shopping center leases. Instead of invalidating them as *de facto* anti-assignment clauses, courts following *Trak Auto* will honor such clauses, thereby respecting the rights of landlords. This result also bodes well for the rights of non-debtor tenants in a shopping center. Even though the victory was the landlord's, the court reached its opinion based on legislative history, which demonstrates that the 1984 Amendments were enacted for the benefit of landlords and non-debtor tenants alike.<sup>17</sup>

Notably, the lease that the debtor-tenant sought to assign contained a clause mandating that the tenant use the premises "only as a Trak Auto store," thus effectively making the lease non-assignable. The

<sup>15</sup> *In re Trak Auto Corp.*, 367 F.3d at 245, citing 130 Cong. Rec. S8891 (daily ed. June 29, 1984) reprinted in 1984 U.S.C.A.N. 590, 600.

<sup>16</sup> *Id.*

<sup>17</sup> This topic will be explored in Part II of this article, which will appear in the February 2005 issue of the *ABI Journal*.

landlord, however, did not seek to enforce this particular clause to restrict assignment to a tenant operating as a Trak Auto store. Thus, the "Trak Auto store" designation was not a consideration in the court's holding in the case.

Because the Fourth Circuit disposed of the case based on its analysis of §365(b)(3)(C), the court did not consider issues of tenant mix and balance arising under §365(b)(3)(D), or the issue as to how §§365(b)(3)(C) and 365(b)(3)(D) interact.

The last chapter on the interrelationship between §§365(f)(1) and 365(b)(3) has yet to be written, but the *Rickel* decision provides insight into what may come.

### Trak Auto Did Not Reject Rickel

The *Trak Auto* decision has already been interpreted by some commentators as disagreeing with the often-cited *In re Rickel Home Centers* decision and calling into doubt the cases that follow *Rickel*'s reasoning.<sup>18</sup> Nevertheless, while the Fourth Circuit overruled the lower courts' decisions, both heavily relying on *Rickel*, *Trak Auto* is factually distinguishable. In fact, when the Fourth Circuit spoke of a "shopping center provision designed to prevent any assignment whatsoever" being "a candidate for the application of §365(f)(1),"<sup>19</sup> it is the *Rickel* decision that comes to mind.

In *Rickel*, the debtor, a home-improvement store operator, sought to assign its numerous shopping center leases to Staples, the office-supply store chain. Use restrictions in the various leases ran the gamut. One of the leases sought to be assigned limited the tenant use to a "home improvement center."<sup>20</sup> Similarly, another lease sought to be assigned, provided that the "[t]enant may use the premises as a Channel Home Center similar in operation to a majority of the Channel Home Centers then in operation in New Jersey [and] for no other purpose."<sup>21</sup> Others were more or less restrictive. Objecting landlords argued that these restrictions were important to preserving the tenant mix in their shopping centers.

The district court, which heard the matter in the first instance, found that the use provisions contained in the leases constituted *de facto* anti-assignment clauses, and permanently struck the provisions from the leases as invalid under §365(f)(1) of the Code. The court based its ruling on the debtor's un rebutted proffer, which the court found to be credible, that the typical Channel Home Center or "home-improvement center" referred to in the leases had "either

<sup>18</sup> Full disclosure: the authors' firm represented the entity acquiring leases in the *Rickel* case.

<sup>19</sup> *In re Trak Auto Corp.*, 367 F.3d at 245.

<sup>20</sup> *In re Rickel Home Ctrs.*, 240 B.R. at 831.

<sup>21</sup> *Id.* at 831.

become obsolete or is struggling to remain in existence, as a result of the advent of warehouse type home-improvement stores like Home Depot."<sup>22</sup> In essence, it was "impossible" to comply with the restriction clauses contained in the leases because the operation described in the lease simply did not exist or, at most, was irretrievably doomed to extinction. Neither landlord nor tenant was able to find "a single viable entity engaged in the home-improvement business"<sup>23</sup> able to operate in the square footage of the debtor's stores.

The court noted that §§365(b)(3)(C) and 365(f)(1) must be read together: §365(f)(1) renders unenforceable not only those lease provisions that prohibit assignment outright, but also lease provisions that are so restrictive as to constitute *de facto* assignment clauses. Given that the market for *Rickel*-size home-improvement centers is "either non-existent or in dire straits,"<sup>24</sup> such a limitation would make it impossible for the debtor to assign to any entity. Accordingly, the court struck the provisions permanently from the leases.

### Comparing Rickel with Trak Auto

Impossible vs. uneconomical is the major distinction to be made between the facts of the two cases. In *Rickel*, the *Rickel*-size home-improvement store was found to be obsolete—hence, the debtor could never assign a lease containing such a restriction. In *Trak Auto*, the market was saturated. Saturation is a relative concept, which fluctuates depending on market conditions. While the use clause in *Rickel* effectively barred any assignment whatsoever, the use clause in *Trak Auto* made the assignment economically unattractive based on present market conditions.

An analogy may be illustrative of this distinction. Applying the reasoning of *Rickel*, a lease provision restricting use to stores specializing in selling hand-written and hand-bound encyclopedias most likely would be found to be so restrictive as to constitute a *de facto* anti-assignment clause. In contrast, a lease provision limiting use to bookstores "selling encyclopedias" may or may not be overly restrictive depending on current market saturation in the area.

In the case of auto parts, market saturation will certainly change, making it possible to assign, if not now, then later. Unlike *Rickel*-size home-improvement centers, the auto-parts industry is alive and well.

Public policy considerations bear out the significance of this distinction. Had the *Rickel* court upheld the *de facto* anti-

<sup>22</sup> *Id.* at 830.

<sup>23</sup> *Id.* at 831.

<sup>24</sup> *Id.* at 832.

assignment clauses at issue, the landlords would have obtained not the benefit of their original bargains, but the inevitable reversion of the debtor's leasehold interests to the landlords. Such a holding would have produced an assured windfall for the landlords, who could re-let the properties for alternative, non-restrictive uses at market rates. The actual holding in *Rickel* effectively preserved this value for the benefit of creditors.

By contrast, the debtor in *Trak Auto* could have held its properties for future assignment at such time as market conditions may have changed. In the alternative, if the carrying cost of the leases had made this option impracticable, the debtor could have sold designation rights in the properties, deferring and preserving the issue of compliance with all applicable requirements of §365(b)(3) until such time as a proposed assignee and intended use were identified.

### Impact on Sales of Designation Rights

The *Trak Auto* decision will have significant consequences, mostly related to the practice of selling designation rights pursuant to §§363 and 365 of the Code. In essence, the basic idea of such sales is that the debtor transfers to a third party its right to control the disposition of its leasehold interests and agrees to assign its leases to the purchaser's designees. The process usually involves extensive marketing of leasehold assets to potential bidders, followed by an auction process. The primary objective of the bidding process is to identify the highest bidder. Designation rights deals bring immediate liquidity to the bankruptcy estate while allowing the debtor to focus on issues other than marketing unwanted leases. Typically, such leases will have value to the third parties mostly because their rental rates are below-market, but also because historically, a debtor has been able to sell and assign leases to third parties notwithstanding restrictive provisions included in such leases. In addition to permanently striking restrictive provisions included in the leases, bankruptcy courts have been willing to make a new tenant's life easier by allowing time for property improvements. For example, the courts will authorize debtors to allow their premises to remain "dark" for a limited period of time, contrary to the "going dark" prohibitions contained in standard commercial leases.

At times, the practice of designating leasehold rights for future assignment has had a negative impact on non-debtor tenants in the shopping center. First and foremost, these tenants are usually not notified before

the bidding process, and may find out who the new tenant is only after the designation process has been completed, when it may be too late to object. The unfortunate practice of no notification or untimely notification may persist even though the due process rights of non-debtor tenants, including timely notice and a fair hearing, may be violated.

Debtors and putative purchasers of designation rights have been heard to argue, in at least one instance, that this result may be inevitable given the difficulty in ascertaining who the affected parties are. Thus, in a case recently decided on appeal to the same Delaware district court that decided the *Rickel* case,<sup>25</sup> the court rejected the non-debtor's arguments that it had not received notice of a proposed lease assignment to a competitor pursuant to a designation rights order.<sup>26</sup> In addition to raising due-process issues, the non-debtor tenant asserted that its statutory right under §365(b)(3)(D) to preserve the tenant mix and balance in the affected shopping center had been abrogated. The court sidestepped the issue of a non-debtor tenant's rights in connection with a shopping center lease assignment, so the issue remains essentially unresolved—thus offering fertile ground for subsequent litigation, particularly in the designation-rights context.

Ideally, parties (and courts) should assume that the entire shopping center complex is affected by a proposed assignment—particularly the assignment of an "anchor" store—and that all non-debtor tenants should be notified. Timely notice is especially important to non-debtor tenants because, as a practical matter, it may be difficult, if not impossible, to undo the assignment process after the fact.

The *Trak Auto* decision is likely to undercut, but not eliminate, one of the primary attractions of designation rights sales: the ability to reject restrictive provisions. Following *Trak Auto*, new tenants must comply with use restrictions contained in the leases unless they constitute *de facto* anti-assignment clauses.

Nevertheless, the practice of selling designation rights will continue to have appeal as long as leases can be assigned at below-market value. In *Trak Auto*, for example, the debtor could have sold designation rights in and to its leases provided that such sales were made expressly subject to all applicable provisions of §365(b)(3). Such a sale would have enabled the debtor to bridge the timing discrepancy created by temporarily difficult market conditions, while deferring the issue of compliance

with §365(b)(3) until an actual assignment was in prospect.

### Conclusion

To sum up:

- In *Trak Auto*, the Fourth Circuit Court of Appeals has ruled that use clauses making assignments seemingly unviable due to market conditions are enforceable;
- Sen. Hatch's comments on the purpose of the 1984 Amendments suggest that use clauses requiring operation under a specified trade name are probably unenforceable; and
- The *Rickel* opinion stands for the proposition that use clauses requiring assignment for non-existent uses to non-existent entities constitute *de facto* anti-assignment clauses with which it is impossible to comply, and therefore, they are unenforceable. Had the *Rickel* court upheld the *de facto* anti-assignment clauses at issue, the landlords would have obtained not the benefit of their original bargain, but the inevitable reversion of the debtor's leasehold interests to the landlords. In effect, such a holding would result in an assured windfall for the landlords, who could then re-let the properties for alternative uses at market rates. By contrast, the debtor in *Trak Auto* could have held its properties for future assignment or, if the carrying cost of the properties were the principal issue, could have sold designation rights in the properties.

In the second part of this article, we will explore the statutory rights of non-debtor tenants to preserve the tenant mix and balance in their shopping centers based on a right grounded both in the plain language of §365(b)(3)(C) and (D) of the Code and in the legislative history touched upon by the Fourth Circuit in *Trak Auto*. ■

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<sup>25</sup> The authors' firm represented the non-debtor tenant.

<sup>26</sup> *Staples Inc. v. Montgomery Ward LLC (In re Montgomery Ward LLC)*, 307 B.R. 782 (D. Del. 2004).