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SULLIVAN & WORCESTER BANKRUPTCY ADVISORY

Acquiring (And Preserving) Leasehold Value Under the New Bankruptcy Code Amendments

A lot has been written and said about the amendments to the Bankruptcy Code that were enacted in 2005 (taking effect in October of that year). While the media focus on the consumer amendments has given way to a sober realization that Congress in fact passed many significant business law changes as well, not much has been written yet about the impact that those changes have actually had on the business of retail bankruptcy in the past year, particularly on leasehold acquisitions and dispositions post-bankruptcy. Here are some observations we have made, some 15 months into the new Code regime:

- One of the most significant Code changes affecting the ability of debtor-tenants to access the value in their operating leases was, of course, the change explicitly making the free assignability provisions of § 365(f) subject to the shopping center restrictions contained in § 365(b) of the Code. This change was a direct result of the shopping center landlords' visceral reaction to In re Rickel Home Centers, Inc., a series of decisions we obtained from the Delaware bankruptcy court in 1998. (Some critics have considered the decisions "astonishing" in that Judge Farnan voided various provisions of existing leases, thereby allowing the acquiror, Staples, to change the use and disregard "go dark" provisions as necessary, to complete its acquisition of some 41 leases from the debtor-tenant). Ironically, under the old Code language, the more restrictive the lease provisions, the more likely they would be stricken as "*de facto*" anti-assignment provisions. That has changed. What has not changed, however, is that use restrictions and "go dark" provisions will continue to be the landlord's twin horsemen, used as stumbling blocks to the debtor-tenant's ability to sell its leases. Tenants beware.
- The Code now requires that, as a condition to assuming a store lease, a debtor-tenant must cure any default under a "go dark" provision in the lease, by performance "at and after" the time of assumption (as well as compensating the landlord for any pecuniary loss). A literal reading of the statute would block an assignee from keeping the store dark long enough to change signage, remodel and restock inventory. That interpretation, of course, would be devastating to the financial prospects of retail debtors. So far it has not proved necessary for any court to rule on the issue. Instead, a landlord's objection to a proposed assumption and assignment is often viewed as the first salvo in a round of

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negotiations directed at shifting, from debtor to landlord, a greater share of the profit locked up in a below-market lease. Moreover, debtors have learned to frame their motions to assume in such a way that landlords who are not vigilant in seeking relief from the bankruptcy court never obtain the promised benefits of the new Code protections.

- Changing the balance of power substantially in favor of landlords, the new Code amendments have not blocked lease assignments, as many expected. To the contrary, debtors are continuing to sell leases, auctions are being held and leases (as well as designation rights) are being sold and assigned with and without cooperating landlords. The recent case of Tower Records saw dozens of leases on the block to be sold by the designation rights purchaser, and many of the assignment orders sailed through the court. Tower Records is not the exception.
 - What we are seeing as a result of the changed landscape on lease sales is an increased need to share the oft-times tremendous value of a debtor-tenant's leasehold with a sophisticated landlord. The purchaser of leasehold interests is typically an attractive new tenant, if only the landlord can take back part of the space or increase the rent (just a little). Buyers would do well to look to leaseholds slightly larger than the requirements of their prototype store, particularly if a well-placed demising wall could create a separate, usable space to give back. Landlords who generally base their financial arrangements on existing leases are not averse to picking up the windfall. Now more than ever, buyers are in a three-way negotiation.
 - Other pro-landlord changes have yet to be tested in the courts. A change in § 365(d)(4) of the Code imposes a firm deadline of 210 days within which a debtor must assume or reject its leases, unless the landlord agrees to an extension. Under the prior Code, many courts allowed debtors to postpone those decisions repeatedly and virtually indefinitely "for cause", until they were ready to file a plan of reorganization. The new law was plainly intended to protect landlords from being forced to continue to extend credit for protracted periods. Since a too-hasty decision to assume may result in substantial administrative costs, and a premature rejection in valuable opportunities being missed, pre-bankruptcy planning has become critically important. To the extent that time pressure does not allow retailers to take advantage of seasonality in their markets, we expect that the
- more marginal, less sophisticated or cash-strapped chains will find it far more difficult (if not impossible) to survive and reorganize under the Code.
 - Many predicted that retail credit availability would be dampened by the various Code changes, among them, limiting time that reorganizing debtors can spend in Chapter 11, beefing up reclamation claims, and hindering the debtor-tenants' access to the hidden value locked in store leases. We understand, however, that retail credit is still widely available, interest rates low and advance rates high. Perhaps the liquidity in this cycle has not yet run its course but we believe that, ultimately, the Code changes will have the predicted effect on credit availability. That said, tenants would be wise to negotiate their leases with an eye to the potential value they represent, and fight for the assignability of the leasehold interest.
 - Finally, there has been no change to the need for vigilance on the part of non-debtor tenants. The revised Code retained existing provisions designed to protect use, exclusivity and other provisions contained in a shopping center lease – even where the debtor is not a party to the lease – and to protect "tenant mix" in the center. The history of the statute strongly suggests that Congress intended to give non-debtor tenants a right to be heard in (for example) the bankruptcy case of an anchor tenant. As we saw in the Montgomery Ward case, however, debtors and designation rights purchasers do not always give proper notice of a proposed assignment to all parties in interest in a center. A non-debtor tenant's local store manager must be alert to bankrupt co-tenants and any unexpected construction or retrofit activity in a center, so that counsel can quickly become involved to protect the non-debtor's rights. Likewise, as we saw in the Scotty's case, every non-debtor leasing from a bankrupt landlord should take care to ensure that its own leasehold (or subleasehold) interest is protected whenever the debtor-landlord seeks to assume and assign or to reject a prime lease (or sublease), or to sell the property at issue.

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