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Column
Last in Line

*18 DEBTOR BEWARE!

Fourth Circuit Enforces Restrictive Use Clause to Block Debtor/Tenant's Assignment of Shopping Center Lease

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Landlords hate it when their tenants file bankruptcy because suddenly, they are at risk of losing control over their property--literally--if the debtor/tenant elects to assume and assign the lease to a stranger. For the landlord of a shopping center, the possibility of a debtor/tenant's assignment of the lease is especially problematic because, in order to attract other tenants and ensure the desired tenant mix (so as to enhance profitability), shopping center leases generally contain restrictive-use clauses. Lease negotiations with national retailers now often center around the retailer's form of shopping center lease (rather than the landlord's form), and the retailer's form might state that if the national retailer's exclusivity within the shopping center is breached by another tenant in the center, or if another tenant begins to operate a business at the shopping center that constitutes a "prohibited use," the "injured" national retailer/tenant has remedies against the shopping center landlord. Consequently, shopping center landlords who are parties to leases that contain such provisions are legitimately concerned about the possibility that a debtor/tenant can assign the lease to a third party, upset the tenant mix within the shopping center and trigger a violation of various use and/or exclusivity clauses contained in the leases between the landlord and the other tenants within the shopping center.

In an effort to protect themselves, shopping center landlords (indeed, most commercial landlords) often insert lease clauses that prohibit the tenant from assigning the lease; however, Bankruptcy Code §365(f)(1) [1] renders such clauses ineffective if the debtor/tenant files bankruptcy and wants to assign the lease. Commercial leases also tend to contain lengthy anti-bankruptcy provisions that render the debtor/tenant's bankruptcy filing an automatic termination or default under the lease; however, those provisions are inoperative due to the Bankruptcy Code's prohibition on so-called "*ipso facto* " clauses. *See* 11 U.S.C. §365(e)(1). [2]

But what about restrictive-use clauses that are so characteristic of shopping center leases? Can the shopping center landlord use the restrictive-use clauses to defeat a debtor/tenant's attempt to assume and assign a shopping center lease? The answer--at least in the Fourth Circuit--appears to be "yes."

On April 22, 2004, the Fourth Circuit Court of Appeals issued its opinion in *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004). Trak Auto Corp. was a retailer of automotive parts and accessories and once operated 196 stores throughout nine states and the District of Columbia. After filing chapter 11 on July 5, 2001, Trak Auto sought to assume and assign its lease in the West Town Center, a shopping center located in Chicago. Trak Auto's lease in the West Town Center limited the debtor/tenant's use of the leased premises to the "sale at retail of automobile parts and accessories and such other items as are customarily sold by tenant at its other Trak Auto Stores." 367 F.3d at 240.

After filing chapter 11, Trak Auto hired a real estate firm to market its West Town Center lease and to solicit bids. No auto parts retailer bid on the Trak Auto's West Town Center lease. The high bidder was a clothing store, which offered $80,000 to "buy out" Trak Auto's lease so that it could open a discount clothing store in the West Town Center. Thus, Trak Auto filed a motion for authority to assume the West Town Center lease and assign it to the high bidder--the discount clothing store.

The landlord of West Town Center objected to Trak Auto's motion and argued that the proposed assignment would violate the restrictive-use provision in Trak Auto's West Town Center lease, which limited the use of the leased premises to the retail sale of automotive parts and accessories and other items customarily sold at Trak Auto stores. The bankruptcy court held an evidentiary hearing and made several interesting findings of fact, as follows:
a. The West Town Shopping Center was in Chicago--an urban area where only 59 percent of the population owns cars.

b. The shopping center was surrounded by competing shopping areas.

c. There were 25 tenants in the West Town Center, including clothing stores, food vendors, a Kmart, a laundromat, a travel agency, a bank, a small loan agency, an adult entertainment outlet and a public library branch.

d. Although Trak Auto was the only auto-parts retailer within the West Town Shopping Center, there were seven auto-parts retailers within a three-mile radius.
These findings of fact were accepted by the Fourth Circuit Court of Appeals; however, the bankruptcy court and the Fourth Circuit Court reached vastly different legal conclusions.

The bankruptcy court concluded that because no auto-parts retailer bid on the debtor's West Town lease, "the market in the area is saturated and cannot bear [the] restriction limiting the use to sale of auto parts and accessories." 367 F.3d at 244. Thus, the bankruptcy court reasoned that the market had the practical effect of transforming the use restriction into an anti-assignment clause, which is unenforceable under Code §365(f)(1). The bankruptcy court also found that the landlord did not present sufficient evidence to demonstrate that the assignment of the lease to a clothing retailer would upset the tenant mix. 364 F.3d at 240. Consequently, the bankruptcy court authorized the debtor to assume the lease and assign it to the clothing store. The landlord appealed to the district court, which affirmed.

When the landlord appealed to the Fourth Circuit Court of Appeals, the circuit court framed the issue differently than had the lower courts. Basically, the Fourth Circuit Court of Appeals stated that the issue was how to deal with the conflict between Code §365(b)(3)(C),[3] which "specifically requires a debtor/tenant at a shopping center ***60** to assign its store lease subject to any provision restricting the use of the premises," 367 F.3d at 241, while Code §365(f)(1) generally allows a debtor to assign its lease notwithstanding a provision in the lease that restricts the assignment. In other words, the Fourth Circuit Court of Appeals honed in on an inherent conflict within two subsections of §365.

The Fourth Circuit began its analysis with an in-depth review of the legislative history of §365 and found evidence that Congress intended to protect shopping center landlords because:

> A shopping center is often a carefully planned enterprise, and though it consists of numerous [sic] individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the 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.

367 F.3d 242, *citing* H.R. Rep. No. 95-595 at 348 (1977), U.S. Code Cong. & Admin. News 1977 at 5963, 6305. The Fourth Circuit observed that the original version of §365(b)(3) provided that the debtor/tenant could not assign a shopping center lease unless there was adequate assurance that "assignment of the lease would not breach *substantially* any provision, such as a radius, location, use or exclusivity provision, in any other lease, financing agreement or master agreement relating to said shopping center." 367 F.3d at 243. However, shopping center landlords found this protection to be inadequate because the

debtor/tenant could avoid the effect of these provisions by convincing the bankruptcy court that the assignment would not cause a *substantial* breach of a use, radius, location or exclusivity provision. Also, the reference in the 1978 version of the Bankruptcy Code to "any other lease" was construed by debtors (and some bankruptcy courts) to mean that the landlord of the shopping center was only eligible for protection if it could prove that *some other* lease related to the shopping center would be breached. Consequently, the shopping center landlords lobbied Congress to amend §365(b)(3) to provide shopping center landlords with additional protection in order to preserve the tenant mix. In 1984, Congress amended §365(b)(3)(C) to delete the word "substantially" and to fix the confusing statutory reference to "any other lease." Thus, §365(b)(3)(C) now requires the debtor/tenant of a shopping center lease to provide adequate assurance:

> (C) that assumption or assignment of such lease is subject to all provisions thereof, including (but not limited to) provisions such as 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 ...

Armed with this clear understanding of the legislative history of Bankruptcy Code §365(b)(3)(c), the Fourth Circuit Court of Appeals then squarely faced the conflict between §365(f)(1)--which contains a general invalidation of anti-assignment clauses--and §365(b)(3)(C), which the Fourth Circuit considered to be a "more specific provision that requires the assignee of a shopping center lease to honor a clause restricting use of the premises." Citing the general rule of statutory construction that a more specific statutory provision will control a general one, 367 F.3d at 243, the Fourth Circuit held that §365(b)(3)(C) effectively "trumps" §365(f)(1). Consequently, at least in the Fourth Circuit, the use restrictions contained in a shopping center lease will be enforced, and a debtor/tenant will be unable to assume and assign that shopping center lease to a non-conforming tenant.

The ruling in *Trak Auto* is especially interesting because there is nothing in §365 that makes §365(b)(3)(C) expressly superior to §365(f)(1). Certainly, Congress knows how to make one statute superior to another. For example, §365(d)(3) is made expressly superior to §503(b)(1) because §365(d)(3) states that it applies "*notwithstanding §503(b)(1) of this title.*" After its in-depth analysis of the legislative history behind §365(b)(3)(C), it is surprising that the Fourth Circuit did not consider the meaning or effect of Congress's *failure* to make §365(b)(3)(C) expressly superior to §365(f)(1), but instead simply resorted to rules of statutory construction to resolve the inherent conflict between the two provisions. Perhaps it was obvious to the Fourth Circuit that §365(b)(3)(C) *must* trump §365(f)(1), but other courts might have declined the invitation to use statutory construction for fear of judicially rewriting the Code, and thus might have ruled that this conflict between §§365(b)(3)(C) and 365(f)(1) is for Congress to resolve via an amendment to the Code.

Obviously, *Trak Auto* is very good news for shopping center landlords who want to enforce the restrictive-use clauses in their shopping center leases so that they can regain control over the leased premises or block the assignment of the shopping center lease to a tenant that would violate use and/or exclusivity provisions. Conversely, *Trak Auto* is bad news for shopping center tenants who may become debtors and find it more difficult than ever before to find viable assignees who satisfy the restrictive use clauses in their shopping center leases. Indeed, the paucity of satisfactory assignees (many of whom may be the debtor's competitors, who don't want to see the debtor/tenant survive the bankruptcy anyway) is likely to drive down the price that the debtor/tenant can get for the assignment of its shopping center leases. Consequently, if the other circuits follow the Fourth Circuit's opinion in *Trak Auto*, then shopping center tenants who file bankruptcy could lose the ability to reap the financial gain from assumption and assignment of their shopping center leases. This could be a significant loss to the debtor/tenant's bankruptcy estate, especially if the debtor/tenant enjoys below-market rental rates on its shopping center leases, or if the ***61** leases are valuable due to location or other factors. In the aftermath of *Trak Auto*, debtor/tenants will probably still bring motions to assume and assign the leases, and it will be up to the shopping center landlord to insist that the use restriction be honored. Once the shopping center landlord objects to the assignment and demands compliance with the restrictive use provisions, the debtor/tenant will have an "uphill slide" in jurisdictions that follow *Trak Auto*, and the shopping center landlords will get their desired result--control over the leased premises--once again. For the shopping center landlord, this outcome represents a long-desired trip to the "head of the line."

Footnotes

1 Bankruptcy Code §365(f)(1) states:

(f)(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired 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 under paragraph (2) of this subsection; except that the trustee may not assign an unexpired lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event.

2 Bankruptcy Code §365(e)(1) states:

(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

3 Bankruptcy Code §365(b) states, in pertinent part:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default, and

(C) provides adequate assurance of future performance under such contract or lease ...

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

(3) For the purposes of paragraph (1) of this subsection and paragraph (2)(B) of subsection (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--

(A) 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 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.

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