

How Are Shopping Center Leases Treated in Bankruptcy?

Creditor's Rights Toolkit

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This article will discuss the protections and obstacles for landlords when a tenant of a shopping center enters bankruptcy.

Section 365(b)(3) of the Bankruptcy Code provides special protections for landlords of shopping center leases, which often come into play when a tenant-debtor selling its assets seeks to assume and assign a lease to a potential buyer. These landlord-friendly protections apply only to shopping centers and require, among other things, a would-be assignee of a shopping center lease to remain in compliance with exclusivity and use provisions in shopping-center-wide agreements and co-tenant leases. Further, the assignee cannot upset the shopping center's tenant mix. These protections can help prevent tenant-debtors from assigning leases to undesirable tenants and are possible obstacles that a potential buyer of a debtor's lease must consider.

KEY ISSUES

WHAT IS A "SHOPPING CENTER" LEASE?

Not all nonresidential real property leases qualify as "shopping center" leases and whether a lease does qualify is a fact-intensive determination. Courts consider numerous factors, including, but not limited to, whether there is a single landlord among a combination of leases, whether there is a master lease, whether the tenants are engaged in commercial retail, and whether there is a common parking lot.

ENHANCED ADEQUATE ASSURANCE REQUIREMENTS

Whenever a debtor seeks to assume, or assume and assign, a contract or lease, the counterparty is entitled to receive "adequate assurance of future performance." For shopping center leases, the Bankruptcy Code expands what is needed to provide the landlord with adequate assurance:

- **Financial Condition of Tenant and Guarantors.** The debtor must provide assurance of the source of rent and other consideration to be paid under the lease. In addition, if the lease is to be assigned the financial condition and operating performance of the proposed assignee (and its guarantors, if any) must be similar to the financial condition and operating performance of the debtor (and its guarantors, if any) as of the time the debtor entered into the lease.
- **Percentage Rent.** Any percentage rent due under the lease must not decline substantially.

- **Radius, Location, Use and Exclusivity Provisions.** Assumption or assignment will be subject to all the provisions of the lease, and so the lease cannot be assumed or assigned if the proposed use will violate any terms of the lease, including any radius, location, use or exclusivity or use provisions, or any such provisions in any other lease, financing agreement or master agreement relating to the shopping center. These protections can lead to disputes over seemingly simple lease provisions.

For example, consider the case of a debtor seeking to assume and assign to a buyer a lease that has no use restrictions itself, but where the lease premises are in a shopping center where a co-tenant has a lease that provides that the co-tenant shall be the only grocery store in the shopping center. Obviously, the debtor cannot assign the lease if the assignee plans to operate a grocery store. What if the would-be assignee operates a deli? Would assignment run afoul of the exclusivity provisions simply because the deli sells food (even though it does not offer the full gamut of food that a grocery store would stock)? If the lease containing the restriction does not define the term “grocery store,” this could become a fact-intensive, evidentiary issue that could even require industry experts to resolve.

Further, not all use or exclusivity provisions are enforceable, as the Bankruptcy Code’s prohibition on blanket anti-assignment provisions in leases still applies to shopping center leases. An overly strict use restriction or exclusivity provision could be considered a *de facto* anti-assignment clause and not be enforceable against a potential buyer, if it would effectively preclude an assignment to any buyer at all. For example, if debtor Acme Hardware Co. wants to assign its lease to a buyer, and the lease contains a use restriction providing that the premises can only be used to operate an Acme Hardware Co. store, the use restriction is a *de facto* anti-assignment clause that the debtor and buyer can safely conclude will be unenforceable. However, if the use restriction were broader — allowing only the operation of a hardware store — the provision is likely enforceable.

Finally, some courts have ruled that provisions in third-parties’ leases or other agreements that post-date the shopping center lease the debtor wants to assign cannot be considered when determining if the lease can be assigned. These courts reason that the terms of a deal made following the original tenant’s entry into the lease cannot be retroactively imposed on the debtor and would-be assignee.

- **Tenant Mix.** Assumption or assignment of a shopping center lease must not “disrupt any tenant mix or balance” in the shopping center. Unfortunately, the Bankruptcy Code does not define or provide guidelines for what constitutes a tenant mix or tenant balance or disruption thereof, leaving courts across the country to develop their own standards. Some courts have found that it is the burden of a landlord opposing assignment to show there was an intent to establish a tenant mix, and that such intent is demonstrated by reference to specific provisions in the lease in question pertaining to tenant mix.

TAKEAWAY

The protections for shopping center landlords contained in section 365(b)(3) can lead to complex issues for landlords and would-be buyers alike. Landlords should be aware that while the protections in section 365(b)(3) can often assist them in blocking assignment to an unwanted tenant, the protections are not absolute and might be overcome. Buyers should anticipate these issues when bidding on leases being sold by a debtor by asking to examine not just the leases being acquired, but the leases of co-tenants or master leases to the extent available, for relevant restrictions, and being prepared to argue why assignment of the lease does not violate section 365(b)(3). In both cases, experienced bankruptcy counsel is vital to navigating this complex, and potentially litigious, area of bankruptcy law.

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