

Bankruptcy, a Landlord's Perspective
Part 4: Assignment of Leases and Practical Business Advice: The Final Frontier

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Assignment

A third alternative available to a debtor is assignment of its lease. For a lease to be assigned, all requirements for assumption of the lease apply.^{1 2}

One element which clearly cannot be satisfied by the debtor upon a proposed assignment is the requirement to provide adequate assurance of the lease. In an assignment situation, this element must be satisfied by proposed assignee.³ The Code specifically addresses adequate assurance of future performance in the context of a shopping center and requires:

1. that the financial condition of the proposed assignee is similar to the financial condition of the debtor as of the time the debtor entered the lease⁴;
2. that any percentage rent due under the lease will not decline substantially⁵;
3. that assignment of the lease is subject to all provisions of the lease and will not breach any provisions in any other leases or financing agreements relating to the shopping center⁶;
4. that assignment will not disrupt any tenant mix or balance in the shopping center⁷.

Many times landlords include provisions in their leases which prohibit the assignment of a lease. The practitioner must caution the landlord, however, that in the bankruptcy arena, those clauses are invalidated by the Bankruptcy Code.⁸ Creative drafting in favor of the landlord may not overcome the Code's prohibition on anti-assignment clauses. For example, clauses which have been deemed anti-assignment clauses and thus invalidated include: (1) an increase in rent upon assignment; (2) a requirement to pay the landlord a portion of the purchase price of the lease to the landlord; (3) a provision granting the landlord the right to first refusal in connection with an assignment.⁹

¹ 11 U.S.C. § 365(f)(2)(A)

² Part 3 of this article, published in the November 2004 *Paraclete*, discussed assumption in detail. Assumption requires the debtor to (1) obtain court approval; (2) cure defaults or provide adequate assurance of a prompt cure; (3) compensate or provide adequate assurance of prompt compensation of the landlord for pecuniary losses; and (4) provide adequate assurance of future performance. 11 U.S.C. § 365(a); 11 U.S.C. § 365(b)(1)(A-C).

³ 11 U.S.C. § 365(f)(2)(A)

⁴ 11 U.S.C. § 365(b)(3)(A)

⁵ 11 U.S.C. § 365(b)(3)(B); *In re Rickel Home Centers, Inc.* 240 B.R. 826 (Bankr. D. Del. 1998)

⁶ 11 U.S.C. § 365(b)(3)(C); *In re Rickel Home Centers, Inc.* 240 B.R. 826 (Bankr. D. Del. 1998)

⁷ 11 U.S.C. § 365(b)(3)(D); *In re Federated Department Stores*, 135 B.R. 941 (Bankr. S.D. Ohio 1991)

⁸ 11 U.S.C. § 365(f)(1) and (3).

⁹ *In re David Orgell*, 117 B.R. 574 (Bankr. C.D. Ca. 1990); *In re National Sugar Refining Co.*, 21 B.R. 196 (Bankr. S.D.N.Y. 1982); *In re Mr. Grocer*, 77 B.R. 349 (Bankr. D.N.H. 1987)

A recent opinion which could be characterized as a “victory” for shopping centers landlords was issued by the Fourth Circuit in *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004). The lease in *Trak Auto* limited the use of the space 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. No companies bid on the lease whose sales conformed to this provision. The highest bidder was a discount clothing store. The landlord objected to the assignment of the lease to the clothing store, citing the restrictive provision. The bankruptcy court held that because no auto retailer bid on the lease, the market had effectively transformed the provision into an anti-assignment provision in violation of 11 U.S.C. § 365(f)(1). Accordingly, the bankruptcy court approved the assignment, which was affirmed on appeal, but overturned by the Fourth Circuit.

The Fourth Circuit took a different approach and recognized that the dispute actually involved two conflicting provisions of the Bankruptcy Code, §365(b)(3)(C) and 365(f)(1). The court, after careful consideration of the legislative history of § 365, held that the more specific statutory language of §365(f)(1) controlled over the general language of § 365(b)(3)(C). Thus, at least in the Fourth Circuit, a shopping center landlord faces less risk that provisions of its lease will be overcome by the Bankruptcy Code. Whether other circuits will follow the Fourth Circuit’s lead remains to be seen.

Generally, the assignment process is as follows: The debtor prepares bid guidelines which are subject to court approval. The landlord has the opportunity to object to those guidelines. Bids are made which commonly include a list of provisions of the lease which need to be modified and/or nullified. The debtor then reviews the bids and may either object to the assignment or file a motion to assign the lease. The landlord is then given the opportunity to object to the proposed assignment and the bankruptcy court issues a ruling.

Final Thoughts

Part IV concludes our general discussion of a landlord’s perspective of a tenant who files bankruptcy. In summary, upon the bankruptcy filing, the debtor has the option of treating the lease three ways: (1) rejection; (2) assumption; and (3) assignment. Each option has both practical and legal consequences which the landlord must consider. In our experience, the treatment of leases is somewhat different in every bankruptcy and is controlled by numerous factors including the number of leases held by the debtor, the complexity of the debtor’s chapter 11 case, the time remaining on the lease, the structure of the lease, the bankruptcy court’s latitude in allowing the debtor to extend the time in which it decide what to do with the lease, etc.

In our tumultuous economy, a landlord will likely confront a bankruptcy tenant. In order to better protect itself, a landlord may want to consider pre-bankruptcy protections such as: (1) requiring a third-party guarantor on the lease; (2) limiting the term of the lease; and (3) terminating the lease of a tenant who is financially distressed pre-petition. Additionally, post-bankruptcy the landlord should (1) obtain advise of bankruptcy counsel (2) consider rent concessions based on numerous variables including (a) the value of the tenant; (b) the demand for the space in the market; (c) whether the tenant will reject the lease if the landlord does not

compromise; and (3) file a proof of claim and administrative claim in the maximum amount permitted under the Code.

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