
HARDWARE EMPORIUM
HARDWARE EMPORIUM
GRAND OPENING
CTRONICS
RLD
ELECTR
WORL
LICHT

ASSIGNMENTS OF RETAIL LEASES IN BANKRUPTCY, PART 1

What's Left of the Lease?

By Susan G. Talley and Harris Ominsky

When negotiating a retail lease—and in particular a lease for space in a shopping center—a landlord will insist on many lease provisions that are critical to it besides rent. A sophisticated landlord reasonably expects that a tenant bankruptcy can cause both an interruption in its rental income stream and delays while the tenant (as debtor in possession) or its trustee decides whether to accept or reject the lease. If the tenant rejects the lease, then the landlord is left with vacant space and a limited damage claim in the tenant's bankruptcy proceeding. What the landlord may not expect is for the lease to be assumed by the debtor and then assigned to another party without the assignee's being bound by key nonmonetary provisions that the landlord negotiated in its lease.

As a result of current case law, a landlord may be in for some unexpected surprises in a retail tenant's bankruptcy. A landlord may be left with a binding lease, but without the nonmonetary protections it negotiated and with a tenant the landlord does not want. This result is becoming even more prevalent in bankruptcies of large retailers, in which auctions of the debtors' "designation rights" are taking place. Landlords, however, are not without hope.

This article is one of a two-part series. The first article will describe the kinds of nonmonetary lease clauses that an assignment in bankruptcy can affect. There will then be an overview of Bankruptcy Code § 365, which governs assignments of leases in bankruptcy, and a review of various reported decisions addressing assignments of leases and the effect on nonmonetary lease clauses, with a focus on the seminal case of *In re Rickel Home Centers, Inc.*, 240 B.R. 826 (D.C. Del. 1998).

The second article, which will appear in the magazine's March / April issue, will discuss the use of designation rights auctions in retailer bankruptcies and the recent Fourth Circuit decision in *In re Trak Auto*, 367 F.3d 237 (4th Cir. 2004), which is very favorable to landlords. The second article will conclude with some suggestions for landlords.

Susan G. Talley is a member of the New Orleans, Louisiana, firm of Stone Pigman Walther Wittmann L.L.C. She is a member of the Section Council and former Editor of *Probate & Property*. Harris Ominsky is in the Philadelphia office of Blank Rome LLP.

Max Licht

Key Nonmonetary Clauses

Besides rent and term, a retail lease may include a number of provisions that are very important to a landlord and for which the landlord may have vigorously negotiated, such as:

- the particular identity of the tenant,
- restrictions on assignment and subletting, including provisions calling for the tenant to pay the landlord a percentage of any net profits generated by the assignment or sublease,
- landlord rights of first refusal and recapture in connection with an assignment or sublease,
- use restrictions,
- radius restrictions limiting the tenant's ability to operate a competing store nearby,
- percentage rent clauses providing for additional rent based on a percentage of gross sales,
- operating covenants requiring that the tenant continuously operate and prohibiting the tenant from "going dark" except in limited circumstances,
- provisions governing alterations and improvements to the premises and requiring the landlord's consent to changes, and
- provisions governing the tenant's signage.

For ease of discussion, this article will refer to these and similar provisions as "key nonmonetary clauses."

Bankruptcy Code § 365(b)

Bankruptcy Code § 365 governs a debtor tenant's rights to assume or reject a lease. Code § 365(b)(1) provides, in essence, that a trustee may not assume an unexpired, defaulted lease unless the trustee:

> (A) cures, or provides adequate assurance that [it] will promptly cure, such default;

> (B) compensates, or provides adequate assurance that [it] will promptly compensate . . . [the other party] for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such . . . lease.

Code § 365(b)(2) then provides that Code § 365(b)(1) does not apply to 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. . . .

The provisions listed in Code § 365(b)(2) are commonly referred to as ipso facto clauses and are clearly unenforceable in bankruptcy.

Code § 365(b)(3) creates an important rule intended to protect shopping center owners (the "Shopping Center Rule"). It provides that adequate assurance of future performance of a shopping center lease 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.

Bankruptcy Code § 365 (b)(3) (emphasis added).

Code § 365(f)(1) and (2) purport to invalidate so-called anti-assignment clauses by providing that "notwithstanding a provision in an . . . unexpired lease of the debtor . . . that *prohibits, restricts, or conditions the assignment of such . . . lease,* the trustee may assign such . . . lease" (emphasis added) if:

> (A) the trustee assumes such . . . lease in accordance with the provisions of this section; and
>
> (B) adequate assurance of future performance by the assignee of such . . . lease is provided, whether or not there has been a default in such . . . lease.

Code § 365(f)(3) then states:

> Notwithstanding a provision in an . . . unexpired lease . . . of the debtor, or in applicable law that terminates or modifies, or *permits a party other than the debtor to terminate or modify, such . . . lease* or a right or obligation under such . . . lease *on account of an assignment of such . . . lease,* such . . . lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such . . . lease by the trustee.

Bankruptcy Code § 365(f)(3) (emphasis added).

In all of these provisions, references to the trustee include a debtor in possession.

Although Code § 365(b)(3) would appear to give shopping center owners a certain amount of comfort in a tenant bankruptcy, bankruptcy courts have been reading Code § 365(f) broadly to override, as "de facto" anti-assignment provisions, just the kinds of clauses that the Shopping Center Rule is supposed to protect.

Rickel

The case of *In re Rickel Home Centers, Inc.,* 240 B.R. 826 (D.C. Del. 1998), affirmed on grounds of mootness, 209 F.3d 291 (3d Cir.), cert. denied, 531 U.S. 873 (2000), is a good starting point for discussion. *Rickel* involved a debtor home improvement store that sought bankruptcy court approval to sell 41 of its leases to Staples for a total of $35.5 million. The agreement provided that leases could be subsequently assigned to a nominee, which the parties testified would be a Staples affiliate. *Rickel* technically did not involve a sale of designation rights, primarily because the assignments were to one initial end user—Staples. Nevertheless, given the number of stores, differing landlords, and varying lease provisions, the *Rickel* court addressed many of the same issues arising in the designation rights cases.

As part of the court-approval process in *Rickel,* various objections to the sale terms were settled with a number of landlords. Three of the affected landlords, however, did not settle. They argued that the sale would violate various restrictions in their leases because the sale would**,** among other things:

- cause the stores to be closed for a period of time,
- violate use restrictions in the leases,
- require subdividing the leased premises and subletting excess space not used by Staples,
- disrupt the tenant mix because the stores would "go dark" for a period of time, and
- cause a loss of percentage rent.

In approving the sale, the court cited Code § 365(f)(1) for its anti-assignment provisions. It stated that the Shopping Center Rule must be read in conjunction with the anti-assignment prohibitions of Code § 365(f). The court found that Code § 365(f) bans not only lease provisions that specifically prohibit assignment but also lease provisions that are so restrictive that they constitute de facto anti-assignment provisions. It concluded that the provisions asserted by the landlords were de facto anti-assignment provisions.

Use Restrictions. The landlords had raised varying degrees of objections that the proposed sale to Staples violated use restrictions in their leases. One limited its objection to a potential use other than a Staples. Another objected even to a Staples. The court accepted the debtor's testimony that the type of home improvement center operated by Rickel would either become obsolete or would struggle to compete against stores like Home Depot. It stated that the lessors offered no evidence to rebut the debtor's position. Given the market conditions, the court found the use clauses were anti-assignment provisions.

Altering/Dividing Space. The court found that restrictions on altering and dividing the space were "nuisance" provisions that should not be used to thwart an assignment of the leases. One landlord, Vornado, had argued that the consent provisions on alterations were more substantive and should be read in the context of the use restrictions. The court noted that Vornado, in fact, had eight Staples stores in other locations. The court indicated that Vornado's concerns about alterations were disingenuous. Another landlord argued that a smaller store would not serve as an anchor to its center. In rejecting that claim, the court accepted the debtor's evidence that Staples stores did serve as anchors to a number of shopping centers.

Tenant Mix. Two of the landlords argued that changing the use of the premises would disrupt the tenant mix of their centers. The third landlord argued that allowing the premises to remain dark during the renovations (in violation of a continuous operations clause) would disrupt the tenant mix of the center. As to the use restrictions, the court fell back on its earlier conclusions. The court also found it was reasonable to go dark for the limited period of time necessary to complete the alterations. Testimony indicated it would take about six months for a Staples store to become operational. The court did not find that period of time so unreasonable as to affect the use or disrupt the tenant mix.

Percentage Rent. One landlord argued that an assignment to Staples would cause a substantial decline in percentage rent. It argued that other tenant percentage rents in the shopping center would drop because Staples would not be as much of a draw. The court refused to look at other tenants' percentage rents. Staples had also submitted evidence that the debtor had not been paying percentage rent, so that percentage rent for the leased premises would not substantially decline by reason of an assignment to Staples.

Financial Condition of Assignee. One landlord argued that Staples had not submitted sufficient evidence of its financial condition. At the hearing, Staples offered evidence of its financial condition, which the court found sufficient to meet the lease obligations.

The court did give the landlords some relief. It:

- reserved the landlords' rights to pursue Staples if Staples acted to violate other "reasonable" lease provisions in violation of Code § 365,
- made it clear that, in its approval of partitioning the space into smaller stores and subleasing, it did not authorize further partitioning or subleasing for future tenants, and
- left open the landlords' ability to enforce use restrictions if they were necessary to protect other shopping center tenants' exclusive rights.

Other Case Law

The *Rickel* case is not an aberration. As evidenced by other reported decisions, bankruptcy courts have tended to find key nonmonetary clauses as de facto anti-assignment clauses and to allow retail debtor/tenants to assign or sublet. A few illustrative

A TYPICAL LANDLORD AND ITS COUNSEL MIGHT NOT SEE A USE RESTRICTION AS NECESSARILY A RESTRICTION ON ASSIGNMENT.

decisions, organized by types of key nonmonetary clauses, follow.

Landlord Consent to Assign/Sublet

Lease restrictions on assignment and subletting come in a variety of forms, ranging from absolute bans to requirements for a landlord's consent, which might be withheld in the landlord's sole and absolute discretion, to requirements for a landlord's consent, which might not be unreasonably withheld, to landlord consent provisions conditioned on a number of somewhat objective criteria such as the tenant's financial condition, reputation, and proposed use. Are all of these clauses anti-assignment provisions? Some cases seem to suggest so.

For example, in the case of *In re Bradlees Stores, Inc.*, Nos. 00-16033(BRL), 00-16035(BRL), 00-16036(BRL), 01-CV-3934, 2001 WL 1112308 (S.D.N.Y. Sept. 20, 2001), the court dealt with a lease-assignment clause. In the debtor's first bankruptcy, the bankruptcy court approved a settlement among a lessor, lessee, and the debtor sublessee to resolve a dispute over the primary lease and the debtor's sublease. The court-approved settlement made the sublease subject to the terms and conditions of the primary lease, including a use restriction (use only as a department store) and a restriction on assignment without lessor consent, except to certain affiliates and similar successors (it is not clear from the case whether a reasonableness standard applied). The debtor filed a second bankruptcy proceeding after financial difficulties kept it from consummating its prior plan of reorganization. In the second bankruptcy, the court approved an assignment of a number of lease rights (including the sublease) to a third party (to act like a broker) for purposes of further assignments to ultimate users. The court found that the settlement was an executory contract, held that the restrictions on assignment violated the anti-assignment provisions of Code § 365(f), and allowed the debtor to assign the sublease as contemplated.

Use Restrictions

A typical landlord and its counsel might not see a use restriction as necessarily a restriction on assignment. When the landlord has demonstrated real harm if the use restriction is ignored, the courts have shown some restraint in approving assignments. This article will discuss cases leading up to the landlord-favorable decision in *Trak Auto*. The second article in this series will contain a discussion of *Trak Auto*.

IT IS COMMON FOR A LANDLORD TO NEGOTIATE FOR KEY NONMONETARY CLAUSES THAT OBLIGATE A TENANT TO MAINTAIN A PARTICULAR NET WORTH, ACHIEVE A CERTAIN LEVEL OF SALES, OR MEET OTHER FINANCIAL TESTS.

In re Federated Department Stores, Inc., 135 B.R. 941 (Bankr. S.D. Ohio 1991), dealt with an assumption and assignment of a lease from a retail department store to a "specialty" department store geared toward the cost-conscious customer. In this case, the court found that the Federated store was an anchor store of a shopping center. The court did not approve the assignment, finding that it would disrupt the tenant mix by changing the image of the shopping center, would require subdivision of the space, and would leave part of the space dark until another tenant was found. In reaching its conclusion, the court stressed that an anchor store has a major effect on the entire shopping center.

The *Federated* decision is distinguishable from the *Rickel* case in several respects. In *Federated*, the landlord presented very specific arguments why a "specialty" department store would frustrate the long-term goals of the shopping center to appeal to a more upscale clientele. In contrast, the *Rickel* court found that Staples would not hurt the tenant mix and that the landlord's objections appeared "disingenuous." Also, for at least one of the *Rickel* leases, the contract rent payments were significantly lower than then-current fair market rent. That landlord stood to make a large profit if it could prevent the lease assignment.

In the case of *In re Paul Harris Stores, Inc.*, No. 91-2100-RLB-11, 1992 Bankr. LEXIS 2418 (Bankr. S.D. Ind. Feb. 14, 1992), the court allowed the assignment of leases for women's apparel stores to a maternity apparel store chain. The court found that lease provisions requiring the tenant to operate under the name "Paul Harris" were de facto anti-assignment provisions and that other lease restrictions, including a provision restricting the use to selling "women's apparel," would not be violated by the proposed assignment. The court looked at testimony and the mall's own brochures to determine that maternity apparel was women's apparel.

The case of *In re Martin Paint Stores*, 199 B.R. 258 (Bankr. S.D.N.Y. 1996), aff'd, *Southern Blvd., Inc. v. Martin Paint Stores*, 207 B.R. 57 (S.D.N.Y. 1997), involved a paint store in a three-story commercial building. A ladies' dress shop was located in the street level of that building. The lease for the dress shop included an exclusive use clause for ladies' clothing. Martin sought to assume and assign its lease to another ladies' dress shop. After first finding that the premises were not located in a shopping center, the court permitted the assumption and assignment without imposing the use restriction.

By allowing the assignment, the court put the landlord at risk of defaulting under its other lease. If another tenant's lease is breached, then who has liability for the breach? The landlord who is acting under a court order? The debtor's bankruptcy estate? The new assignee?

In the case of *In re Sun TV and Appliances, Inc.*, 234 B.R. 356 (Bankr. D. Del. 1999), the debtor proposed a temporary assignment of an outparcel ground lease to a third party to "shop" the lease, with no specific use proposed. The court found that the proposed assignment would violate the use restriction in the lease and that the use clause in the lease did not violate the Bankruptcy Code anti-assignment rules. Therefore, the proposed assignment was not permitted. It is interesting that the proposed assignment in *Sun TV* was very similar to the sales of designation rights that will be described in the second article of this two-part series. In *Sun TV*, however, it appears that only one ground lease was involved.

The case of *In re J. Peterman Co.*, 232 B.R. 366 (Bankr. E.D. Ky. 1999), involved a use restriction and a 60-mile radius restriction. The use clause specifically required use of the "J. Peterman" brand name. The proposed assignee, a children's clothing retailer, did operate stores within the 60-mile radius. The proposed assignee did not and would not operate under the name "J. Peterman" or sell similar merchandise. The bankruptcy court denied approval of the assumption and assignment. The court looked at the tenant mix of the shopping center in which the space was located. It also found that the radius restriction was reasonable for the relevant market and was not in violation of the Bankruptcy Code anti-assignment rules. In this case, the court seemed to give more weight to the Shopping Center Rule than to the anti-assignment rules of Code § 365(f).

Continuous Operations/Going Dark

Having a shopping center store, especially an anchor store, go dark can be a devastating event for a landlord. Although the courts have tended not to allow a complete closure of a store in violation of a continuous operations clause, they have allowed partial closures or closures for what are deemed reasonable periods of time to allow assignment, renovation, refixturing, restocking, and the like.

The case of *In re Goldblatt Bros., Inc.,* 766 F.2d 1136 (7th Cir. 1985), did not involve an assignment, but illustrates a bankruptcy court treatment of a continuous operations covenant. There, the debtor / lessee sought to assume an unexpired lease. The debtor proposed closing for two months for renovation and planned to discontinue using its second floor (about 50% of the leased premises). By downsizing, the debtor would likely not pay percentage rent. The court found that, as long as the debtor / lessee did not violate any explicit provisions of the lease, the temporary closure and discontinuance of use of the second floor would not violate the operating covenant. The court allowed the debtor / lessee to assume the lease. The operating covenant in this lease did refer to operating "without interruption," but apparently did not specifically reference *all* of the leased premises. It is important to note that the *Goldblatt* court did not find sufficient evidence that a shopping center was involved and did not apply the Shopping Center Rule.

In *Connellsville Plaza v. Jiffy Foods Corp.,* 92 B.R. 136 (W.D. Pa. 1988), the lease authorized the lessee to make improvements to the leased premises. The proposed assignee (a new entity formed by shareholders of the debtor) needed to close 60 days for remodeling. As a result of lengthy appeals, the premises were vacant for a considerably longer period of time. The court found that there would be no breach of the lease by the assignee's temporary closure.

Minimum Sales Levels/Financial Tests

It is common for a landlord to negotiate for key nonmonetary clauses that obligate a tenant to maintain a particular net worth, achieve a certain level of sales, or meet other financial tests. Questions have been raised by bankruptcy debtors about whether these provisions are de facto anti-assignment clauses.

In the case of *In re Joshua Slocum, Ltd.,* 922 F.2d 1081 (3d Cir. 1990), the debtor's lease included a minimum sales requirement that was averaged over a six-year period. Either party could terminate the lease if the sales did not meet the requisite test after either three or six years. The debtor / lessee's trustee sought to assume and assign the lease without the minimum sales requirement. The trustee argued that it would be unlikely for any new store to be able to meet the average in the short period of time left on the six-year window. After first finding that the premises were located in a shopping center, the court found that the landlord could enforce the minimum sales requirement against subsequent tenants. In doing so, the court emphasized that Congress intended for bankruptcy courts to be very sensitive to the contractual rights of nondebtors when applying Code § 365(b)(3).

The relevant lease was signed in 1983 and the events leading up to the case took place in 1989. It is not entirely clear from the reported decision how the court would enforce the three- and six-year tests against the assignee or even a further assignee. For example, would a new period of time start to run on the assignment?

The case of *In re R&J, Inc.,* 140 B.R. 316 (Bankr. D. Mass. 1992), affords an interesting analysis. *R&J* involved the existing debtor / tenant's assumption of its own Faneuil Hall restaurant lease. An assignment was not involved. The lease included a percentage rent clause. In reaching its decision to permit the assumption by the debtor / tenant, the court looked at the tests for analyzing a prospective assignee under Code § 365(b)(3)(A) and for reviewing the debtor's percentage rent under Code § 365(b)(3)(B). As cited above, Code § 365(b)(3)(A) requires a proposed lease assignee (and its guarantors, if any) to have a similar financial condition and operating performance as did the debtor (and its guarantors, if any) *at the time the debtor became the lessee under the lease.* Code § 365(b)(3)(B) is the test for percentage rent under the Shopping Center Rule. The percentage rent test of Code § 365(b)(3)(B) states that "any percentage rent due under such lease will not decline substantially."

The landlord in *R&J* argued that the approach of Code § 365(b)(3)(A)—looking to the time the debtor first became a lessee—should likewise apply to the test for percentage rent under Code § 365(b)(3)(B). The court did not accept that argument. It is interesting that the court did not address the language in clause (B) of the Shopping Center Rule that percentage rent is not to "decline substantially." It would seem that language, which defines, in part, adequate assurance of future performance, should apply to a simple debtor assumption, as well as to an assumption and assignment.

Share of Net Profits on Assignment/Sublease

A lease may require a tenant to share with the landlord any profits that the tenant gains in assigning the lease or subletting the premises. Those clauses discourage a tenant from assigning or subletting purely to take advantage of a rising market. Bankruptcy courts have consistently found these provisions to be de facto anti-assignment clauses.

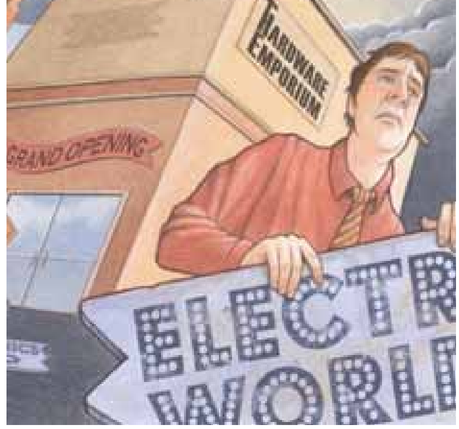
In the case of *In re Boo.com North America, Inc.,* No. 00-15123 (JHG), 2000 WL 1923949 (Bankr. S.D.N.Y. Dec. 15, 2000), the lease required the lessee to pay the landlord 100% of the profit generated by a lease assignment or sublease. The court held that was a de facto anti-assignment provision. See also *In re Office Products of America, Inc.,* 140 B.R. 407 (Bankr. W.D. Tex. 1992) (invalidating lease provision requiring tenant to pay over sale proceeds from any lease assignment); *Robb v. Schindler*, 142 B.R. 589 (D. Mass. 1992) (invalidating a requirement to pay the landlord 80% of profits from an assignment or sublease); *In re Standor Jewelers West, Inc.*, 129 B.R. 200 (B.A.P. 9th Cir. 1991) (invalidating a requirement to pay the landlord 75% of the profit resulting from an assignment, even though valid under state law).

In re Jamesway Corp., 201 B.R. 73 (Bankr. S.D.N.Y. 1996), involved three leases. One had a 50% (at a certain point increasing to 60%) profit-sharing provision. The other two leases granted the landlord one-third of any profits on assignment. The court found that all three provisions, including those only requiring a one-third share, violated the anti-assignment rules. It is interesting that the *Jamesway* court found a share as low as one-third to constitute a de facto anti-assignment provision.

Is that share of profits (or an even lower share) really a burden on assignment or a "termination" or "modification" of the lease "on account of" the assignment within the meaning of Code § 365(f)? What if the lease makes it clear that the landlord's minority share is net of all assignment costs? Do these cases suggest that a landlord will never be allowed to share in any profits on an assignment in bankruptcy? In these cases, the courts may be trying to maximize the value of the assignment to the debtor's estate but clothing their reasoning in the provisions of Code § 365(f).

A different but similar tactic a landlord might try is to increase rent on an assignment of the lease. In many instances, a landlord might grant rent concessions to a particular tenant for other reasons. For example, the tenant may have multiple leases with the same landlord or other dealings that would justify a lower rent.

In the case of *In re David Orgell, Inc.*, 117 B.R. 574 (Bankr. C.D. Cal. 1990), the debtor / lessee operated several high-end silver, crystal, and china shops in California. The debtor sought to assign the lease for its Rodeo Drive location. The lease in question included a provision that the rent would increase to then-current market rates if the lease were ever assigned. The court found



the rent increase invalid under Code § 365(f)(3). The court concluded that Congress had adopted a policy favoring assumption and assignment of contracts as a means of assisting debtors. Any rent increase clause tied to an assignment of a commercial lease would be unenforceable under Code § 365.

In light of the existing cases, there can be no assurance that a bankruptcy court will protect any clause that may appear to be a deterrent to assignment or appear to provide additional income to a landlord on assignment. If, however, the lease formula provides a fair share of profits to a landlord, a court might support it. A court might also enforce reasonable review and processing charges or legal fees or legal fee provisions that compensate a landlord for the inevitable time and expense of reviewing a proposed assignment or sublease.

Rights of First Refusal/Recapture

In conjunction with requirements for assignments and subleases, it is also typical for a landlord to negotiate a right of first refusal or a right to "recapture" the premises if the tenant proposes to enter into an assignment or sublease. These provisions do not prohibit assignments or subleases. They simply require that the tenant give the landlord the first chance to gain back the premises. By and large, the courts have still found these provisions to be de facto anti-assignment clauses.

In the case *In re Mr. Grocer, Inc.*, 77 B.R. 349 (Bankr. D.N.H. 1987), the lease granted the landlord a right of first refusal if the lessee proposed to assign the lease. The right of first refusal extended to assignments by operation of law. The court found that the landlord's right of first refusal violated the anti-assignment rules of the Bankruptcy Code. In reaching that result, the court first suggested that any condition on assignment would violate the anti-assignment rules. It then noted the chilling effect a right of first refusal has on third-party bids. Would the court have reached the same conclusion if the landlord had retained only a right of first offer? A right of first offer would not seem to have the same "chilling effect" on assignment.

The court in *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45 (Bankr. M.D.N.C. 2003), reached a different result from the court in *Mr. Grocer*. The *E-Z Serve* affiliated debtors operated convenience stores throughout the United States at a variety of owned and leased locations. The Chapter 11 trustee conducted an auction sale of a number of the leased locations. Hartrampf was the lessor of the site known as "Store 48." He also owned the property across the street on which one debtor's Store 68 was located. The lease for Store 48 included a right of first refusal. Without knowledge of the right of first refusal, another party, Hewatt, submitted a bid for Store 48 in the amount of $250,000. That bid was part of a larger "all or nothing" bid by Hewatt on a group of stores. The lessor, Hartrampf, also participated in the auction and placed a bid of $301,000 for Store 48. The trustee nevertheless accepted Hewatt's bid and Hartrampf objected.

In this case, the court enforced the lessor's right of first refusal and rejected the rationale of *Mr. Grocer*. The court applied a three-pronged test:
(1) the extent to which the lease provision hampers a debtor's ability to assign,
(2) whether the provision would prevent the bankruptcy estate from realizing the full value of its assets, and (3) the economic detriment to the nondebtor party. Here, the court agreed with the lessor's evidence of economic detriment. The lessor demonstrated that the right of first refusal was bargained for and agreed to as a material element of the lease and in consideration of below-market rent.

The court also considered Hartrampf's argument that an inappropriate use of the Store 48 site could put him in breach of radius restrictions he committed to in the Store 68 lease. The court found that the right of first refusal would not burden or restrict future assignments of the lease.

The court further noted that a right of first refusal did not limit bidding on Store 68 nor did it compel a sale at a price below what might be offered in the open market. Finally, the court determined that Hartrampf's higher bid would yield value to the estate.

Rights Personal to Lessee

It is not unusual for a lease to provide that certain rights, such as renewal options, are personal to the initially named lessee and may not be exercised by an assignee or sublessee. The case of *Double K Properties, LLC v. Aaron Rents, Inc.*, No. 1:03CV00044, 2003 WL 21657914 (W.D. Va. July 15, 2003), involved a lease with an option to renew that was stated to be personal to the original tenant, Helig-Meyers Furniture Company. In its bankruptcy, Helig-Meyers assigned the lease to Aaron Rents. Aaron Rents then exercised the renewal option contained in the lease.

In response to the landlord's objections, and on cross motions for summary judgment, the court ruled that Code § 365(f) invalidated the lease provision purporting to make the renewal right personal to the original tenant. The court found that the provisions of Code § 365(f) must be read in conjunction with the provisions of Code § 365(b)(3). The court found that the language in question did "modify" the lease "on account of assignment," bringing it within the ambit of Code § 365(f)(3). Of course, if simply naming lessee rights as personal in the lease could move those provisions outside the ambit of Code § 365(f), then landlords would be tempted to make all lease provisions "personal" to the originally named tenant.

Conclusion

As the cases described in this article demonstrate, bankruptcy courts have tended to decide lease assignment cases so as to facilitate assignments and subleases and bring value to the debtor's estate. The use of designation rights in large retail bankruptcies has brought even more insecurity to landlords, as will be described in the second article.

Landlords, however, are not without protections. The Fourth Circuit decision in *Trak Auto*, discussed in the second part of this series in the March / April issue, may bring much needed relief to retail landlords. ■