

Assumption, Rejection or What's Behind Door No. 3: What's a Landlord to Do About Sales of Leases in a Retail Chapter 11 Bankruptcy?

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The recent surge in retail bankruptcy filings often leaves commercial landlords in the frustrating position of waiting until their debtor-tenant decides whether to assume or reject an unexpired lease. Assumption, with its attendant cure of past defaults, is often met with a sigh of relief. Rejection, on the other hand, may leave a landlord scrambling to find a tenant to fill suddenly vacated space. But some very recent chapter 11 debtors, including Toys “R” Us and The Bon Ton Stores, have even added some additional twists to this often frustrating scenario. First, they delay assumption-rejection decisions until after they know if the sale of their assets, including unexpired leases, will be to an operating or a liquidating buyer, often leaving previously negotiated lease modification agreements in limbo. Then, if the buyer is of the liquidating kind, this will mean that the debtors’ rights under their leases are in the hands of such third parties, who will have their own agendas, motivations and strategies. This panel will (i) explore the various issues facing commercial landlords caused by these debtor strategies, (ii) discuss the options available when confronted with these strategies, and (iii) identify ways in which commercial landlords may use these strategies to their own advantage.

Assumption, Rejection or What's Behind Door No. 3: What's a Landlord to Do About Sales of Leases in a Retail Chapter 11 Bankruptcy?

As 2017 came to a close, many landlords hoped that the worst was over. 2017 saw a record number of retail Chapter 11 filings; familiar names such as Payless Shoes, The Limited, hhgregg, Toys r Us and Gymboree all sought protection under Chapter 11 of the Bankruptcy Code. Many of these companies dreamed of a successful reorganization, of being able to move forward and continue to provide goods and services to their faithful customers. Unfortunately, in many cases, these dreams turned to nightmares as a number of these iconic names disappeared from the retail landscape. Over 3,200 store locations store locations closed during 2017. Surely, landlords thought, 2018 would be better.

It was not to be. 2018 saw a continuation of the “Retail Apocalypse” as hopeful reorganizations turned to liquidations, and additional familiar names sought protection

under Chapter 11 of the Bankruptcy Code. Since the close of 2017, events related to big names in retail include:

- A. Toys R Us: Filed in September 2017 with hopes of a going concern sale that would allow it to move forward, albeit on a smaller scale. Ultimately, these hopes were dashed and Toys R Us closed all store locations and liquidated substantially all of its U.S. assets.
- B. Nine West: Closed all store locations and sold the Nine West brand. The company is attempting to reorganize its business around other owned brands including Anne Klein and Gloria Vanderbilt.
- C. Claire's: The discount jewelry retailer entered bankruptcy in March and confirmed a reorganization plan in October. Along the way, Claire's shuttered approximately 5,000 locations worldwide, including 150 in the United States.
- D. Tops: The grocery chain sought protection in February and exited bankruptcy in October after closing 15 store locations.
- E. Southeastern Grocery: The parent of the Winn-Dixie and Bi-Lo grocery chains exited bankruptcy in June. Over 100 store locations were closed during the pendency of the bankruptcy case.
- F. The Bon-Ton Stores: The more than century old department store chain began wholesale liquidation efforts shortly after filing bankruptcy in February, and ultimately closed all of its 250 store locations.
- G. Brookstone: The specialty retailer filed for bankruptcy protection in August and announced plans to close all of its 101 mall locations.
- H. Rockport: Shortly after filing its May bankruptcy filing, Rockport announced the closing of all of its stand-alone retail store locations. Rockport's brands and other intellectual property were ultimately sold to private equity firm Charlesbank Capital Partners.
- I. Mattress Firm: The Houston based sleep shop chain filed Chapter 11 on October 5th and, within several weeks, confirmed a pre-packaged plan of

reorganization that allowed it to exit bankruptcy by mid-November. During its brief stay in Chapter 11, Mattress Firm closed approximately 650 stores.

- J. Sears: The iconic retailer filed Chapter 11 on October 15. On January 17, 2019, Sears announced that ESL Investments, a hedge fund controlled by Sears' largest shareholder, Eddie Lampert, had prevailed in the auction for the iconic retailer's assets. ESL has announced its intention to continue operating approximately 425 stores under the Sears banner. To date, Sears has announced the closure of approximately 250 store locations.
- K. Gymboree: The children's clothing retailer filed its second Chapter 11 case in three years, and announced the closure of all its 900 store locations. Gymboree previously filed for Chapter 11 protection in 2017, when it closed 380 stores in an attempt to reorganize its business operations.

REASONS FOR RETAIL APOCALYPSE

While every case is unique, several themes have become apparent in this most recent surge of retail bankruptcies:

1. Decline of Physical Retail.

The "Amazon Effect". With the shift to e-commerce, fewer and fewer customers are shopping at big-box physical retailers and malls. Additionally, many of these iconic retailers have lost the cache they once had as new direct-to-consumer brands with a focus on specific products have taken off.

2. Digital Laggards.

A surprisingly large number of big-box retailers either failed or were too slow in establishing an online presence. With the rise of Amazon and digitally native direct-to-consumer brands, retailers that failed to adapt quickly to the new marketplace were unable to compete.

3. Mounting Debt.

Crippling debt, in many cases fueled by post-financial crisis leveraged buyouts by private equity firms, has forced many retailers into bankruptcy. Over 20% of all

retailers acquired by private equity firms over the last 15 years have filed bankruptcy.

4. Changes in Consumer Spending

Young people are spending less money on clothing and furnishings, and more on experiences they can post on social media such as travel and dining out. As Millennials are set to overtake Baby Boomers as the largest consuming class this trend is particularly alarming for the housewares and apparel industries.

5. Too Many Malls

Even before the e-commerce boom, the U.S. was considered over-stored. The U.S. has more than five times more retail space per person than France, Japan and the U.K. This was largely the result of investors pouring money into commercial real estate decades ago as the suburbs boomed. These buildings needed to be filled with stores, which resulted in the birth of big-box retailers. These big-box stores often served as anchors for the specialty retailers that fed off the mall traffic these anchors generated. As these anchors have sunk, they have often dragged their fellow mall tenants down with them.

Primarily as a result of the factors listed above, it is estimated that over 16,000 store locations have or will close since the beginning of 2018. While many of these store closings were unrelated to any bankruptcy filing, over 3,000 store locations were closed in connection with bankruptcy proceedings. Set forth below is a chart listing those stores closed as a result of recent bankruptcy filings:

Debtor	Filing Date	Court	Stores Closed
A’Gaci	January 9, 2018	W.D. Texas	25
Kiko USA	January 11, 2018	Delaware	25
The Bon-Ton Stores	February 4, 2018	Delaware	250
Tops	February 21, 2018	S.D.N.Y	15

The Walking Company	March 6, 2018	Delaware	25
Claire's	March 19, 2018	Delaware	150
Southeastern Grocery	March 27, 2018	Delaware	100
Nine West	April 6, 2018	S.D.N.Y	70
Bertucci's	April 15, 2018	Delaware	30
Rockport	May14, 2018	Delaware	75
Brookstone	August 2, 2018	Delaware	100
National Stores	August 6, 2018	Delaware	185
Samuel's Jewelers	August 7, 2018	Delaware	45
Toys R Us	September 18, 2017	E.D. Virginia	675
Mattress Firm	October 5, 2018	Delaware	650
Sears	October 15, 2018	S.D.N.Y	250
David's Bridal	November 19, 2018	Delaware	0
Gymboree	January 16, 2019	E.D. Virginia	900
Charlotte Russe Holding	February 3, 2019	Delaware	94
Things Remembered	February 6, 2019	Delaware	250

Filing Locations.

Interestingly, unlike 2017, when retail bankruptcy cases were filed in various courts throughout the country, we seem to have returned to the more typical scenario where large retail cases are almost exclusively filed in Delaware and the southern District of New York.

There are a number of reasons why debtors often opt to file in these jurisdictions, including:

1. Proximity to lenders and other parties in interest;
2. Familiarity of judges with business/bankruptcy interplay;
3. Extensive use of technology;
4. Established body of bankruptcy case law, particularly related to sales of assets in bankruptcy;
Procedures for payment of professional fees;
5. Speed and efficiency; and
6. Familiarity with judges, counsel and court personnel.

UNEXPIRED LEASES IN BANKRUPTCY

A. General Rules

1. Section 365 of the Bankruptcy Code authorizes a debtor to assume or reject any unexpired lease
2. Assumption is basically a decision to retain a lease.
3. Rejection is essentially a decision to terminate a lease.
4. Debtor must cure monetary defaults to assume a lease.
5. Special rules governing assignment of leases.

B. Leases governed by Section 365

1. Must be lease transaction.
2. Sale or disguised secured transaction not governed by Section 365
3. Must be unexpired.
4. State law determines whether a lease has been terminated pre-bankruptcy.
5. Redemption period during which tenant may cure defaults.

C. Timing Issues

1. Debtor has an initial 120-day period to determine whether to assume or reject a lease.
2. Debtor may obtain one 90-day extension by leave of bankruptcy court. These requests are generally granted.
3. Subsequent extensions require written consent of landlord.

D. Assumption

1. Motion to assume filed with bankruptcy court.
2. Cure monetary defaults or provide assurance of prompt cure.
3. Compensate landlord for actual pecuniary losses.
4. Provide adequate assurance of future performance.

E. Rejection

1. Motion to reject filed with bankruptcy court.
2. Vacate space and return to landlord
3. Broom clean condition, return keys, alarm codes.
4. Rejection of a lease may result in various claims to be asserted by landlords, including:
 - a. amounts owed pre-petition, which should be allowable in their entirety as an unsecured claim.
 - b. postpetition rent claim, which is entitled to administrative expense treatment.
 - c. year lease rejection damages claim (unsecured), which is calculated pursuant to formula set forth in §502(b)(6) as the greater of (i) one years' rent or (ii) fifteen percent of the remaining term under the lease, not to exceed three years.

F. Assumption and Assignment

1. Debtor may assign lease despite anti-assignment provision in lease.

2. Comply with requirements for lease assumption regarding cure of defaults and adequate assurance requirements.
3. Landlord can require deposit or other security from assignee.

G. Special Provisions for Shopping Centers

1. Assurance that assignee has same ability to pay rent as original tenant.
2. Any “percentage rent” will not decline substantially.
3. Assignee subject to lease requirements regarding such as radius requirements, use of premises and exclusivity provisions, and will not breach any other lease, finance agreement or master agreement related to the shopping center.
4. Assignment will not disrupt any tenant mix or balance in shopping center.

SALE OF LEASES IN BANKRUPTCY

While many landlords are familiar with the assumption and rejection procedures set forth above, 2018 saw a continuation of a growing trend in bankruptcy cases: the sale of a debtor’s interest in an unexpired lease of nonresidential real property. Simply put, the sale of leases offers debtors an opportunity to monetize estate assets that in most cases (i) fails to provide a financial return to the estate and (ii) results in large rejection damage claims against the debtor’s estate. Attempts to monetize this particular asset have met with varying results. Nevertheless, it behooves landlords to be aware of this trend, and the attendant risks and opportunities presented.

History

The marketing and sale of leases in bankruptcy is not a novel concept. Recently, debtors in the chapter 11 cases of *Toys R Us*, *The Bon Ton Stores* and *Sears* have employed this strategy to varying degrees of success. *Toys R Us* has sold over fifty leases, while *Bon Ton* has been able to sell less than ten. In the past, debtors such as *Mervyns LLC*, *The Sports Authority*, *Linens Holding Co.*, *Sharper Image*, *Freedom Rings, LLC* and

Montgomery Ward Holding Co. all employed this strategy, again to varying degrees of success.

Advantages to the Sale of Leases

From a debtor's perspective, there are a number of reasons for pursuing a sale of its leasehold interests:

- A. Funds realized from sale: The funds received from the sale of a lease may be significant, depending on the value of the underlying lease.
- B. Possible avoidance of payment of cure costs: In many instances, the cure cost may be paid by the buyer.
- C. Reduce costs of sale: The amounts received by the debtor's broker may be less than the costs accrued if the debtor handled the sales internally. Attempts to limit broker to receiving commission only, avoid up-front costs.
- D. Avoid rejection damage claims: These typically large claims may be avoided by selling the lease.
- E. Avoid various landlord claims: Any other claims held/asserted by a landlord may be dealt with in the sale process.
- F. Ability to select replacement tenant: In a reorganization setting, the debtor retains the ability to select successor tenant. Critical in industries where debtors may have more than one store in a particular area and wants to keep competition from moving into the area. Think about how stores selling a similar product, such as mattresses, tend to be clustered together.

Process for Lease Sales

The legal process typically used in connection with a sale of a debtor's rights under unexpired leases of non-residential real property includes the following steps:

- A. Retention of a broker to market and sell the leases
 - 1. Retention application must be filed and approved by the bankruptcy court

2. Payment terms must be included in retention application
3. Broker to assist in identifying leases suitable for sale
4. Negotiate with prospective buyers
5. Design marketing plan

B. Modifications to Existing Leases

Landlords are understandably nervous when a tenant files bankruptcy. If a lease is rejected, the landlord must (i) move quickly to locate a new tenant to fill this suddenly available space and (ii) often make significant expenditures to the space to fulfill the new tenant's needs. Consequently, debtors often seek to use the leverage they have during the post-petition, pre-rejection period to modify existing lease terms. Indeed, debtors often create artificial short deadlines in an attempt to force landlords to act quickly on the proposed modifications if they wish to avoid rejection of the lease. Further, debtors often provide that such modifications are not subject to court approval. Among the modifications often sought by debtors are:

1. A period of occupancy without paying rent and other charges
2. Reduction of rent for the remainder of the term of the lease
3. Reduced CAM charges
4. Longer grace periods to cure defaults
5. Reduction in space occupied by debtor
6. Elimination of guarantees

C. Motion to Approve Sale Procedures and Approve Sales

1. Two-step process: (i) approval of rules governing sale of leases and (ii) approval of actual sale.
2. Auction vs. Private Sale
3. Qualified Bidder determination
4. Treatment of landlords

5. List leases available for sale
6. Bid deadline
7. Process for submitting bids/date of auction
8. Deadline to object to proposed sale procedures
9. Stalking-horse

D. Notice of Auction Results

1. Identifies proposed assignee
2. Sale Amount
3. Proposed cure amount
4. Date of sale hearing
5. Deadline to object to sale and/or proposed cure amount
6. Often will include draft of transfer/assignment agreement (see case study below)

E. Sale Hearing

1. Draft sale order distributed prior to hearing
2. Objections to sale
3. Remaining objections to proposed cure amounts. These are often left open to a later date to allow for additional negotiations
4. Resolve issues regarding terms of sale order
5. Resolve any adequate protection issues
6. Entry of sale order

F. Additional Considerations

1. Debtors may request streamlined procedures for additional sales
2. Debtors often request lease concessions from landlords including (i) reduced rent, (ii) reduction in other charges, and/or (iii) additional time to decide whether a lease should be assumed or rejected. In exchange, Debtors may

- offer (i) waiver of avoidance actions, (ii) payment of legal fees to document agreement, and (iii) agreement not to reject lease for a period of time.
3. Private sales often involve limited notice.

Landlord Issues

Each step set forth above may create issues for landlords. While each sale process is unique, Debtors often provide landlords with limited time to review the process and any documents and information provided. It is, therefore, imperative that landlords stay vigilant throughout the sale process. Below are issues landlords should consider at each step of the sale process.

A. Broker Retention

1. Potential business conflicts with the broker.
2. Experience and expertise of the proposed broker.
3. Fairness of fee/commission structure.
4. Marketing budget.
5. As a general rule, the bankruptcy court will respect a debtor's choice of broker.

B. Sale Procedures

1. Review list of leases available for sale closely. A debtor may refer to a given lease in an unfamiliar manner.
2. There are a number of reasons why a lease may not appear on a list. The debtor may (i) plan on assuming or rejecting the lease, (ii) be unaware the lease exists, (iii) plan on listing it at a later date, or (iv) be hoping to renegotiate lease terms, after which it may make its ultimate decision regarding the lease.
3. Reasonableness of proposed timeline and deadlines
4. Reasonableness of protections offered to stalking-horse bidder.

5. Are landlords automatically “Qualified Bidders”?
6. Can landlords credit bid amounts owed by the debtor?
7. Do landlords have to post a deposit?
8. Procedure for obtaining information regarding leases available for purchase.
9. Accuracy of information provided.
10. Opportunity to match highest bid. Particularly important in the event of a private sale.
11. Is listed lease an “unexpired lease”.
12. Consider retaining counsel.
13. Consider bidding on lease, particularly if lease terms are well below market rates.
14. Know the value and desirability of your lease.

C. Notice of Auction Results

1. Accuracy of cure amount.
2. Receipt of adequate assurance information regarding purchaser and sufficient time to review same.
3. Responsibility for year-end adjustments such as CAM charges, insurance and taxes. Who will pay and when. Make sure this is clear and in writing.
4. Effect of buyer on current tenant mix.
5. Effect of buyer on landlord’s future development plans.
6. Will presence of buyer violate terms of other existing leases or master agreements? In *Toys R Us*, the court overruled objections along these lines, allowing a sale to a buyer whose presence in the landlord’s shopping center appeared to breach an existing lease with another tenant.
7. Review of financing agreements
8. Cost to renovate space if objection to proposed sale is sustained.
9. Analysis of any existing sub-leases.
10. Review deadlines for reasonableness.

11. Cost of objecting. Time and resources.
12. Review terms of any agreement between debtor and purchaser.
13. If necessary, request additional time to review/object. Often this can be done informally, particularly where the extension date is still prior to the sale hearing.
14. Opportunity to object by offering higher bid.

D. Sale Hearing

1. Review proposed order.
2. Confirm order includes any agreed-upon terms.
3. Reservation of rights.
4. Contact other landlords regarding potential issues/arguments.

E. Additional Considerations

1. Reasonableness of any streamlined procedures.
2. Consider becoming "Notice Party", entitled to be noticed of any sale-related issues.
3. Possible exposure on avoidance actions.
4. Debtors often impose arbitrary deadlines, don't be afraid to push back.
5. If the debtor states that your lease will be assumed, get it in writing.
6. Whenever possible, obtain written court approval of any agreement with the debtor. Debtors often state that such approval is not necessary. Remember, court approval is generally required for any action taken by a debtor that is outside the ordinary course of business.
7. Be extra careful when dealing with private sales.
8. If the debtor offers to pay legal fees, be very specific as to how much will be paid. Debtors often provide a pool of money to pay such fees to landlords – it's not always enough.

Case Study: Toys R Us

On September 17, 2017, Toys R Us and its affiliates (the “Debtors”) filed for protection under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Eastern District of Virginia (the “Bankruptcy Court”). Toys R Us and Brea 1 (the “Landlord”) were parties to a lease (the “TRU Lease”) entered into on December 20, 1996 for a parcel in a shopping center referred to as Brea Union Plaza (the “Shopping Center”). On March 23, 2018, the Bankruptcy Court entered an order establishing bidding procedures to be used in connection with the auction sale (the “Auction”) of certain of the Debtors’ assets, including the TRU Lease.

At the conclusion of the Auction, the Debtors designated Festival Development Corporation (“Festival”) as the successful bidder and Burlington Coat Factory (“Burlington”) as the backup bidder. Festival subsequently withdrew its bid, and the Debtors filed a notice proposing to assume and assign the TRU Lease to Burlington. The Landlord objected (the “Objection”) to the assignment of the TRU Lease to Burlington based upon, among other things, the Landlord’s assertion that such an assignment would violate the terms of an existing lease (the “Ross Lease”) between the Landlord and Ross Dress for Less (“Ross”).

The Ross Lease contained an exclusive use clause prohibiting the Landlord from leasing space in the Shopping Center to any party that would, like Burlington, use the space for off-price sale. Consequently, an assignment to Burlington would violate section 365(b)(3) of the Bankruptcy Code which, in brief, prohibits the assignment of a lease where such assignment would breach of the provisions of a lease with another tenant in a shopping center.

In Overruling the Objection, the Bankruptcy Court found (i) the TRU Lease pre-dated the Ross Lease and did not include a provision requiring compliance with the use restriction contained in the Ross Lease, or in the alternative (ii) the prohibition in the Ross Lease only applied if the Landlord “has the capacity to do so.” The Bankruptcy Court found that its approval of the assignment to Burlington pursuant to section 365 of

the Bankruptcy Code would leave the Landlord without the capacity to prevent Burlington's intended use of the property. Consequently, there would be no violation of the provisions of section 365(b)(3) of the Bankruptcy Code if the TRU Lease was assigned to Burlington. The Landlord timely appealed the ruling of the Bankruptcy Court, but the appeal was ultimately dismissed.

Query: Would the decision have been different if the TRU Lease had a provision prohibiting any assignment that would violate the terms of another lease with the shopping Center such as the Ross Lease or would the Bankruptcy Court have found such a provision to be void like many other anti-assignment provisions commonly found in leases? What about the Bankruptcy Court's second rationale? Would that hold up on its own?

Landlord Opportunities

Debtor lease sales may provide opportunities for landlords beyond simply providing a substitute tenant. In addition to purchasing their own leases, landlords, RIETs and financial institutions have purchased leases in shopping centers belonging to others. This may be prudent if (among other reasons):

1. The lease terms are well below market.
2. The landlord knows he can "flip" the lease at a profit.
3. The landlord has an existing tenant looking for such a location.
4. The landlord has some agreement with the other landlord that is mutually beneficial.

However, once the lease is purchased, the landlord must pay all amounts due thereunder. Consequently, this strategy does involve a degree of risk on the part of the landlord.

Take-aways

1. Lease sales are here to stay. As more retailers are forced to seek bankruptcy protection, the sale of leases is likely to become more prevalent.

2. Much of a landlord's strategy in lease sale situations depends on knowing the value of one's property and the ease/cost of locating a new tenant.
3. Always note target dates and deadlines. If you need more time, ask for an extension.
4. Always get agreements in writing. Where necessary, insist upon court approval.
5. If an opportunity presents itself, be ready to act. Things can move quickly in bankruptcy court.

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