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Sears (MOAC v. Transform): Landlord May Rest (Adequately) Assured of 'Similar' Financial Condition and Operating Performance, But Not Necessarily Tenant Mix

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Introduction

A recent decision from the United States District Court for the Southern District of New York (the District Court) in the bankruptcy cases of Sears Holdings Corp. may loom large in a day and age when shopping mall operators are seeking creative alternatives to the traditional, retail-oriented anchor-store business model.

The Bankruptcy Code (via 11 U.S.C. § 365) enables a debtor to assume and assign certain types of contracts, such as commercial real estate leases, where each party to the contract has continuing performance obligations under the contract (such that the failure to perform by either party would constitute a breach of the contract). Such assignment is permitted only if "adequate assurance of future performance" by the assignee is provided pursuant to section 365(f)(2)(B) of the Bankruptcy Code. Specifically with respect to "shopping center leases," the Bankruptcy Code expressly sets forth four categories of adequate assurance that must be provided, two of which were at issue in *MOAC Mall Holdings LLC v. Transform Holdco LLC et al.* (MOAC v. Transform):

> (A) 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, a**s of the time the debtor became the lessee under the lease**; and
>
> (D) Assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

11 U.S.C. §§ 365(b)(3)(A), (D) (emphasis added).

In its Feb. 27 decision on *MOAC v. Transform*, the District Court reversed the Bankruptcy Court (in part), holding that while the court may look to the underlying lease for purposes of determining whether the "tenant mix" will not be disrupted in accordance with section 365(b)(3)(D), the court may not look to lease-based requirements in lieu of the "similar" financial condition and operating performance requirement under section 365(b)(3)(A).

Background and Procedural History

The *MOAC v. Transform* decision arises out of a dispute between Sears Holdings Corp. and its affiliated debtors (collectively, Sears) and the entities created by Sears' former CEO for the purposes of acquiring substantially all of Sears' assets and real estate holdings (collectively, Transform) and MOAC Mall Holdings LLC (MOAC), the owner of Mall of America, a "shopping mall cum amusement and entertainment venue" located in Minneapolis. In connection with its bankruptcy case, Sears sought to assume and assign the lease it had entered into with MOAC in 1991, and related agreements (collectively, the Lease), to Transform. However, MOAC—in an effort to control who occupies the large anchor space vacated by Sears—objected to the assumption and assignment of the Lease, arguing that the Bankruptcy Code's "adequate assurance"

requirements for “shopping center” leases (namely, subsections (A) and (D) of section 365(b)(3)) had not been satisfied.

The Bankruptcy Court concluded that, because the Lease neither contained any restriction on the tenant mix nor guaranteed that Sears' space would even be operated as a retail store after 2007 (in fact, the only arguable tenant mix restriction, which is really no restriction at all, is that the space have uses that are “compatible and consistent with (and are not detrimental, injurious or inimical to) the operation of a first-class regional shopping center”—such an uncommon lack of restrictions in a retail lease, which the District Court described in this context as an “(admittedly) most unusual lease”), the tenant mix of the Mall of America would not be disrupted, in accordance with section 365(b)(3)(D), so long as Transform agreed (as it did) to abide by what limited-use restrictions did exist under the Lease.

As for section 365(b)(3)(A), the Bankruptcy Court did not find that Transform demonstrated that its financial condition and operating performance were “similar” to those of Sears in 1991. Notwithstanding Transform's failure to satisfy section 365(b)(3)(A), the Bankruptcy Court held that the required “adequate assurance” had been provided because, under the Lease, Sears could relieve itself of its obligations as long as it assigned the Lease to an entity with a net worth or shareholder equity of $50 million or more, and it was “highly likely” that Transform met this $50 million threshold based on the funding that third-party lenders had agreed to provide Transform. The Bankruptcy Court held that Congress had not imposed any “independent requirements” when passing the special “shopping center” protections set forth in section 365(b)(3), and therefore subsections (A) and (D) had to be interpreted in light of the terms of the Lease. In other words, section 365(b)(3)(A) entitled MOAC to no greater level of assurance than it was entitled to under the Lease.

MOAC appealed the decision, arguing that the Bankruptcy Court erred in holding that the terms of the Lease defined the protections of subsections (A) and (D). Specifically, MOAC argued (1) section 365(b)(3)(D) prohibits *any* assignment of the Lease that would affect the tenant mix (regardless of the Lease terms) and, in any event, the Bankruptcy Court could not make a determination under subsection (D) because Transform had not yet identified the end user to occupy the space, and (2) the statutory language of section 365(b)(3)(A) must be satisfied and cannot be supplanted by the terms of the Lease.

The District Court's Holding

The District Court agreed with the Bankruptcy Court's holding with respect to section 365(b)(3)(D). Relying predominantly on prior decisions from the Southern District of New York and legislative history, the District Court concluded that without any statutory definition for the phrase “tenant mix,” “it makes perfect sense to interpret the phrase . . . in light of the lease whose performance is being assured.” The District Court further concluded that the Bankruptcy Court could determine whether the tenant mix would be disrupted by the proposed assignment even though no tenant had been identified yet. As the District Court explained, Sears' lease had “virtually no restrictions on what kinds of tenants could occupy the Sears building [after] 2007” and, therefore, the “tenant mix” of the mall, after 2007, included “a space that was free to cease operating as a department store and could be subleased for a variety of uses . . . *without the approval of the landlord, and without regard to objections by any of the mall's other tenants.”* Further, to the extent the Lease contained limited restrictions on uses, subleases, and assignments (such as a landlord right of first refusal and a restriction to uses “compatible with and not detrimental to” the mall), Transform had agreed to abide by such restrictions. The District Court opined that it would be difficult to imagine a use that is not “compatible” or is “detrimental” to this mall given the extremely broad spectrum of businesses the Mall of America houses. And given that Transform agreed to be bound by any such restrictions, the Bankruptcy Court “was free to conclude that MOAC had ‘adequate assurance’ that the allowable ‘tenant mix’ at Mall of America would not be disturbed by the assignment of the Lease to Transform.”

However, the District Court overruled the Bankruptcy Court with respect to section 365(b)(3)(A), holding that the Bankruptcy Code's requirement to establish that the assignee is in similar financial condition and operating performance as the Debtor at the time the Lease was entered into cannot be supplanted by the requirements of, and limitations on, assignment set forth in the parties' Lease.

The District Court explained that, in adopting subsection (A), Congress wanted to “assure the landlord that it would not have to endure a second bankruptcy any time soon.” To do so, Congress imposed additional “independent requirements” for assurance of future performance of shopping center leases; while courts are entitled to interpret and create the standards for satisfying those requirements (like the Bankruptcy Court did with respect to subsection (D)), courts are not entitled to disregard them entirely (like the Bankruptcy Court did with respect to subsection (A)). Indeed, having $50 million in net worth or shareholder equity as required under certain terms of the Lease may be sufficient to satisfy the general “adequate assurance” requirement under section 365(f)(2)(B), but it is not sufficient to satisfy the more stringent and more specific requirements of section 365(B)(3)(A). Transform was required to show it is in “similar”

financial condition and operating performance to the very viable solvent company that entered into the Lease, which analysis allows the court to use a "rather creative 'proportionality' standard," but Transform failed to do so. Therefore, the District Court concluded that the assignment was not permissible.

Analysis and Conclusion

This decision is a win for shopping center landlords seeking leverage over insolvent or bankrupt tenants seeking to sell/assign their interests to entities with limited or nonexistent financial or operating records. The District Court found that the Bankruptcy Court's reliance on the level of financing provided by third-party lenders to Transform was simply not enough. The District Court explained that while proving "identical" financial condition and operating performance is not required (and would likely be impossible when comparing to a one-of-a-kind retail giant such as Sears in 1991), "similar" financial condition and operating performance must be established. In a time when many bankruptcy cases hinge upon sales to private equity funds and similar entities, shopping center landlords may be given an edge to the extent that other courts are guided by the *MOAC v. Transform* decision's refusal to gloss over subsection (A)'s requirements.

On the other hand, the *MOAC v. Transform* decision may take the teeth out of subsection 365(b)(3)(D)'s "tenant mix" protections in today's environment, where the concept of the traditional shopping mall (i.e., its tenant mix) is rapidly evolving. The court may analyze the specific lease language to determine the use restrictions the shopping center landlord bargained for over the term of the lease, and those use restrictions in an older lease may have contemplated a very different shopping center than the landlord markets today. The District Court noted that the Lease here had very limited restrictions on Sears—e.g., the Lease's requirement that the space must be used in a way that is merely "compatible and not detrimental" to the mall could be satisfied by almost any use other than "a house of prostitution or other criminal enterprise." Shopping center landlords need to carefully express and be thoughtful of the use restrictions imposed within their leases; in particular, the flexibility a tenant may seek with use restrictions in the event of an assignment or sublease outside a bankruptcy context, as those negotiated use restrictions, or lack thereof, may be analyzed inside the bankruptcy context under section 365(b)(3)(D).

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