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The Crossroads of State Law and Bankruptcy Law

What Are Commercial Landlords to Do When Tenants File for Bankruptcy?

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Special to the Legal, PLW

Commercial landlords of shopping centers often struggle with keeping their anchor tenants happy. Most anchor tenants demand protective exclusivity rights restricting the type of stores that can occupy a shopping center. But what happens to a landlord when a tenant files for bankruptcy protection and then sells its lease?

Sections 363 and 365 of the U.S. Bankruptcy Code enable debtors to assume, assign and sell their nonresidential real property leases to generate value for the bankruptcy estate. Landlords of shopping centers are often placed in a difficult position when such assumption occurs. The prospective assignee may not fit with the current tenant mix of the shopping center, or the assignee's intended use may violate a covenant in the lease it wishes to acquire. Even if the debtor obtains the landlord's consent or bankruptcy court approval of the assignment, the landlord may still encounter a hidden problem: The assignee's intended use may violate a protective covenant in a co-tenant's lease.

The Court of Chancery in Delaware, in *Penn Mart Supermarkets Inc. v. New Castle Shopping LLC and NWL Holdings Inc. et al.*, recently addressed the issue of whether the assignee and the landlord are bound by a



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restrictive covenant in a lease.

BACKGROUND

Penn Mart Supermarkets Inc. operated a Thriftway supermarket that was the anchor tenant at a shopping center. National Warehouse Liquidators (NWL) acquired a lease from the debtor pursuant to a bankruptcy proceeding and intended to operate a typical NWL store, which was a discount department store selling, among other things, food and food products. The NWL lease contained a restrictive covenant that prevented a tenant from "occupying the premises for any use for

which other premises in the shopping center are occupied pursuant to an exclusive right and use granted by the landlord."

The bankruptcy court eviscerated the use provision in its order approving the transfer of the debtor's lease to NWL and provided, "Notwithstanding any provision of the [NWL] lease to the contrary ... NWL may operate the premises as a typical NWL department store, as same are currently operated, and none of the foregoing shall be deemed a breach or default of any provision of the [NWL] lease."

When Thriftway learned that NWL would be opening a store at the shopping center, it objected to the shopping center's landlord and sought to invoke the protective covenant in its own lease. In the Thriftway lease, the landlord granted Thriftway an exclusive use provision "for the sale of food or food products intended for off-premises consumption." Thriftway argued that if NWL operated as a typical NWL store, it would violate this covenant.

Despite Thriftway's objection, NWL, presumably relying on the bankruptcy court's order, commenced business operations at the shopping center, operations that included the sale of certain food and food products for off-premises consumption.

Shortly thereafter, Thriftway filed a complaint for injunctive relief against the landlord and NWL (collectively, the defendants) with the Chancery Court. The Chancery Court denied Thriftway's request for a preliminary injunction and stayed the matter to allow Thriftway to seek relief from the bankruptcy court.

Thriftway subsequently appeared in bankruptcy court to object to the bankruptcy order. The bankruptcy court rejected Thriftway's efforts, but it noted that the Delaware courts "should deal with the matters of Delaware state law as they see fit."

The bankruptcy court declared that it was "making it clear, that [the bankruptcy order] was not intended in any way, shape or form to affect [Thriftway's] rights under its own lease. ... Whatever rights [Thriftway] has in that regard are unaffected by the [bankruptcy order]. I also am making it clear that the [bankruptcy order] was permissive, not mandatory, except to the extent that it prohibited the landlord from complaining that [NWL] would be violating [its] lease by conducting operations in the manner that [NWL] ultimately has done."

The bankruptcy court did not formally modify the bankruptcy order. Thereafter, the Chancery Court lifted the stay and allowed Thriftway to proceed with its action seeking injunctive relief and damages against the defendants.

In the Chancery Court, NWL and the landlord argued that the bankruptcy order precluded the court from enforcing Thriftway's protective covenant. As NWL was operating as "a typical NWL department store," its operations were consistent with and allowed by the bankruptcy order. The defendants claimed that if the

Chancery Court were to enforce Thriftway's protective covenant, it would be inconsistent "both as a matter of judicial authority and as a matter of comity" with NWL's rights per the bankruptcy order.

COURT'S HOLDING

After a review of the bankruptcy order and the transcript of the related hearing, the Chancery Court rejected the defendants' arguments. The court first examined the language of the bankruptcy order and found that it only modified the duties and rights prescribed in the NWL lease, not the Thriftway lease. Second, the court considered the bankruptcy court's ruling to Thriftway's objection to the bankruptcy order, and found that the bankruptcy court clearly disclaimed any intent to modify the rights of Thriftway under its lease.

The Chancery Court found that while the bankruptcy order modified the terms of the NWL lease, it did not expressly affect Thriftway's rights and protections under its own lease. The court ultimately held that Thriftway was entitled to a limited permanent injunction against NWL and the landlord prohibiting NWL from continuing its sale of certain goods that were found to violate Thriftway's protective covenant, as well as monetary damages against the landlord.

PRACTICE TIP

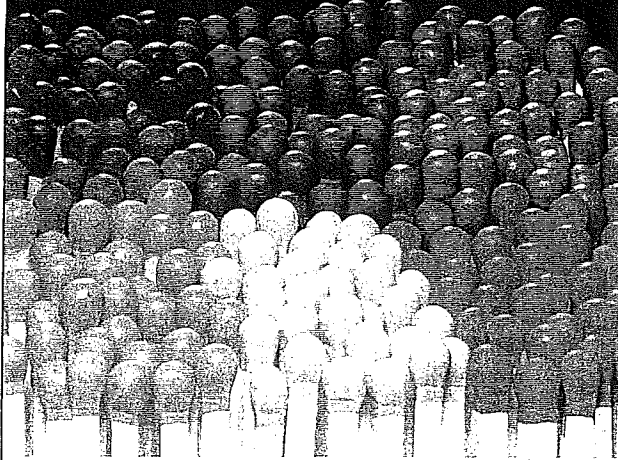
The *Penn Mart* decision suggests that when representing an assignor, assignee or landlord in the assignment and sale of a lease in a shopping center, one should review not only the lease being assigned, but also consider the potential impact of restrictive covenants in the leases of co-tenants in the shopping center. To avoid the *Penn Mart* situation, an assignee will likely need to request and access information relating to any protective covenants found in the leases of co-tenants prior to assignment.

In the event that the landlord refuses to provide such access, warn the landlord that it may be subject to liability arising from one of two irreconcilable positions it will have to take in the event the assignee's use would violate a co-tenant's protective covenant: liability arising from the violation of the protective covenant of a co-tenant by the assignee, or liability arising from the landlord preventing the assignee from operating as provided for by the use provision in its lease.

Prior to assignment, an assignee should also investigate and conduct a search of the applicable land records for instruments, including protective covenants relating to the shopping center, as these instruments could affect the lease or provide notice of special provisions.

By reviewing the lease provisions of a debtor's co-tenants, an assignee is better able to protect itself from the inability to operate its business free from co-tenants' protective covenants, or, at a minimum, adjust the acquisition price to reflect the possibility of limited uses at the subject premises. •

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