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MODERNIZING LEASE ASSIGNMENTS UNDER § 365 IN ORDER TO EXPAND THE ECONOMIC PIE

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Section 365 of the Bankruptcy Code provides for the assignment of below-market leases for consideration in order to maximize the value of a debtor's estate for the benefit of its creditors. In order to increase a lease's value to an assignee, and therefore the consideration that could be paid, the Bankruptcy Code nullifies many of the lease terms that would restrict the use of the real estate to that which were agreed upon by the lessor and lessee. In a commercial setting, this practice harms the landlord and the debtor's neighbors as it can vitiate a carefully cultivated tenant mix and dispenses with the enforcement of operating practices designed not to harm nearby businesses. This harm is not borne by the debtor, its creditors, or the assignee, creating negative externalities. This Note argues that the associated aggregate harm across the United States outweighs the aggregate benefit of the incremental maximization of debtors' estates. While § 365(b)(3) provides protections against these negative externalities for certain leases, namely those pertaining to the traditional suburban conception of a shopping center, it does not capture many of the non-traditional commercial leases that represent an increasingly large share of economic activity in America's urbanizing society. This Note offers two proposals that seek to expand both the protections given and the types of properties those protections can apply to, in order to generate aggregate economic gains.

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INTRODUCTION

On a corporate entity's balance sheet, an operating lease is not considered an asset. However, § 365(a) of the 1978 Bankruptcy Code (Code) allows a debtor's estate in a Chapter 7, 11, 12, or 13 proceeding to "assume an . . . unexpired lease of the debtor"[1] and subsequently assign that lease for consideration under § 365(f). As a result, in bankruptcy, leases often become monetized by the debtor's estate as part of the liquidation or reorganization process. Importantly, federal bankruptcy law preempts state law, allowing any anti-assignment clauses that are generally present in commercial leases to be rendered null in bankruptcy.[2] Therefore, as a practical matter—although assignments of leases may legally be possible in non-bankruptcy contexts—bankruptcy increases the occurrence of this practice because it mandates that debtor-tenants be allowed to assign for consideration, in violation of whatever private contract may exist, below-market leases, and without a

1. 11 U.S.C. § 365(a) (2012).

2. David S. Kupetz, *To Assume or Not to Assume: Real Estate Leases*, 8 J. BANKR. L. & PRAC. 395 (1999) (citing Testa v. Katt, 330 U.S. 386 (1947)).

landlord's consent.[3] The Bankruptcy Code dramatically expands the debtor's control over the landlord's asset to such an extent that, for some period, the landlord loses functional ownership of her property.

Courts have attributed to Congress an "express policy . . . of favoring assignment"[4] as a way to "maximize and preserve the debtor's estate."[5] However, as a result of this policy, the interests of both landlords and neighboring tenants are often harmed. Congress recognized this countervailing consideration as demonstrated by its inclusion of special protections for "shopping center" landlords in § 365(b)(3). This Note will address two issues: (1) how protections for landlords are insufficient, especially in light of the rapid urbanization in the United States combined with the increasing sophistication of the real estate market; and (2) how this insufficiency leads to inefficiencies that are harming landlords, non-debtor tenants, and future tenants. Therefore, this Note suggests that the economic pie could be increased through an expansion of the aforementioned special protections or a shift of control from debtor-tenant to landlord in § 365 assignments.

This Note is organized into three main parts. Part I will explain the character of § 365 and the applicable case law as it relates to unexpired leases. It will then explain why the assignment of leases under § 365 affects landlords in different and more extensive ways than normal nonfinancial creditors. It will also discuss the resulting changes that Congress and the courts have made to § 365 as applied to commercial leases in recognition of these additional effects on non-debtor stakeholders.

Part II will discuss why Congress's and the courts' recognition of the landlord's legitimate concerns, regarding assignment powers, should continue. The shortfalls of the protec-

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3. While adequate assurance must be provided under § 365, for properties that do not receive § 365(b)(3) protection such a requirement only applies to monetary performance and does not address compliance with nonpecuniary lease terms, despite their importance (which will be demonstrated throughout this Note). Jason B. Binford, *Beyond Chimerical Possibilities: The Meaning and Application of Adequate Assurance of Future Performance under the Bankruptcy Code*, 18 AM. BANKR. INST. L. REV. 191, 194 (2010).

4. *In re* U. L. Radio Corp., 19 B.R. 537, 543 (Bankr. S.D.N.Y. 1982).

5. Daniel J. Favero, *Solid Rock to Shifting Sand: How the U.S. Bankruptcy Code Effectively Re-Writes Commercial Real Estate Lease Provisions*, J. OF BANKR. L., April 2009.

tions provided by § 365(b)(3) will be explained. Furthermore, Part II will review the other stakeholders harmed by the current drafting and interpretation of § 365. Lastly, the economic effects of § 365 will be analyzed.

Part III will put forth two different statutory recommendations. The first is to expand the § 365(b)(3) "shopping center" protections to all retail leases. The second is to provide, in the Code, the option for tenants and landlords to contract into an arrangement whereby the landlord, and not the debtor, is charged with overseeing the assignment of the below-market lease. The advantages and disadvantages of both proposals will be discussed. United States Federal Bankruptcy Courts are courts of equity, and this Note will demonstrate that in the case of § 365, as it impacts the commercial real estate market, there is a need for a rebalancing of the equities.

I.
The Current State of Affairs

A. *General Background*

Prior to the Bankruptcy Reform Act of 1978, a lease (whether commercial or not) could contain, and a landlord could enforce, a clause that allowed for the termination of that lease if the tenant filed for bankruptcy.[6] Some courts refused to enforce these clauses, termed "ipso facto" clauses, because they believed enforcement was unfair to a debtor-tenant's creditors.[7] Congress codified this policy preference and rendered these clauses unenforceable with the enactment of the 1978 Bankruptcy Code.[8] Specifically, Congress created § 365, which allows for "the trustee" to "assume or reject any . . . unexpired lease of the debtor"[9] notwithstanding any provision in the lease that would terminate or modify the lease solely because of the "insolvency or financial condition of the debtor" or "the commencement of a [bankruptcy] case."[10]

Once a debtor opts to take the requisite steps to effectuate a lease assumption, Congress statutorily enables the debtor

6. Bruce H. Roswick & Stephanie McEvily, *Use Clauses in Shopping Center Leases: The Effect of the Tenant's Bankruptcy*, 14 Real Est. L.J. 3, 8–9 (1985).
7. *Id.*
8. 11 U.S.C. §§ 365(b)(2)(A), (e)(1) (2012).
9. § 365(a).
10. § 365(e).

to assign the unexpired leases. In addition to disallowing "ipso facto" clauses, § 365 also nullifies any lease provision that "prohibits the assignment of [a] . . . lease."[11] In order to give force to the congressional preference for allowing such assignments, bankruptcy courts have held that lease terms that have the effect of limiting or restricting the assignment of leases may not be enforced.[12]

The statutory scheme of § 365, and the case law that surrounds it, is founded on three basic principles.[13] The first is that a debtor's unexpired lease can be a valuable asset of the debtor's estate, and should be monetized, either through reorganization or assignment, for the benefit of the creditors. The second is that some leases carry burdens that outweigh their benefits and should not be retained. The final principle is that the debtor is entitled to choose whether to assume or reject the lease, and if assumed, how best to extract value from the lease. These principles are seen as so important that Congress and the courts have, to varying degrees, felt that they overrode countervailing considerations such as the harm done to landlords and non-debtor tenants.[14]

That being said, certain protections do exist for landlords, mainly § 365(b), which reflects Congress's realization that "carefully planned enterprises" within the commercial real estate world can create situations where "the tenant mix . . . may be as important to the lessor as the actual promised rental payments."[15] In other words, Congress and the courts recognize that landlords can suffer unintended effects beyond those of other creditors due to § 365 assignments.

B. *The Debtor-Friendly Mechanics of Lease Assignment Pursuant to § 365*

Once a debtor files for bankruptcy a toll begins, limiting the length of time that the debtor has to decide whether or not to assume the leases. Prior to the 2005 Bankruptcy Abuse

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11. § 365(f)(1).

12. Forlini v. Ne. Sav. F.A., 200 B.R. 9, 10 (D.R.I. 1996) (relying on § 365(f)(1)).

13. Michael J. Goldberg & Nathan R. Soucy, *Current Issues in Commercial Leasing*, 071008 AM. BANKR. INST. 13 (2008).

14. *Id.*

15. Harris Ominsky, *Shopping Centers: Use Clauses Honored in Tenant Bankruptcy*, REAL EST. L. REP., July 2004, at 1.

Prevention and Consumer Protection Act, § 365(d)(4) provided that a commercial lease had to be assumed or rejected within sixty days of filing. However, the court could, for cause, provide additional time in 60-day increments. It was in fact normal for a court to approve successive extensions, sometimes even until the confirmation of the bankruptcy plan.[16] This time period was modified by the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which limited the time period to 120 days after filing for the debtor to decide whether to assume or reject the lease, and if adequate cause existed, allowed for only one 90-day extension on the motion of the trustee or lessor.[17]

Between the time that the debtor files and the debtor decides whether to assume or reject the lease, the Code mandates that the debtor "shall timely perform all the obligations of the debtor."[18] Despite this clear language, some courts have released debtors from some of their lease obligations prior to the assumption or rejection.[19] For instance, in seeking to preserve value for the creditors, certain courts have relieved tenants of their obligation to stay open under "going dark" clauses, despite the negative effects this may have on the landlord and other non-debtor tenants.[20] For similar reasons, some courts have also been unwilling to enforce contract provisions that limit "going out of business" sales, again without regard to the negative effects this may have on other stakeholders.[21]

As mentioned, a debtor first needs to assume a contract (at least nominally) before it can be assigned, usually via a § 363 sale.[22] Even if the debtor continues to perform its obligation on the lease, there is no implied assumption of the lease and instead a court order is required for assumption.[23] However, if debtor has not been performing its lease obligations,

16. Richard F. Broude, *Executory Contracts and Unexpired Leases in Bankruptcy*, SL100 A.L.I. 969, 989 (2006).

17. § 365(d)(4).

18. § 365(d)(3).

19. Goldberg & Soucy, *supra* note 12.

20. *See, e.g.*, *In re* R.H. Macy & Co., Inc., 170 B.R. 69, 76 (Bankr. S.D.N.Y. 1994).

21. *See, e.g.*, *id.* at 77; *In re* Tobago Bay Trading Co., 112 B.R. 463, 467 (Bankr. N.D. Ga. 1990).

22. § 365(f)(2)(A).

23. *In re* Whitcomb & Keller Mortg. Co., 715 F.2d 375, 380 (7th Cir. 1983).

§ 365(b)(1) requires that "where there has been a default under the contract or lease, the trustee, in order to assume (A) must cure the breach or provide adequate assurance of prompt cure . . . (B) compensate the non-debtor party for actual pecuniary loss resulting form the default . . . and (C) provide adequate assurance of future performance."[24] It is important to note that when a debtor continues to fulfill its obligations post-filing, some of the requirements of § 365(b)(1) do not apply. For instance, where there is no default, "adequate assurance [of future performance] is not required."[25] Adequate assurance can be given through a credible plan to assign. Once the contract is assumed, any damages resulting from a subsequent breach or termination are treated as an administrative expense.[26]

Even after the debtor assumes a lease, in order to assign the lease, the assignee must also provide adequate assurance of future performance whether or not there has been a default.[27] Furthermore, the lease must be assigned as a whole and it cannot be modified in any way.[28] A landlord can also require that the assignee provide "a deposit or other security . . . substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant."[29]

As mentioned, § 365(f) renders provisions unenforceable to the extent that they "prohibit, restrict, or condition the assignment of [a] . . . lease."[30] Courts have demonstrated a willingness to excise clauses that they view as disguises for anti-assignment provisions, such as a term entitling the landlord to profits on assignment[31] or a term requiring that the debtor pay the landlord a 4% assumption fee.[32] Similarly, courts have held that the Code, under § 365(f)(3), renders invalid any

24. Broude, *supra* note 16, at 998 (referencing §§ 365(b)(1)(A)–(C)).

25. *In re* Harry C. Partridge, Jr. & Sons, Inc., 43 B.R. 669, 671 (Bankr. S.D.N.Y. 1984).

26. § 365(g).

27. § 365(f)(2).

28. Am. Flint Glass Workers Union v. Anchor Resolution Corp., 197 F.3d 76 (3d Cir. 1999).

29. § 365(l).

30. § 365(f).

31. *In re* Nat'l Sugar Refining Co., 21 B.R. 196 (Bankr. S.D.N.Y. 1982).

32. *In re* Howe, 78 B.R. 226 (Bankr. D.S.D. 1987); Broude, *supra* note 16, at 1012.

lease provision that calls for an increase in rent to a market rate upon assignment.[33]

Terms that mandate rights of first refusal in favor of the landlord, with respect to lease assignments pursuant to § 365(f), are also held to be invalid.[34] Courts have held such clauses to be unacceptable restrictions or conditions on the assignment of the lease, and therefore unenforceable.[35] The logic behind such decisions is that such terms would deter a potential assignee from pursuing the purchase of a lease from the debtor's estate because that assignee is aware that her efforts and money expended in formulating a bid may be in vain if that bid can more easily be frustrated. In general, courts seem to be very willing to deem any lease provision that will at all deter a potential assignee from offering the highest possible amount for the debtor's lease as unenforceable under § 365(f).

Even though § 365(f)(2) requires a showing of adequate assurance of future performance for a lease to be assigned, landlords cannot contract into a requirement where they reserve the right to pre-qualify potential assignees. Similarly, courts will not allow for such a procedure even if specifically requested by the landlord.[36] In a landmark case, the Third Circuit denied a landlord's request for a stay of entry of the order approving the assignment of a lease.[37] The landlord argued that the potential bidder's qualifications should have been presented at a hearing prior to the bidding. The court rejected this argument "on the grounds that it would chill open competitive bidding and thus disadvantage the estate."[38]

Not only can debtors be released from many of their lease obligations when the debtor institutes a bankruptcy proceeding,[39] but they may also sell the rights to assign leases to a third

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33. *In re* David Orgell, Inc., 117 B.R. 574 (Bankr. C.D. Cal. 1990).

34. Broude, *supra* note 16, at 1013.

35. *In re* Mr. Grocer, Inc., 77 B.R. 349 (Bankr. D.N.H. 1987).

36. Edward M. Flint, *Lease Assignments and Anti-Assignment Clauses: Lessors and Lessees and Creditors—Oh My!*, 9 J. BANKR. L. & PRAC. 321, 323 (2000).

37. *In re* Joshua Slocum, Ltd., 99 B.R. 250, 313 (Bankr. E.D. Pa. 1989), *aff'd sub nom.*, *In re* Joshua Slocum Ltd., CIV. A. 89-4277, 1989 WL 428204 (E.D. Pa. Dec. 21, 1989), *vacated*, 922 F.2d 1081 (3d Cir. 1990).

38. Flint, *supra* note 36, at 323.

39. As mentioned on page 508 of this Note, courts have held that debtor tenants do not need to comply with certain lease terms that would lead to a diminution of the value of the debtor's estate (such as clauses which prohibit

party.[40] The right to assign one or more leases has been referred to as a "designation right," and it has become increasingly common, especially in liquidating retail bankruptcy cases, for debtors to monetize these rights.[41] Bankruptcy courts have upheld this practice as an agreement for the sale of property, authorized by § 363, provided the sale was based on the debtor's reasonable business judgment.[42] In a seminal case on the subject, the court reasoned that the "economic benefits to the debtor from this transaction outweighed the harm to landlords and, thus approved the transaction."[43] Again, the courts demonstrated a willingness to place debtors' considerations ahead of those of other stakeholders.

In addition to the fact that the Code significantly inhibits landlords' abilities to protect themselves from the negative ramifications of lease assignments, the Code also severely limits the damages that a court is able to award landlords. Any claim for damages by a lessor, resulting from the rejection of a lease, is limited to either 15% of the unpaid rent due under that lease for a maximum of three years or one year's worth of rent—whichever is less.[44] This amount is in addition to any unpaid rent from before the date of filing.[45] These provisions serve to harshly constrain the amount of damages that a landlord can receive, again notwithstanding whatever lease terms may exist to the contrary.

C. *Issues Specific to Commercial Landlords in Bankruptcy*

The bankruptcy process, due to the provisions of § 365, affects commercial landlords in different and more extensive ways than other creditors. Tenants are non-fungible from a landlord's perspective, and they often have a non-pecuniary

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"going dark"). Similarly (and as documented on pages 506–07 of this Note), § 365(b)(2) and its associated case law nullifies any effect of "ipso facto" clauses i.e., those clauses which would terminate a lease due to the financial condition of the tenant or the tenant's filing for bankruptcy protection.

40. Christine D. Lynch et al., *Designation Rights: When and How They Are Sold and How They Work*, 071703 ABI-CLE 465 (2003).

41. *Id.*

42. *In re* Ernst Home Center, Inc., 209 B.R. 955 (Bankr. W.D. Wash. 1997).

43. Lynch et al., *supra* note 40.

44. 11 U.S.C. § 502(b)(6) (2012).

45. *Id.*

value to landlords—value that the Bankruptcy Code does not fully account or provide compensation for. The amount of value that the specific identity of a tenant can plausibly provide can range from negligible (in the instance of a single-tenant office property) to more significant than the monetary value of the rent that the tenant pays (in the instance of an anchor tenant within a retail center).

The non-fungible nature of tenants is most readily understood within the concept of "tenant mix" in shopping centers. Shopping center tenants are often very concerned about the other tenants in their common retail center because there are tremendous revenue implications due to realizable synergies. This is because an optimal combination of different retailers allows stores to complement each other by attracting customers of the same socioeconomic or cultural group; each customer demographic is interested in shopping at a distinct type of retail offering. Furthermore, sales can be increased by limiting the amount of retailers purveying the same types of goods in one shopping center. These synergies are so important that one of the original developers of the modern strip-mall testified before the Senate, that "the success of a shopping center, and thus all of its tenants, is based in large part on its 'tenant mix.'"[46] He went on to note that "the use of any tenant space for purposes other than those contemplated by the shopping center and its other tenants . . . could thus cause a shopping center's operations to be seriously impaired."[47] Often, retail tenants contract to pay commercial landlords a percentage of sales as part of their total rent in order to properly incentivize their landlords to constantly for an optimal tenant mix.[48]

In addition to altering a tenant mix, landlords and non-debtor tenants are harmed by a debtor tenant's bankruptcy

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46. Pamela Smith Holleman & Magdalena Ellis, *Reexamining the Protections Afforded to Solvent Shopping Center Tenants under § 365 in Light of* In re Trak Auto Corp.*: Part II*, AM. BANKR. INST. J., Feb. 2005, at 12, 52 (internal quotation marks omitted) (citing *Bankruptcy: The Shopping Center Protection Improvement Act of 1982: Hearing on S. 2297 Before the S. Subcomm. on Courts of the Comm. on the Judiciary*, 97th Cong. 27–28 (1982) (statement of Wallace R. Woodbury, Chairman, Woodbury, Corp.)).

47. *Id.*

48. *See* Tony Shun-Te Yuo et al., *Tenant Mix Variety in Regional Shopping Centres: Some U.K. Empirical Analyses* 5 (Univ. of Reading, Working Paper No. 02/04) *available at* http://centaur.reading.ac.uk/21650/1/0204.pdf.

through the Code's aforementioned limitations on prohibitions of "going dark" and "going out of business" sales. In the first place, neighboring non-debtor tenants are negatively impacted if a debtor-tenant's store is not open for business. When a store goes dark, it both reduces the attractiveness of the overall retail center and also deters shoppers from traveling past the vacant store to the further open stores.[49] Going out of business sales alter the general atmosphere of a shopping mall and reduce the perceived elegance and desirability of the retail offering as whole.[50]

It is clear that not only are landlords impaired by the limitations that § 365 places on them, but that neighboring non-debtor tenants experience negative externalities as well. This can be particularly unjust because, as previously mentioned, landlords are limited in the damages they can seek and non-debtor tenants have no standing in a bankruptcy proceeding.

D. *Congress and the Court's Efforts to Rectify the Code's Treatment of Landlords*

Congress, even in drafting the 1978 Code, recognized that the damage suffered by parties who have no ability to control ex-ante the negative effects of assignment (i.e., non-debtor tenants). Furthermore, Congress was also aware of the long-term unmanageable effects on landlords who were unable to receive compensation through damages. This recognition manifested itself in § 365(b)(3) of the Code, which provides special protections for shopping center landlords. However, the effectiveness of these protections were initially frustrated both by the court's application of that section and the difficulty of adjudicating the question of whether a property constitutes a "shopping center" for the purposes of the Code.

As previously mentioned, a lease cannot be assumed and assigned unless the assignee gives adequate assurance of future performance. The current iteration of the Code under § 365(b)(3), provides that "adequate assurance . . . of a lease . . . in a shopping center" requires that (1) the operating performance of the proposed assignee be similar to that of the debtor at the time the debtor became the lessee; (2) any variable rent connected to retail revenue won't decline "substan-

49. *Id.*
50. *Id.*

tially"; (3) the "assignment of such lease is subject to all the [lease] provisions . . . such as radius, location, use, or exclusivity provision"; and (4) the "assignment of such lease will not disrupt any tenant mix or balance in such shopping center."[51]

In 1984, Congress realized that courts were avoiding the above restrictions through decisions that "adversely affect[ed] shopping centers in order to facilitate assignments by debtor-tenants."[52] As a result, Congress deleted the word "substantially" from much of § 365(b)(3) in order to inhibit courts from disregarding the protections for landlords contained in that section.[53] This amendment—which was partially the result of lobbying by shopping center landlords—sprung from a congressional understanding that the initial language in the 1978 Code did not adequately protect landlords and non-debtor tenants.[54] This amendment represented an early, but important step in a shift towards a realization that the 1978 Code's protections were insufficient as applied.

Despite strong indications of congressional intent, such as the 1984 amendments, many courts were still adhering to the spirit of the 1978 Code (and ignoring much of § 365(b)(3)). In the case *In re Rickel Home Centers, Inc.*, the bankruptcy court invalidated a use restriction provision in a lease that mandated the retail space be used only for a home improvement store similar to the Rickel store.[55] The court instead permitted the assignee, Staples, to subdivide the space and use it for the sale of office supplies. That court reasoned the use restriction provision was a "de facto anti-assignment clause"[56] because "market conditions were such that these tenant-type centers would become 'obsolete.'"[57] Decisions such as this one demonstrate the tendency of bankruptcy courts to disregard the rights of landlords and non-debtor tenants in an effort to maximize the value of the estate.

However, bankruptcy courts have increasingly been acknowledging that decisions such as *In re Rickel*, are ill-conceived and contrary to congressional intent. In 2004, the

51. 11 U.S.C. § 365(b)(3) (2012).
52. Ominsky, *supra* note 15, at 1.
53. *Id.*
54. *In re* Trak Auto Corp., 367 F.3d 237, 242–43 (4th Cir. 2004).
55. *In re* Rickel Home Centers, Inc., 240 B.R. 826 (D.C. Del. 1998).
56. *Id.* at 832.
57. *Id.* at 831. *See also* Ominsky, *supra* note 15, at 1 (describing the case).

Fourth Circuit issued a significant opinion marking an important shift by the judiciary towards the enforcement of § 365(b)(3) and tenant mix protections. This opinion, which is one of the first by a Federal Court of Appeals to support this interpretation of § 365(b)(3), marked a "turning point in upholding a landlord's rights to enforce lease restrictions."[58] In a fact pattern similar to *In re Rickel*, the debtor went into bankruptcy and tried to assign its lease, but did not receive any interest from auto parts retailers (the only type of retailer allowed use of the retail space per the lease). Instead the debtor found a discount apparel retailer to purchase the lease. The Fourth Circuit determined, in a break from prior case law, that the specific requirements of § 365(b)(3) overshadowed the general prohibition of "anti-assignment" clauses by § 365(f)(1), and therefore the use restriction contained in the lease should be upheld.[59] In reaching this decision, the court noted that the legislative history leading up to the Bankruptcy Reform Act of 1978 demonstrated that Congress sought to preserve the value of a carefully planned tenant mix.[60] The court relied heavily on the clear legislative intent that the 1984 amendments provided, noting that "Congress's purpose in § 365(b)(3)(C) is to preserve the landlord's bargained—for protections with respect to premises' use and other matters that are spelled out in the lease with the debtor-tenant."[61] It is important to note, however, that the landlord only sought to enforce the use provision requiring that a substantially similar retailer be placed in the retail pad, and not the provision that restricted the pad to use only as a "Trak Auto Store" since such a clause almost certainly would have been struck down under § 365(f)(1).[62] Overall, the *In re Trak* decision has proven to be an important step in the paradigm shift regarding landlord's rights.

Shortly after the *In re Trak* decision, landlords secured another victory with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005. As mentioned above, one significant change to § 365 was its

58. *Id.*
59. *Trak Auto*, 367 F.3d at 244.
60. *Id.* at 242.
61. *Id.* at 244.
62. Ominsky, *supra* note 15.

limitation on the ability of a judge to extend the timeframe in which a debtor could decide whether to assume or reject a lease. Often, landlords had to wait years before learning of the debtor's intentions, which was incredibly disruptive to the landlord and the debtor's tenant neighbors.[63] BAPCPA limits this time frame to 120 days following the date of filing with one discretionary 90-day extension. After that time, the lease is deemed rejected. This important change dramatically benefited the landlord at the expense of debtors. Furthermore, it also represents another instance where Congress created a statutory response to the courts' repeated interpretation of § 365 in favor of debtors' interests.

The second major statutory modification contained in BAPCPA clarified the language in § 365(b)(2) concerning the type of defaults that need to be cured before a lease can be assumed. Before BAPCPA, courts such as the Ninth Circuit often did not require non- monetary defaults to be cured for the assumption to transpire.[64] The imprecise language of the original 1978 Code allowed for this debtor-friendly interpretation of § 365(b)(2). BAPCPA refined the language of the statute and today non-monetary defaults under leases "must be cured at or promptly after the time of assumption."[65] However, it is important to note that non-monetary defaults that are impossible to remedy at the time of assumption still do not have to be cured.[66] This modification is yet another example of a congressional rebuke of overly debtor-friendly interpretations of § 365 by the courts.

The final major change in BAPCPA was to further clarify how § 365(f)(1), the prohibition on "anti-assignment" clauses, operates in conjunction with the landlord protections contained in § 365(b)(3).[67] Although Congress had addressed the general issue of the enforceability of the aforementioned provision through the 1984 amendments, decisions such as *In re Rickel* illustrated that further congressional clarification was required. As a result, § 365(f)(1) was modified specifically to include "except as provided in subsections (b) and (c) of this

63. Leslie A. Cohen, *Shopping Center Leases in Bankruptcy and the Impact of BAPCPA*, 30 CAL. BANKR. J. 31, 33 (2009).

64. *Id.*

65. *Id.*

66. § 365(b)(2).

67. *Id.*

section"[68] in order to explicitly prioritize the protections contained in § 365(b) over the general prohibition of anti-assignment restrictions contained in § 365(f). Therefore, BAPCA represents a congressional endorsement of the Fourth Circuit's decision in *In re Trak Auto*.

As demonstrated, both Congress and the courts, since the enactment of the 1978 Code, have steadily—albeit slowly—recognized that landlords are harmed in a distinct and often more extensive manner by the bankruptcy process relative to other creditors. While courts were initially slower to recognize these considerations than was Congress, recent decisions have indicated an acceptance of the clear congressional desire for bankruptcy courts to consider the type of maltreatment unique to retail landlords.

II.
Why Progress Still Needs to Be Made

Despite the inclusion of § 365(b)(3) in the original Code, the 1984 amendments, BAPCPA, and recent court decisions such as *In re Trak*, the current legal landscape regarding lease assignments in bankruptcy still harms landlords, causes negative externalities to neighboring tenants, indirectly disadvantages small businesses,[69] and as a result, may damage the overall economy. The "shopping center" protections that provide the basis for landlords to assert their contractual rights during the bankruptcy process are primarily limited to the traditional conception of a suburban retail center. Therefore, these safeguards fail to include the important tenant mix considerations in an increasingly urbanized America. Similarly, the § 365(b)(3) protections often do not apply to non-traditional retail real estate assets. The statutory guidelines for determining what constitutes a shopping center for the purposes of the Code is highly fact specific and often results in heavily contested, drawn out litigation. Lastly, because of § 502(b)(6)'s limitation on damages in combination with the undesirability of having a

68. § 365(f)(1).

69. As will be explained on page 524 of this Note, all else being equal, small businesses are likely to face higher rents and required deposits than "credit tenants" to compensate for the fact that landlords do not receive protections against non-pecuniary losses in an assignment of a lease not covered by § 365(b)(3).

tenant not of the landlord's choosing, landlords strongly favor well-established large corporate tenants at the expense of small businesses and startups. The later class of tenants incur extra expenses, which raises the barrier to entry for growing businesses. In effect, what may on the surface appear to be a policy preference that favors the weaker stakeholder (the debtor) actually creates a cost disproportionately borne by small businesses. While there are countervailing concerns that favor benefiting the debtor's estate in the manner that the Code currently envisions, the ex ante incentives are such that the current statutory and case law landscape may in fact stifle economic growth at the margin.

A. *The Difficulty of Determining What Is and Is Not a Shopping Center*

Due to a lack of statutory definitions, what constitutes a "shopping center" for the purposes of § 365(b)(3) of the Code is determined on a case-by-case basis.[70] This mechanism makes the legal character of non-typical retail offerings very difficult to determine ex ante, leaving this large decision to the discretion of the bankruptcy courts, which in turn results in protracted litigation. However, these factors clearly do not apply to standalone urban retail real estate assets, as will be explained below.

While the burden is on the landlord to establish that a real estate asset is a shopping center, if challenged, "the typical enclosed mall or strip mall with contiguous retail stores, off-street parking, common areas jointly maintained, fixed store hours, so obviously fit the typical conception of a shopping center that parties never bother to litigate the character of the property."[71] However, in less well-defined instances, such as a collection of stores in a commercial area of a small town such as Freeport, Maine, the issue becomes less clear. The leading case on the issue—which resulted from the dispute centered around that fact pattern—established fifteen different factors to determine whether a group of stores constitutes a shopping center, none of which are dispositive:

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70. *In re* Joshua Slocum Ltd., 922 F.2d 1081, 1086 (3d Cir. 1990); *In re* Goldblatt Bros., Inc., 766 F.2d 1136, 1140 (7th Cir. 1985); *In re* Ames Dep't Stores, Inc., 121 B.R. 160, 164 (Bankr. S.D.N.Y. 1990).

71. Cohen, *supra* note 63, at 31.

> (a) A combination of leases; (b) All leases held by a single landlord; (c) All tenants engaged in the commercial retail distribution of goods; (d) The presence of a common parking area; (e) The purposeful development of the premises as a shopping center; (f) The existence of a master lease; (g) The existence of fixed hours during which all stores are open; (h) The existence of joint advertising; (j) [sic] Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases; (k) The existence of percentage rent provisions in the leases; (l) The right of the tenants to terminate their leases if the anchor tenant terminates its lease; (m) Joint participation by tenants in trash removal and other maintenance; (n) The existence of a tenant mix; and (o) The contiguity of the stores.[72] The "existence of 'anchor tenant'" may be another factor.[73]

It is readily apparent that the vast majority of these factors have no clear application to urban retail landlords because criteria, such as anchor tenants (e.g., a department store in a shopping mall), are not part of the urban retail paradigm.[74] Furthermore, with urban retail real estate assets there is normally no contractual interdependence between tenants, no contractually mandated coordination between tenants, etc. As a result, the issue of whether or not a stand-alone urban retail asset qualifies for § 365(b)(3) protections has not yet been litigated in an Article III Court.

However, there is ambiguity when it comes to non-traditional retail assets such as a multiple retail spaces owned by the same owner on the same street. The Third Circuit, when considering such a fact pattern, did exhibit a willingness to consider a non-traditional retail grouping a shopping center.[75] On the other hand, in a leading case decided by the Seventh Circuit, because only three of the mentioned factors were satisfied, the real estate asset was not considered a shopping

72. *Joshua Slocum*, 922 F.2d at 1087–88. The opinion skips (i) and misnumbers the list.

73. *Goldblatt Bros.*, 766 F.2d at 1140.

74. David Uberti, *The Death of the American Mall*, GUARDIAN (June 19, 2014), http://www.theguardian.com/cities/2014/jun/19/-sp-death-of-the-american-shopping-mall.

75. *Joshua Slocum*, 922 F.2d at 1089.

center.[76] Unfortunately, the unpredictability of the current method for determining what constitutes a shopping center provides landlords and tenants in non-traditional environments with no real certainty ex ante as to whether the bankruptcy court will honor lease provisions that seek to avail themselves of § 365(b)(3) protections. As a result, it is hard for the market to appropriately price rent and required deposits in an efficient fashion.

B. *The Shopping Center Protections of § 365(b)(3) Have Become Inadequate*

As explained above, the determination as to whether or not, for the purposes of § 365(b)(3) of the Code, a retail space is considered to be part of a shopping center is a highly fact-specific inquiry. In its current form, the case law does not seem to include urban retail-focused real estate in the definition. This gap in the statute and the associated case law leaves the landlords of this country's most valuable real estate (on a per square foot basis) without protection. Increasing urbanization in the United States exacerbates this problem. Furthermore, the shopping center definitions do not encompass mixed-use buildings in suburban environments, despite the fact that they often contain tenants who possess non-pecuniary value to their landlords and neighbors.

As of 2010, 80% of the American public lived in a city with a population of 150,000 or more, and 85% of U.S. GDP came from such cities.[77] Additionally, between 1978 and 2010, the largest thirty U.S. cities accounted for half of the nation's GDP growth.[78] During this same time period, the urban population as a percentage of the total population of the United States increased by 7%.[79] Therefore, there does not seem to be any compelling reason for the economic interests of the urban markets in the United States to not receive the same legal protections enjoyed by those of the suburban markets.

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76. *Goldblatt Bros.*, 766 F.2d at 1140–41.

77. James Manyika et al., *Urban American: US Cities in the Global Economy*, McKinsey & Co. (April 2012), http://www.mckinsey.com/insights/urbanization/us_cities_in_the_global_economy.

78. *Id.* at 27.

79. U.S. Census Bureau, United States Summary: 2010, *available at* http://www.census.gov/prod/cen2010/cph-2-1.pdf.

The importance of urban retail to the overall economy cannot be overstated. A recent lease of retail space on New York's Fifth Avenue was signed for $4,000 per square foot per year, a staggering figure, especially when compared to typical shopping center rents in suburban New Jersey of $80 per square foot per year.[80] Interestingly, § 365(b)(3) and the surrounding case law do not protect the Fifth Avenue landlord even though they almost certainly protect the suburban shopping mall landlord. Tenant mix is important to both landlords, even if the former does not own the retail pads directly neighboring its rented space. Many landlords concentrate purely on retail real estate assets in a certain city and often own interests in several noncontiguous properties in the same immediate area.[81]

Even those landlords who only own one retail asset presumably make economic decisions under the assumption that the existing character of each area's retail offering and the economic motivations of each area's properties' landlords will not change significantly. The ability to rely on these expectations contributes to the value of the properties as it lowers the associated risks. The symbiotic nature of New York's Fifth Avenue is no different than that of a shopping center in suburban New Jersey, yet the case law associated with the Code's provisions regarding lease assignments does not protect the former.

While the synergies inherent in tenant mix for nearby retail offerings is contemplated by § 365(b)(3), there is not a similar respect for the importance of the character of a retail tenant to the non-retail tenants in a mixed use (multiple types of tenants in a single building) property. For example, residential tenants of an apartment building in Manhattan have a non-economic interest in the character of the retail tenant on the ground floor of their building that is not accounted for by the Code. The intensity of this interest was recently illustrated by a Manhattan condominium board that filed a lawsuit seeking an injunction and, in the alternative $10 million in dam-

80. Adam Pincus, *The Syrian Retail Touch*, REAL DEAL (Jan. 1, 2014), http://therealdeal.com/issues_articles/the-syrian-retail-touch/; Yaffi Spodek, *The Malls Are All Right*, REAL DEAL (Dec. 30, 2010), http://therealdeal.com/issues_articles/the-malls-are-all-right/.

81. Pincus, *supra* note 80.

ages, in response to an attempt by a Denny's restaurant to lease the ground floor retail space in their building.[82] If, as is common in many cities across the United States, a condominium board owned the retail space on the ground floor of its building for the benefit of the buildings residents, and a tenant became bankrupt, the residents would have no means by which to restrict an undesirable assignee from occupying the space for the remainder of the lease. A diminution of the residents' condominium values may very well follow as a result. A similar tenant preference has the potential to affect residential rents in an apartment building that has a retail-focused ground floor, yet the landlord is also not protected by the current iteration of the Code.

Similarly, landlords of buildings that are primarily composed of office tenants have a strong non-pecuniary interest in the character of the retail tenants on such properties, regardless of whether or not the real estate is suburban or urban. These tenant mix considerations are also not captured by the shopping center protections. Many office tenants desire a certain character of retail offerings for the convenience of their employees as well as the associated prestige of their workspace, and therefore office tenants make workspace procurement decisions mindful of the identity of an office building's retail tenant. For instance, a law firm may desire an office building that has both a coffee shop and a high-end restaurant for the convenience of its employees and clients.

Overall, the lack of protections afforded to urban retail landlords, office landlords, residential landlords, and tenants in mixed-use buildings by § 365(b)(3) of the Code and the surrounding case law creates a large gap that is unwarranted and inconsistent with the stated aims of the shopping center protections currently provided to suburban malls as pronounced by Congress and courts. As a result, a large portion of the real estate market, which is only expanding as this country becomes increasingly urbanized, is not adequately protected against the damage that a debtor's lease assignment rights can inflict on a landlord and non-debtor neighboring tenants.

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82. David Jones, *150 Nassau Board (Grand) Slams Denny's in $10M Lawsuit*, REAL DEAL (June 6, 2013, 6:00 PM), http://therealdeal.com/blog/2013/06/06/150-nassau-condo-board-grand-slams-dennys-in-10m-lawsuit/.

C. *The Negative Effects of Providing Lease Assignment Rights to the Debtor*

Congress's decision to mandate that debtors retain the right to freely assign leases in bankruptcy, like many policy choices, unavoidably results in courts delivering value to one party at the expense of another. However, this choice is differentiated from similar value allocation decisions in that the information available to the stakeholders at the time economic choices are made does not create a situation where the debtor can realize the benefit provided by the Code's lease assignment system. When a tenant signs a lease with a landlord, the agreed upon rent reflects the market's expectations for the future rents that are locked in by the lease term. In an efficient market, this implies that any later movement in the real estate market that renders the lease either more valuable (because market rents have increased beyond what was expected at the time the lease was signed) or less valuable (because market rents have declined beyond what was expected) cannot be effectively predicted in the ex ante. Therefore, any value that a lease has when the debtor later files for bankruptcy is somewhat fortuitous and represents a windfall of sorts for the creditors, at least those who have lent to the debtor before the lease was signed or without full knowledge of the lease's value. Because the value derived from the debtor being party to a below-market lease is not accounted for by creditors who lent before the debtor entered into a below-market lease, lending rates are not dramatically influenced by whether the debtor has the right to assign a lease in bankruptcy. At most, the debtor can be thought of as selling a statutorily mandated call option. The option's "premium" is reflected as a relative decrease in the spread over the risk-free rate at which the debtor is borrowing, and the option is "in the money" only when (1) the debtor is bankrupt, (2) the debtor decides not to retain the lease as part of a reorganization, and (3) the lease has value beyond the market's expectation at the time of lease signing. One can assume that such a difficult to discount scenario does not result in a large call premium (i.e., a large decrease in lending spreads).

While lenders may discount the aforementioned probability of lease monetization, one can assume that the present value of the incremental savings for the debtor in terms of

the cost of funds will be smaller than the increased deposit and rent demanded by landlords for "non-credit" tenants. This is because, unlike other potential claimants in bankruptcy, landlords have to use deposits at lease signing as their main source of recourse in the event of insolvency as § 506(b)(3) limits landlords' damages and therefore the size of their claims. Additionally, the harm suffered by landlords in ways for which damages are not typically awarded, such as the incremental decrease in desirability of the property by potential neighboring tenants of a lease assignee, needs to be accounted for through deposit size and rent. Therefore, non-credit tenants, i.e., tenants who do not have a strong credit rating assigned by a nationally recognized statistical rating organization (e.g., Moody's, Standard & Poor's, Fitch, etc.) or a similarly strong credit profile, are at an increased disadvantage when securing leases relative to other lending relationships. The increase in deposit demanded, in addition to the higher rent that is often required by landlords when renting to non-credit tenants can significantly increase the cost of expansion for growing non-credit businesses—the same category of businesses that account for the majority of incremental job growth in the United States.[83] Therefore, under the current legal scheme, the Code forces non-credit tenants to "sell" to creditors the right to benefit from the assignment of leases in the event of bankruptcy. The cost borne by the landlord that results from the value transfer mandated by such a scheme is partially passed on to the tenant in the form of higher rent and a larger deposit than would otherwise be necessary.

As mentioned above, mandatory lease assignment and other provisions of § 365 impose negative externalities borne by non-debtor neighboring tenants, which (by definition) harm the actors who are not directly party to the lease without imposing an equal cost on those parties who are able to either mitigate (the landlord through increased deposit or rent) or benefit from (the debtor-tenant) the associated harm. There is deadweight loss whenever the value derived from lease assignment by the debtor is less than the value destruction to the non-debtor tenants. The negative externalities include the lost

83. U.S. SMALL BUSINESS ADMINISTRATION, FREQUENTLY ASKED QUESTIONS (Sept. 2012), *available at* http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

synergies from tenant mix that are not completely accounted for by rent tied to sales revenue, and the loss in goodwill and revenue due to protected practices such as "going dark" and "going out of business" sales. These inefficiencies also, theoretically, can result in at least a marginal drag on economic growth.

As a result, the current landscape benefits creditors in bankruptcy at the expense of landlords, non-debtor neighboring tenants, and non-credit tenants looking to lease new space. The inability of the market to determine who values this right more, landlords or creditors—as expressed by incremental rent and deposit demands and incremental lending rates respectively—creates an inefficiency that, in theory, is an overall drag on the economy. When the effects of this inefficiency are combined with the negative externalities placed on neighboring non-debtor tenants, the costs of mandatory lease assignments appear to outweigh the benefits of maximizing the value of the debtor's estate for the benefit of its creditors.

III.
Policy Recommendations

This Note puts forth two proposals, either of which would serve to mitigate the harm done to landlords and non-debtor neighboring tenants as a result of lease assignments enabled by the bankruptcy process. Implementing either recommendation would therefore reduce the overall economic drag that results from the current system. These proposals both envision a statutorily enabled "opt-in" mechanism so that (1) debtors and their creditors may still enjoy the perceived benefits of the current lease assignment system; yet (2) the lease assignment rights can be priced through a market mechanism in order to ensure economic efficiency and allow for the negative externalities suffered by the non-debtor neighboring tenants to be internalized by the landlord.

A. *The First Proposal*

The first proposal is to modify the language of § 365(b)(3) of the Code to provide the drafters of any commercial lease the option to include a clause indicating that the retail asset is deemed part of a "shopping center" and therefore is per se qualified for the protections of § 365(b)(3).

There are several advantages to such an approach. First, the negative externalities that result from the current system could be eliminated. If this proposed change to the statute is adopted then all tenants, depending on their level of concern regarding tenant mix, could exert pressure on a landlord to "purchase" such a term. This stands in contrast to today's market, in which it is unrealistic for a tenant to require such a lease term in its neighboring tenants' contracts when such a term would be unenforceable in court. The proposed change would force the two parties, whose decisions influence the harm done to the potential non-debtor tenants, to internalize the externality.

Second, because such a term would be bargained for between the tenant and landlord, the market could determine the appropriate consideration for including a "shopping center" designation in each instance. Landlords would be incentivized to offer reduced rent to debtors who were willing to include such a designation, and the size of such a rent reduction would be a function of (1) the perceived likelihood of the tenant filing for bankruptcy, (2) the perceived likelihood that the lease would be assigned instead of retained or canceled, (3) the damage that would be done to the landlord if a tenant that the landlord did not approve of moved into the retail space at issue, and (4) the damage that would be done to the non-debtor tenants in such an instance. Debtors would make a similar calculus that would factor in the incremental cost of borrowing imposed upon them by their creditors for not retaining the right, in bankruptcy, to assign leases to the highest bidding assignee. Therefore, the price of such a term could be easily determined. Lastly, non-credit tenants could "sell" their right to assign their lease without any restrictions in the form of reduced rent and deposit as a way to lower the cost of expanding their businesses. This would be an efficient way to stimulate job growth, as it allows startups and small businesses to develop more rapidly.

However, there are also several disadvantages to this proposal. First, while contractual creditors may be able to influence the debtor's decision of whether or not to bargain for the right to freely assign a lease, tort creditors would not be in a position to influence the debtor in the same manner. Second, the debtor would not be able to realize the maximum amount of monetary value in bankruptcy from what is most certainly

an asset—a below-market lease. Lastly, the landlord does not get to choose the optimal tenant for the retail space. Rather, the landlord only receives the protections contained in § 365(b)(3) while the debtor ultimately makes the decision of which tenant is assigned the lease, so there may still be some inefficiencies.

One may argue that the debtor will always seek to "sell" her right to freely assign a lease to the landlord as debtors frequently underestimate their own likelihood of declaring bankruptcy. However, this fear is unwarranted because the debtor's assessment of her own chances of filing are not relevant; it is rather a question of which of the debtor's counterparties is willing to pay the debtor more for the right to freely assign—the landlord via reduced rent and deposit or the lender via a reduced lending rate. It is the lender, not the debtor, who may ultimately benefit from the debtor's decision to retain such a right as the lender will become the claimant on the debtor's estate. Therefore, the fact that debtors are unrealistic regarding their chances of insolvency does not affect this, or the following proposal.

B. *The Second Proposal*

The second proposal is slightly more complex, but solves the disadvantages of the first proposal (although it is not perfect either). Again, this proposal involves an opt-in statutory mechanism, but instead allows for a term whereby the landlord rather than the debtor receives the right to choose who is the new tenant. The landlord and the new tenant would agree to a new, long-term lease, and any incremental increase in rent above the debtor's prepetition lease would be passed to the debtor's estate. This arrangement prevents the landlord from receiving a windfall at the expense of the debtor's estate yet still gives the landlord the ability to secure a tenant that provides the maximum total value to the landlord and the non-debtor neighboring tenants. The value proposition to the landlord of including this term is even greater than the prior proposal because here the right being sold is not merely the right to restrict the debtor's ability to freely assign the lease, it is the right to actually control the lease assignment. As a result, landlords would be incentivized to pay even more than they would under the first proposal, potentially leading to an even

greater economic benefit for small business lessees nationwide.

An obvious danger of this proposal is that the landlord is incentivized to choose a new tenant that provides a large non-pecuniary benefit regardless of whether or not that tenant is willing to pay a rent that reflects the full value of the below-market lease. This inefficiency can be mitigated, but by allowing the courts to deny a lease assignment to a tenant of the landlord's choosing if any inference of bad faith can be demonstrated by the debtor. However, in order to diminish the amount of litigation surrounding the issue, the landlord can establish that the new lease is fair and was negotiated for the benefit of the debtor's estate by negotiating a new lease for a period of time that is at least twice as long as the length of time remaining on the original lease. If, in the new lease, there are no substantial rent increases immediately after the original lease is scheduled to expire, then presumably the landlord's and the debtor's estate's incentives with respect to the rent figure are aligned. This is because the landlord has a desire to receive the maximum possible amount of rent without harming the landlord's and non-debtor neighbor's non-pecuniary interests.

An illustration of such a proposal is useful. Suppose that Debtor A—upon evaluating the potential economic value of the size of the reduced borrowing rate from its lender relative to the size of the reduced security deposit and rent from its landlord—chooses to include the optional but statutorily available clause that gives the landlord the right to choose who is the new tenant in the event that bankruptcy is declared. Similar to the first proposal, the ability to make such a decision allows the debtor to fully capture the value that her counterparties place on the ability to control the assignment of the below-market lease in bankruptcy. Debtor A, an electronics store, then signs a fifteen-year lease with the landlord (of course including the proposed term) for a rent of $50 per month. The debtor files for bankruptcy five years later with a below-market lease, which the landlord is now able to assign to a tenant of its choosing. The landlord finds another electronics store, in order to retain a similar tenant mix, and signs a lease with that retailer, Tenant B, for $75 per month for twenty years with no rent increases. The landlord is required to remit to Debtor A's estate $25 per month for the ten years remain-

ing on the lease, but keeps the incremental $25 per month for the following ten years. Because the new lease is twice as long as the period of time remaining on the debtor's lease post-filing, and because there are no substantial rent increases after year ten, there is a rebuttable presumption that the lease is fair. This is because the incentives of both the landlord and Debtor A are aligned from a monetary perspective, as both are party to the same economic terms for ten years each.

Like the prior proposal, this scheme also has the benefit of forcing the parties who can minimize the effects on the non-party stakeholders to internalize the negative externalities that would otherwise result. Similarly, this proposal also enables price discovery as to which party holds the right to assign leases in bankruptcy. As a result, this proposal enables non-credit tenants to sell their assignment rights, thereby lowering the cost of expansion. Unlike the prior proposal, this recommendation allows for the value resulting from a below-market lease to be divided among all stakeholders, mitigating some of the harm done by decreasing the size of the estate to the detriment of tort creditors. The disadvantage of this proposal, however, is the possible increase in litigation surrounding the issue of whether or not the landlord acted in good faith when securing and agreeing to a rent figure for the new tenant.

Because both proposals allow for a market pricing system for the inclusion of a term that would not allow the debtor to assign a lease in bankruptcy without restriction, the theoretical economic harm done by the current system would be eliminated. As mentioned, this is because the parties who have the ability to influence whether or not the term is included would be forced to internalize the negative externalities borne by the non-debtor neighboring tenants and because non-credit tenants could receive reduced rent and required deposit (albeit potentially at the cost of higher incremental lending rates for creditors), thereby lowering the barrier to growth for such companies. Similarly, both proposals allow for all parties involved to make informed decisions as to the value of their contractual rights and then act accordingly. This effect leads to increased efficiency because it promotes price discovery and value optimizing choices by presumably economically rational actors. Therefore, both proposals are arguably superior to the current state of the law with respect to lease assignments in bankruptcy pursuant to § 365.

One potential criticism of this proposal is that it vitiates the traditional common law conception of the leasehold as a legal estate that is under the control of the lessee. A property law scholar may very well characterize a leasehold as ownership of real estate for a specific period of time, entitling the holder of the leasehold (the debtor) the right to control the real estate's future for the duration of the leasehold.[84] A proposal that prematurely reverts this control back to the landlord would violate this common law conception.

However, it is necessary to note that the common law provides mechanisms that can allow individuals to exercise control over their neighbors in order to maximize the value of all the related property in the aggregate. For instance, property law allows for easements to be granted, servitudes exacted, and covenants to be placed on the land.[85] In short, the common law recognized that there are efficiency gains to be had by giving property owners a mechanism to control the actions of their neighbors. Clauses within a retail lease that require the tenant to act in a certain manner for the benefit of her neighbors (e.g., "going dark" clauses, "going out of business" sale prohibitions, retail offering restrictions, etc.) serve the exact same function as the aforementioned mechanisms.[86] In fact the Bankruptcy Code respects such common law mechanisms, as evidenced by the § 363(e) restrictions on selling a property free and clear of easements, covenants, and servitudes in a § 363 sale.[87] This proposal therefore is, in spirit, congruent

84. David A. Thomas, *Anglo-American Land Law: Diverging Developments from a Shared History Part II: How Anglo-American Land Law Diverged after American Colonization and Independence*, 34 REAL PROP. PROB. & TR. J. 295, 300 (1999).

85. Susan F. French, *Design Proposal for the New Restatement of the Law of Property Servitudes*, 21 U.C. DAVIS L. REV. 1213, 1217 (1988).

86. Arguably, the landlord is merely an instrumentality for the neighboring tenants in this instance, as the neighboring tenants seek to align the landlord's incentives with their own through percentage revenue sharing agreements as well as actual tenant requests to include such clauses in all leases. The fact that the neighboring tenants control the debtor via contractual terms within the debtor's lease with the landlord instead of directly is not material.

87. Patrick E. Mears & John T. Gregg, *Sales of Real Estate Free and Clear of Restrictive Covenants under Section 363(f) of the Bankruptcy Code: A Case Comparison*, 041207 AM. BANKR. INST. 973 (2007).

with the traditional common law conceptions of property restrictions.

Conclusion

The cost to the overall economy that results from the uncertainty that landlords face due to § 365 and the negative externalities borne by non-debtor tenants are too great to justify applying the assignment provisions to urban retail and non-traditional retail assets. While the overall aim of the Bankruptcy Code is to maximize the value of the debtor's estate for the benefit of its creditors, this policy can be superseded in discrete areas of the Code by stronger considerations. The "shopping center protections" of § 365(b) is an example of this phenomenon. For the reasons explained above, such a shift in priorities—from blindly seeking to maximize the value of the estate at every turn to inquiring what is the best value maximizing procedure for the overall economy—would be prudent.

Under the current legal scheme, there is no ability for a market-based mechanism to decide the ex ante value of the right to restrict the unconstrained assignment of a debtor's fortuitous below-market lease. As a result, there is no assurance that such a right is being given to the part that most values it. If such a party is not able to express its viewpoint through price action, then the debtor may be overpaying to expand its business, which at the margins stifles job growth, as the expansion of small businesses is a driving force in employment growth.

Not only is the debtor (while still solvent) harmed by this policy, but the landlord and its other non-debtor tenants are also harmed because they are unable to take any measures to mitigate the harm done in the event of the debtor's bankruptcy. While all policy decisions involve tradeoffs, in this case there is a strong likelihood that the costs of the harm done to landlords (which is not fully compensated for due to the damage limitations in § 502(b)(6)) combined with the damage done to the non-debtor tenants—through (1) changes in tenant mixes, (2) "going out of business" sales, and (3) the "going dark" phenomena—is greater than the incremental amount of money recovered by the debtors' estates by being able to as-

sign leases to the highest bidders rather than the highest acceptable bidders to landlords and their tenants.

As a result, the two proposed reforms to § 365 presented in this Note should be considered since both seek to provide the ability to allow a market-based mechanism to set the price of this right for the ultimate benefit of the debtor. In general, much of civil law exists to allow private parties to interact with each other in ways that maximize the overall value of their transactions to themselves and society. While the U.S. legal system restrains this enabling mechanism at times, the instance of retail real estate lease assignment should not be one of them, as there is no clear reason why the protections given to traditional shopping center landlords should not also apply to non-traditional retail landlords or urban retail landlords.