

THE BANKRUPTCY STRATEGIST

Key Win Likely for Commercial Shopping Center Lessor In Second Circuit

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December 2023

The U.S. Court of Appeals for the Second Circuit, on remand from the Supreme Court, further remanded to the district court the key issue of whether the Chapter 11 debtor gave “adequate assurance of future performance of” a commercial real property shopping center lease “as required by [Bankruptcy Code] §365(b)(3)(A),” after the debtor’s assignment of its lease to Transform Holdco LLC (T). *In re Sears Holding Corp.*, 2023 WL 7294833 (2d Cir. Nov. 6, 2023). MOAC Mall Holdings LLC (M), the shopping center lessor, had objected to the lease assignment because the assignee had not met the Code’s financial condition requirement; lost in the bankruptcy court; initially prevailed in the district court on appeal; but lost again in that court and in the Court of Appeals on jurisdictional grounds. The Supreme Court, however, rejected the Second Circuit’s jurisdictional holding and remanded for a review of the merits of M’s appeal. *MOAC Holdings LLC v. Transform Holdco LLC*, 143 S. Ct. 927, 933 (2023) (“... §363(m) is not a jurisdictional provision.”).

FACTS

The superficially complicated fact pattern in *Sears* can be simplified. M was a shopping center

landlord who challenged the debtor’s lease assignment to T because T failed to provide “the requisite adequate assurance of future performance” required by Bankruptcy Code (Code) §365(b)(3) (“similar ... financial condition and operating performance” as the debtor when “the debtor became the lessee under the lease”). After the bankruptcy court denied its objection, M initially prevailed on appeal in the district court. *In re Sears Holdings Corp.*, 613 B.R. 51 (S.D.N.Y. 2020). In its initial decision, the district court held that T “failed to prove financial and operating similarity between [the debtor] in 1991 [when lease signed] and [T] today, under any standard ...” *Id.* at *78. “Congress ... decided that only an assignee with a financial condition and any operating performance that resembled the debtor’s *ab initio* would provide a shopping center landlord with ‘adequate assurance’ that the bargain originally struck would be performed by the lease’s assignee.” *Id.* It further rejected the bankruptcy court’s unsupported finding that T was “an entity with equity of \$50 million ...” *Id.* The evidentiary record failed to meet “the congressionally-mandated standard for providing adequate financial assurance of future lease performance.” *Id.* at *79. Because of the inadequate record and erroneous legal analysis, the district court vacated the bankruptcy court’s approval

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of the assignment of the lease to T and remanded for further findings. T then sought a rehearing instead, requiring the district court to dismiss M's appeal on jurisdictional grounds, based on Second Circuit precedent construing Code §363(m). The U.S. Supreme Court, however, held that §363(m) is not jurisdictional, vacated the Second Circuit's affirmation of the district court, and remanded the case to the Second Circuit for a review of the merits. 143 S. Ct. at 305.

THE SECOND CIRCUIT

The Second Circuit agreed with M that it should "consider the merits of [T's] cross-appeal and, in effect, affirm the District Court's initial order of February 27, 2020" 2023 WL 7294833 at *1. Reviewing the merits, the Second Circuit held that "for the reasons stated in the district court's [initial] February 27, 2020 opinion, [T] has not given 'adequate assurance of future performance of [the] lease' as required by [Code] §365(b)(3)(A)." The court then further remanded the case to the district court because that court's initial opinion "charted a remedial course it might again consider on remand." *Id.*

PERSPECTIVE

The requirement that the Chapter 11 debtor in possession here, acting as trustee, provide "adequate assurance of future performance" under Code §365(b)(3), was triggered when it sought to assign the shopping center lease after assuming it. "Adequate assurance of future performance" for shopping center leases includes the following requirements:

- The source of rent must be assured. §365(b)(3)(A);
- The financial condition and operating performance of the assignee must be similar to that

of the debtor when the debtor first became lessee, here, in 1991. §365(b)(3)(A);

- Any percentage rent will not decline "substantially." Code §365(b)(3)(B);
- The assignment will be subject to all the provisions in the lease, including radius, location, use, and exclusivity. §365(b)(3)(C); and
- The assignment will not disrupt any tenant mix or balance in the shopping center. §365(b)(3)(D).

These requirements make "it more difficult for a debtor-tenant ... to assign" a shopping center lease, shifting the balance of power toward the non-debtor commercial lessor. See, *In re Trak Auto Corp.*, 367 F.3d 237, 245 (4th Cir. 2004) (reversed order ignoring lease's use restriction); *In re Joshua Slocum, Ltd.*, 922 F.2d 1081 (3d Cir. 1990) (provisions in debtor's lease concerning termination and minimum sales not to be removed by bankruptcy court as part of debtor's assumption and assignment of lease).

The Second Circuit in *Sears* said that the district court's "initial opinion charted a remedial course it might again consider on remand." *Id.* at *1. The district court, though, had "remanded to the Bankruptcy Court for further findings." 613 B.R. at 79. "Either [T] meets the standard in the [lease] or it does not. There has to be a finding, one way or the other, and that finding has to be supported by substantial evidence," reasoned the district court. *Id.* at *79. There was no room, moreover, for the bankruptcy court's unsupported "wholly conclusory supposition" *Id.* T will have to show that its financial condition, among other things, satisfies "the mandate of §365(b)(3)(A)." After all this time and effort, though, T may have a tough time making the requisite showing. T failed to make that showing in the first round of this four-year old litigation.