

LEASES, LANDLORDS AND DESIGNATION RIGHTS

Sales of designation rights in retail bankruptcy cases require landlord vigilance.

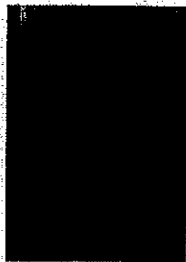
Stan L. Goldberg

A relatively new concept for the disposition of leasehold interests in retail bankruptcy cases has rapidly gained general acceptance and approval by the bankruptcy courts. As demonstrated in the recent liquidation of leases of the Breuners/Huffman-Koos Furniture chain, wherein the only successful bidders were designation rights purchasers, the sale of designation rights is a trend that is here to stay and one that carries with it ramifications for all parties involved — the tenant-debtor and its creditors, as well as the shopping center landlord.

A bankruptcy debtor has historically had three elections under the Bankruptcy Code (the code) with respect to its retail leases — rejection, assumption, or assumption and assignment. The code has never expressly authorized modification of leases as an alternative; indeed, special provisions have been enacted to protect the interests of shopping center landlords on such issues as maintaining use restrictions and avoiding disruption of tenant mix. As a practical matter, however, debtors have used the leverage of the threat of potential assignment to an undesirable tenant or a sudden rejection of the lease to obtain concessions from landlords to facilitate assumption and assignment. And, in furtherance of the goal of creating liquidity by facilitating the sale of leases, the bankruptcy courts themselves have often interpreted the code to permit certain lease provisions — notably “going dark” restrictions — to be enforced with greater flexibility.

HOW DESIGNATION RIGHTS WORK

The sale of designation rights permits the debtor to sell to a third party — most often a real estate investment group — its right to control the disposition of its leases by designating the ultimate assignee. The designation rights sale usually occurs after a marketing and lease auction process and is often coordinated to immediately follow the conclusion of going-out-of-business sales. A designation rights buyer usually purchases the rights to a group of leases in a package bid that exceeds the individual bids for those stores. The transaction is structured pursuant to a designation rights agreement that provides, among other things, that the designation rights buyer will receive an extended period of time, typically 4 to 6 months, within which to further market the leases and negotiate with landlords in an attempt to



Stan L. Goldberg maximize its return. Upon reaching an agreement with the ultimate end-user, the proposed assignment is presented to the bankruptcy

court for approval under the same criteria as if the debtor was assigning to the new tenant directly.

The recent Breuners/Huffman-Koos bankruptcy provides a case in point as to the implication of designation right sales for each of the distinct constituencies involved. For the debtor, it provided an expedited marketing process and combined lower risk with the ability to obtain an immediate cash infusion into the estate. In making the decision to accept a designation rights offer, the debtor, acting in consultation with its secured lender and committee of unsecured creditors, determined that the immediate cash infusion afforded by the designation rights sale outweighed the potential for higher prices that might be obtained were Huffman-Koos to continue to directly market the leases to ultimate end-users. A critical, and often determinative, factor in Breuners/Huffman-Koos' and every other debtor's decision is the uncertainty of the real estate market and the continued carry cost of the leases during an extended marketing period. Under virtually all designation rights agreements, the designation rights buyer assumes all carrying costs for rent, escalations, common area charges, taxes, security and the like as soon as its agreement is approved by the court and thereby bears the cost and risk of the extended marketing period.

DESIGNATION RIGHTS AND LANDLORDS

The sale of designation rights also carries with it multiple ramifications to landlords. As a threshold proposition, landlords can be negatively affected by the bankruptcy assignment process even in the traditional situation of a direct sale by a debtor to an assignee resulting from attempts by the debtor to modify use clauses, tenant mix provisions and the like. The sale of designation rights to what amounts to a temporary purchaser who will further market the lease for an extended period of time adds to the

owner's dilemma of having its premises remain dark for an extended period of time while being relegated to accepting a tenant not of its own choosing at what is likely a below-market rent. In cases where the bankrupt tenant is an anchor store, the effect on the landlord and the synergism of the shopping center in general can be profound.

DESIGNATION RIGHTS BECOMING MORE COMMON

In the case of Breuners/Huffman-Koos, three of the four parties submitting significant package bids were designation rights purchasers; only one bidder was an ultimate end-user. In an auction process that extended well past midnight, the end-user bidder was ultimately unable or unwilling to match the financial wherewithal of the investment group against which it was bidding on

substantially overlapping packages of stores. By contrast, the investment group had already pre-arranged with an identified end-user to assign the leases and thus was bidding with full knowledge of its risk and reward on the ultimate disposition of the lease.

As the designation rights sale concept evolves, the lesson to be learned, particularly for landlords, is for all parties affected to monitor and participate in any retail tenant bankruptcy that may have bearing upon their interest. Counsel should be retained at an early stage to monitor pertinent proceedings and intervene when necessary and appropriate. The landlord must be proactive to protect its rights and economic interest.

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