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The Real Estate Problem of Retail

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The retail sky is falling. At least that is how it appears from recent and unprecedented number of retailers filing for bankruptcy. From iconic stores such as Sears and Toys 'R' Us, to department stores such as Bon Ton, to mall stores including Brookstone, The Rockport Company, Nine West, among others. The reasons given for such filings vary as much as their products but one theme seems to be constant — the inability of retailers to maintain "brick and mortar" operating expenses in the era of online shopping. Accordingly, it appears that what some retailers actually have is a real estate problem.

Another troubling theme of many retail filings is the use of bankruptcy courts to achieve a quick liquidation of the company, rather than a reorganization. Chapter 11 filings over the past several years have shown a dramatic shift away from a process originally focused on giving a company a "fresh start" to one where bankruptcy courts are used for business liquidation. The significant increase in retail Chapter 11 cases and the speed at which assets are sold in such cases is disturbing and provides a cautionary tale for developers and landlords alike. Indeed, such parties need to be extremely diligent in protecting their rights during initial negotiations as well as when these cases are filed, starting from day one, lest they discover that their rights have been extinguished by the lightning speed of the sale process.

Recent statics suggest that the average time to complete a bankruptcy sale is only 45 days from the petition date. Moreover, under the Bankruptcy Code, and arguably, best practices, the sale will close shortly after court approval thereby rendering any appeal likely moot. This leaves little time for parties to protect their rights.

Bankruptcy Code Section 363(f) permits a debtor to sell property free and clear of *interests* in the property if certain conditions are met. Unlike a traditional reorganization, which requires a more engaging process, including a disclosure statement containing "adequate information," a sale under Section 363 is achieved by mere motion, even though it results in property interests being entirely wiped out. Not only are property rights altered by motion, rather than by an adversary proceeding or a plan process, but these sale motions are being filed in retail cases as "first day motions" and concluded in as short as a month and half.

Even more alarming is that the notice accompanying such motions can be ambiguous as to how it will impact parties such as developers who have multiple interests in retail/multi-use properties. Often, the reference to the developer and its property is buried in a 20+ page attachment in 8 point font, listed in an order only the debtor (or its professionals) understands. If that was not concerning enough, these notices are being served by a third-party agent who may not have access to the most updated contact information necessary to ensure that non-debtors are actually receiving the notices in time to properly protect their rights. It is not uncommon for these notices to be inaccurately addressed and not be received until after an order is entered; an order which will undoubtedly contain a provision that notice was proper.

Notably, despite Section 363(f)'s reference solely to "interests" (the group of things that an asset may be sold free and clear of), these sales are commonly referred to as sales free and clear of "*claims* and interests." Lacking an actual definition, courts have expansively interpreted "interests" to include "claims." Indeed, it is now the norm for bankruptcy courts to enter extensive findings of fact and conclusions of law supporting 363 sales that extinguish every imaginable potential *claim* (rather than merely "interests"). While consistent with the overall spirit of the Bankruptcy Code to promote maximization of value through the alienability of property, it comes at the expense of those holding an interest in that property, such as a mall or shopping center developer.

Fortunately, there are certain well-accepted exceptions to the courts' expansive application of "interest." Courts generally limit a debtor's attempt to use Section 363 to strip off traditional *in rem* interests that run with the land. When faced with such attempts, courts routinely constrain the interpretation of the statute to block the sale free and clear of an *in rem* interest.

The majority of state laws have long treated covenants, easements, and other *in rem* interests that are said to "run with the land" as property interests. Although clearly falling within the common definition of "interests," courts routinely hold them not to be strippable interests for purposes of a Section 363(f), as being so ingrained in the property itself that they cannot be severed from it, or, alternatively, that the *in rem* interests are not included in Section 363(f)'s use of the term "interests."

The protection afforded to *in rem* interests should provide forward-thinking transactional attorneys with a valuable opportunity to insulate many rights and remedies for their developer clients. A hypothetical real estate transaction is illustrative — consider a transaction in which a developer sells two parcels to a large retailer as part of a retail/mixed use shopping center and takes back a long-term ground lease for one of the parcels. There are a number of methods available to document this deal: a sale-leaseback agreement; a separate contract to convey in the future secured by a lien; entry into a partnership, joint venture, or similar agreement. When analyzed with respect to the risk of a potential retailer bankruptcy, these mechanisms are inferior to the use of a reciprocal easement agreement ("REA") or similar devise that creates an *in rem* property interest that runs with the land in favor of the developer.

If traditional contractual methods are used, the documents run the risk of being construed as executory contracts in the retailer's subsequent bankruptcy case, subject to rejection, leaving the developer with only a prepetition claim. A lien in favor of the developer would only marginally improve its position, as any lien will likely be subordinated to the retailer's development financing and therefore of little value. But, based on the current state of the law, a non-severable REA or similar document recorded against the retailer's property will not be stripped off the property absent consent or a *bona fide* dispute. Thus, rights incorporated into a properly drafted and recorded REA provide the developer with a level of "bankruptcy-proofing" against a potential future retailer bankruptcy. Further, as REAs in mixed-use developments are the norm in the industry, they are likely to be accepted, if not embraced, by the retailer's construction lender, making their adoption that much more likely.

The lesson is be forward thinking and be diligent.

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