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In Practice

Of Interest

From Canada

In Depth

Bankruptcy Obstacles to Collecting on a Guaranty: Injunctions, Releases and Claim Preclusion—A Primer

*Paul M. Botros**
Bilzin Sumberg Baena Price & Axelrod LLP
Miami, FL

In the current economic climate, landlords are facing unprecedented numbers of tenant bankruptcies. As a result, landlords must be cognizant of their rights against not only the tenant but, perhaps more importantly, the solvent guarantor of the lease obligations. This article briefly explores the landlord-guarantor relationship when the tenant has filed for bankruptcy protection, and how the tenant's bankruptcy case may impact collection efforts against the guarantor both during the tenant's bankruptcy case and after it has been resolved.

Release of Guaranty—What Does the Bankruptcy Code Say?

Generally, when the bankruptcy process discharges a debtor's obligations to third parties, those parties' rights against non-debtor guarantors remain intact. For instance, § 524(e) of the Bankruptcy Code dictates that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any entity for, such debt." 11 U.S.C. § 524(e). Despite the facial clarity of § 524(e), this section of the Bankruptcy Code has been the subject of varied interpretation. Certain courts hold that a guarantor's liability is not released simply due to the debtor's discharge in bankruptcy. Other courts hold that a non-debtor guarantor may be released of its guaranty obligations pursuant to a confirmed plan of reorganization. Further, in some instances, a debtor might only seek a temporary injunction staying litigation against the guarantor while the underlying bankruptcy case is pending, rather than seek a full release of the guarantor's liability. In any event, a party may lose its right to pursue a collection action against the guarantor if the bankruptcy court enters an order confirming a plan of reorganization containing a release of the guarantor's liability, and the party fails either to object to the release provision or appeal the finality of the court's order.

Guarantor Strategy—*Otero Mills* Injunctions

Once a tenant files for bankruptcy protection, the guarantor, often the debtor's principal or parent company, endeavors to limit the exposure on the guaranty by seeking an injunction against enforcing the guaranty. This injunction is referred to generally as an "*Otero Mills*" injunction, named after one of the earliest seminal decisions granting this form of relief. *See Otero Mills, Inc.* v. *Sec. Bank & Trust*, 21 B.R. 777, 778 (Bankr. N.M. 1982). The *Otero Mills* court was asked to enjoin a collection action against the debtor's president and sole shareholder, who guaranteed two promissory notes issued by the debtor in the combined amount of $650,000. The debtor argued that the continued litigation against the president adversely affected the debtor's bankruptcy estate and its efforts to reorganize, because the litigation was unduly pressuring the debtor through the continued efforts to collect against its principal decision maker.

The *Otero Mills* court set forth a three-part test to determine if the propriety of an injunction against enforcing the guaranty is warranted: (i) whether irreparable harm to the bankruptcy estate would occur if the injunction does not issue; (ii) whether there is a strong likelihood of success on the merits; and (iii) whether the other party would suffer minimal or no harm. *Id.; see also In re*

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Third Eighty-Ninth Assoc., 138 B.R. 144 (S.D.N.Y. 1992) (granting injunction to those guarantors who made a financial contribution to the estate and held a crucial position with the debtor, but denying relief to guarantors making a vague request for stay without adequate evidentiary support).

Although the *Otero Mills* court ultimately held that it had authority to issue the injunction, it expressly stated that it could do so only if the court found that a

> failure to enjoin would affect the bankruptcy estate and would adversely or detrimentally influence and pressure the debtor through that third party .… This power to enjoin assures that a creditor may not do indirectly that which he is forbidden to do directly. *Otero Mills Inc.*, 21 B.R. at 778.

The bankruptcy court essentially issued the injunction against the collection action because (i) the guarantor agreed to contribute money or assets into the bankruptcy estate; (ii) the deadline to file a plan had not passed; and (iii) the note holder was in no real danger of losing its collateral. Holders of guaranty rights can oppose an *Otero Mills* injunction by arguing that the debtor and guarantor have failed to establish compelling circumstances to issue the injunction. Generally, if the guarantor is not willing to contribute money or assets to the estate, this provides strong grounds to object to the imposition of a stay. *Id.* Further, if the guarantor simply argues that an injunction is needed to prevent the officer/shareholder/guarantor from spending time defending against personal liability instead of devoting its attention to the debtor's business, "the mere status of the non-debtor as a principal of the debtor has been held as insufficient justification for staying litigation against him." *In re Keyco, Inc.*, 49 B.R. 507, 510 (Bankr. E.D.N.Y., 1985). Also, as a general proposition, an *Otero Mills* injunction is less likely to be granted where the deadline to file a plan is looming or the plan that has been filed is not confirmable, as this is likely evidence that the debtor has no real prospect of reorganization. These are broad suggestions, of course, and there is ample case law that both grants and denies such injunctions.

Attacking Guarantor Release Provisions in a Plan of Reorganization

Although a debtor may attempt to include broad non-debtor third-party releases in a plan of reorganization, affected creditors have a number of counter-arguments to these plan provisions.

Initially, it is necessary to point out that there is no real consensus among circuit courts as to whether non-debtor third-party releases are permitted under the Bankruptcy Code. The circuit courts that have addressed the issue fall into three categories:

(1) Those that have approved non-debtor third-party releases in limited and exceptional circumstances without the consent of affected parties. S*ee*
Monarch Life Ins. Co. v. *Ropes & Gray*, 65 F.3d 973, 980-81 (1st Cir. 1995);
In re Metromedia Fiber Network, Inc., 416 F.3d 136, 142-143 (2nd Cir. 2005);
In re A.H. Robbins Co., Inc., 880 F.2d 694, 702 (4th Cir. 1989);
In re Dow Corning Corp., 280 F.3d 648, 658 (6th Cir. 2002); and
In re Ingersoll, Inc., 562 F.3d 856 (7th Cir. 2009).

(2) Those that allow non-debtor third-party releases only upon consent of the affected parties. *See*
In re Specialty Equip. Cos., 3 F.3d 1043, 1047 (7th Cir.1993); and
Munford v. *Munford, Inc.*, 97 F.3d 449 (11th Cir. 1996).

(3) Those that have rejected non-debtor third-party releases as outside the scope of the Bankruptcy Code. *See*
Matter of Zale Corp., 62 F.3d 746, 761 (5th Cir. 1995);
In re American Hardwoods, Inc., 885 F.2d 621, 626 (9th Cir. 1989); and
In re Western Real Estate Fund, Inc., 922 F.2d 592, 601 (10th Cir. 1990).

It should also be noted that the Supreme Court recently had the opportunity to settle the issue of the propriety of non-debtor third-party releases in bankruptcy, and declined to do so. *See Travelers Indemnity Co.* v. *Bailey*, 129 S.Ct. 2195, 2207 (2009). As such, it is helpful to understand some of the exceptional or unusual circumstances that may warrant a bankruptcy court to allow for such releases.

It is safe to say that there is no universal set of factors warranting rote application to determine the propriety of a non-debtor third-party release. However, such releases are an extraordinary measure, and those courts allowing for non-debtor third- party releases do so only upon a showing of exceptional or unusual circumstances warranting such releases. Some of the factors that courts have considered when granting non-debtor releases include: (1) whether the estate received substantial consideration in return for the release; (2) whether the enjoined claims are channeled to a settlement fund rather than extinguished; (3) whether the enjoined claims would indirectly impact the debtor's reorganization by way of indemnity or contribution claims against the debtor's estate; and (4) whether the plan otherwise provides for the full payment of the enjoined claims. *See In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142-143 (2nd Cir. 2005) (citations omitted).

If faced with a plan of reorganization that attempts to release non-debtor third parties from liability, the first point of attack is likely to argue that § 524(e) of the Bankruptcy Code precludes such a release. If the jurisdiction of the pending bankruptcy case allows releases upon a showing of exceptional circumstances, one would wish to argue that the release is not fair and equitable unless the affected creditor is receiving fair compensation for the loss of its claim against the non-debtor third party. At the very least, the debtor must make a factual showing that a substantial contribution was made to the estate by the party hoping to be released, and that the release sought is "itself important to the plan." *See In re Metromedia Fiber Network, Inc.*, 416 F.3d at 143.

Further, unless the debtor can make a showing that the release sought is "fair and equitable" to the parties whose claims are being released, and that the release is necessary to the reorganization efforts of the debtor, the release provisions may not withstand objection and appeal. Additionally, it is the debtor's burden to prove that the proposed releases are necessary to and are an integral part of the debtor's restructuring efforts. Barring a strong factual showing of any of these factors, it is unlikely that the release of a non-debtor third-party provision will be confirmed upon objection by the affected party. *See In re Continental Airlines*, 203 F.3d 203 (3rd Cir. 2000).

Perils of a Wait-and-See Approach

A party may waive its right to collect on the third-party guaranty in state court by failing to object to the confirmation of a plan of reorganization that includes a release of non-debtor third-party liability. For instance, once an order confirming a plan of reorganization becomes final, it is generally binding on all parties and all claims addressed in the plan.

In *FOM Puerto Rico S.E.* v. *Dr. Barnes Eyecenter Inc.*, a landlord failed to object to the plan of reorganization of its tenant, which included a release of liability of the guarantor in respect of the tenant's lease obligations. 255 Fed. Appx. 909 (5th Cir. 2007). The landlord opted to pursue its collection action against the guarantor directly, rather than address the guaranty issues in the tenant's bankruptcy case. After the order confirming the plan of reorganization became final, the guarantor filed a motion for summary judgment in the collection action, arguing that the landlord's claim was released by the bankruptcy order. The Fifth Circuit upheld the grant of summary judgment dismissing the underlying action since the landlord failed either to object to the plan or appeal the court's order. 255 Fed. Appx. at 912-913. The court found that the plan's release provision was specific enough to include the claims of the landlord; and, since the landlord failed to safeguard its rights by objecting to the release, its claims against the guarantor were released. *Id*. The court relied on prior Fifth Circuit and Supreme Court precedent to reach its result.

The Supreme Court has refused to disturb the finality of the bankruptcy courts' orders granting non-debtor third-party releases, regardless of whether or not the bankruptcy court had authority to grant the release in the first place, simply because the party attacking the order failed either to object to the release provisions in the plan of reorganization or appeal an overruled objection to the release provisions. *See*

Travelers Indemnity Co. v. *Bailey*, 129 S.Ct. 2195, 2205 (2009);
Stoll v. *Gottlieb*, 305 U.S. 165, 177 (1938);
FOM Puerto Rico S.E. v. *Dr. Barnes Eyecenter Inc.*, 255 Fed. Appx. 909 (5th Cir. 2007);
Applewood Chair Co. v. *Three Rivers Planning & Dev. Dist. (In re Applewood Chair Co.)*, 203 F.3d 914 (5th Cir. 2000); and
Republic Supply Co. v. *Shoaf*, 815 F.2d 1046 (5th Cir. 1987).

Consequently, landlords should be cognizant of the risk of a non-debtor third-party guaranty being released by a confirmed plan of reorganization, and forever losing the right to enforce the guaranty, if no objection or response to the plan is lodged during the bankruptcy case.

Conclusion

If a guarantor attempts to pursue an *Otero Mills* injunction, the guarantor must demonstrate that unusual and extraordinary circumstances exist to issue the injunction. Without a strong factual showing that either money or assets are being contributed to the estate and/or the debtor's reorganization is in jeopardy of failing because of the collection action against the guarantor, such requests may be improper. The submittal of a plan of reorganization and disclosure statement proffered by a tenant in bankruptcy should be reviewed carefully to determine whether any proposed releases of third-party guarantors exist. Any argument regarding the impropriety of a plan of reorganization's guarantor release provisions may become moot if it is not raised prior to confirmation of a plan.

***Paul M. Botros** is an Associate in Bilzin Sumberg Baena Price & Axelrod LLP's Restructuring & Bankruptcy Group. Mr. Botros focuses his practice in the areas of bankruptcy and complex commercial litigation. He has represented creditors, Chapter 7 and Chapter 11 trustees, and debtors in bankruptcy and bankruptcy litigation.

Supreme Court Endorses 'Divisibility' Defense at Superfund Sites

*David G. Mandelbaum**
Ballard Spahr Andrews & Ingersoll LLP
Philadelphia, PA

On May 4, 2009, the U.S. Supreme Court rendered its decision in *Burlington Northern & Santa Fe Railway Co.* v. *United States*, No. 07-1601. The case addresses two issues of liability under the federal Superfund statute, the *Comprehensive Environmental Response, Compensation and Liability Act* (CERCLA). First, the court decided that a party does not "arrange for disposal" of a hazardous substance just because the party knows that the delivery of its product will result in spills. Second, and more importantly, the court decided that a party liable for some of an indivisible problem at a Superfund site can avoid joint and several liability by showing that the trial court may reasonably apportion liability based upon time on the site, amount of land owned or volume of waste disposed.

Before this decision, a party facing Superfund liability to the government will have assumed that it will almost certainly have to bear liability for the whole site jointly and severally. That party could hope to get a "fair share" allocation among all of the responsible parties that still have assets, but it could only expect to be responsible to the government for all costs. Now, that party has some reasonable expectation that it can avoid liability for the whole site and that a court may apportion it a separate share.

The Superfund statute generally imposes joint and several liability on anyone in four classes of responsible parties: current owners and operators, owners and operators at the time of disposal, "arrangers," and transporters who chose the disposal site. The United States or a state may recover the entire cost of addressing contamination, and the United States may obtain an order requiring a complete cleanup, from any single party that is jointly and severally liable. A party that pays more than its share can then bring an action for contribution from other parties under §113(f)(1) of the statute, 42 U.S.C. Article 9613(f)(1). *Cooper Industries, Inc.* v. *Aviall Services, Inc.*, 543 U.S. 157 (2004). If a party responds to contamination in advance of a lawsuit, it may bring an action to recover its costs, under § 107(a)(1-4)(B), 42 U.S.C. Article 9607(a)(1-4)(B), against another liable party. *United States* v. *Atlantic Research Corp.*, 551 U.S. 128 (2007).

However, the statute never mentions joint and several liability. Courts have suggested, following § 433A of the Restatement (Second) of Torts, that a defendant may avoid imposition of joint and several liability by showing either (a) that the Superfund site involves two or more distinct harms or (b) that the site involves a single harm to the environment but that a reasonable basis for apportioning that harm among responsible parties exists. These same courts, however, have resisted rather obvious bases for apportionment: volume of material, time on the site, concentration of chemicals, and the like.

In *Burlington Northern*, the trial court found a reasonable basis for apportionment, and the Supreme Court endorsed its conclusion. A pesticide distributor had used the site in question and spilled agricultural chemicals that caused groundwater contamination. The railroads owned only a portion of the site. They leased it to the distributor and only for a portion of the time that the distributor operated. Moreover, only two of the three chemicals of concern had ever been unloaded on the railroad parcel. Accordingly, the district court found that it could apportion the costs at the site in proportion to Acres x Years x Number of Chemicals. That is, the railroads were responsible only for Railroad Parcel Acres x Lease Years x 2/Total Acres x Total Years x 3. That turned out to be 6 percent, which the court increased to 9 percent, to account for any calculation errors. The district court found the railroads liable only for their apportionable share, and not jointly and severally liable for the whole. That kind of simple math would apply in any number of Superfund cases where evidence exists of the number of drums delivered or the number of years operated, or the like. Consequently, many regarded the district court's decision as surprising.

The court of appeals reversed the district court, finding that the evidence could not support apportionment. Eight Supreme Court justices voted to reinstate the district court's judgment, and the Court did not remand for further trial. It simply reversed and assigned the railroads only 9 percent of the governments' costs.

The Supreme Court's holding raises the possibility of parallel issues in virtually every Superfund matter, and makes joint and several liability realistically litigable in many cases. Note that, as a technical matter, when a reasonable basis for apportionment exists, a party that incurs costs may not have a contribution claim against another party because the parties are not jointly and severally liable for the same costs. However, under CERCLA, a claim for cost recovery may exist where the other party has liability.

The Supreme Court also addresses the issue of a pesticide manufacturer's liability as an "arranger" when its delivery method invariably resulted in spills. The manufacturer insisted on delivering by common carrier to bulk storage facilities (i.e., tanks), rather than delivering drums. When the manufacturer's carrier in the *Burlington Northern* case delivered to its distributors, it invariably spilled. The manufacturer knew it would spill and took steps to minimize spills. For a long time, Superfund cases have held that a transaction that necessarily involves spills can make a person in the manufacturer's position an "arranger" of those spills. *See, e.g., United States* v. *Aceto Agricultural Chemicals Corp.*, 872 F.2d 1373 (8th Cir. 1989).

The Supreme Court in *Burlington Northern* disagreed, thereby effectively overruling those cases. "Arranging" requires a state of mind; it requires an intention to dispose. Having knowledge of incidental spilling by a common carrier during delivery does not rise to that level of intention, according to the Court. This decision also makes some "arranging" cases more defensible and, therefore, will spawn additional litigation.

Five years ago, one would have said that Superfund litigation was on the wane. Courts had settled many issues, and litigation costs exceed potential upsides. However, the Supreme Court has unsettled those settled issues three times: (1) In 2004, it decided *Cooper Industries*, confusing the law of contribution. (2) In 2007, it decided *Atlantic Research*, addressing some of the unfairness of *Cooper Industries*, but injecting more confusion into the law of settlements and certain procedural issues. (3) Now, it has decided *Burlington Northern*, making joint and several liability unclear in perhaps a majority of cases.

Prudent parties with inventories of Superfund liabilities may wish to reexamine them. Some underlying assumptions may no longer hold. Parties may not face certain liability for all of a site. Others may not have certain obligations to contribute. Moreover, in some small number of cases, assertions of liability for "arranging" may not stand up. Owners of sites that have obtained prospective purchaser protection in cases where another severally liable party has cleaned up a site may face new exposure.

***David G. Mandelbaum** is Partner-in-Charge of the environmental practice group of Ballard Spahr Andrews & Ingersoll. His principal office is in Philadelphia. Mr. Mandelbaum teaches "Environmental Litigation: Superfund" and "Climate Change" at Temple Law School (Philadelphia) in alternating years. He is the Pennsylvania Governor's Representative on the Delaware Valley Regional Planning Commission and serves on the Pennsylvania Statewide Water Resources Committee.

The Federal Trade Commission Gets Serious About Green Marketing Claims

*Eric E. Boyd**
Seyfarth Shaw LLP
Chicago, IL

Citing a "virtual tsunami" of environmental marketing claims during the past few years, the Federal Trade Commission (FTC) recently announced several initiatives designed to ensure that such claims do not confuse or mislead consumers. These initiatives are particularly relevant to anyone promoting "green" developments, touting building materials as green or otherwise attempting to obtain a green certification for a project.

Examples of green building certification programs include the Green Building Council's Leadership in Energy and Environmental Design program (LEED), the National Association of Homebuilders' Green Building Standard and the Green Globes' Green Building Initiative. Builders also can obtain an "environmentally friendly" certification from the federal government through the Energy Star program, which certifies homes based on energy use.

The Role of the FTC

On June 9, 2009, James A. Kohm, Associate Director of the Enforcement Division in the FTC's Bureau of Consumer Protection, testified before a subcommittee of the Committee on Energy and Commerce of the U.S. House of Representatives. Mr. Kohm's testimony described the three roles that the FTC plays with respect to companies that tout the green attributes (such as the recycled material content) of their products and services. The FTC:

1. Promulgates rules and guides (Green Guides) to make the "rules of the road" clear for businesses,
2. Challenges fraudulent and deceptive advertisements through enforcement actions and
3. Publishes materials to help consumers make informed purchasing decisions.

Mr. Kohm's testimony described, in detail, the FTC's work in each of these three areas. He explained that the FTC is currently reviewing its Green Guides to make sure that they address new green marketing claims that were not in use when the Green Guides were first issued (in 1992) or later revised (in 1996 and 1998). The Green Guides, which apply to all forms of environmental marketing, consist of general principles, specific guidance and examples on the use of environmental claims. The Green Guides are not enforceable regulations. If, however, a marketer makes claims that are inconsistent with the Green Guides, the FTC can take action under § 5 of the *FTC Act*, which prohibits unfair or deceptive practices.

The FTC recently held a series of public workshops and sought public comments to explore three new green marketing issues: carbon offsets and renewable energy, green packaging claims, and claims for green building and textiles. Mr. Kohm explained that the FTC plans to conduct its own research on consumer perceptions of such terms as "green," "renewable," "eco-friendly," "sustainable" and "carbon neutral," and expects to revise the Green Guides based on its research and input from the public workshops later this year.

Mr. Kohm also described recent enforcement actions challenging green marketing claims involving the construction industry. For instance, the FTC recently targeted marketers of home insulation, claiming that the marketers overstated the insulating properties of their products. In addition, the FTC has gone after marketers who claim that their products were biodegradable when the products do not "decompose into elements found in nature within a reasonably short period of time after customary disposal." Similar enforcement cases can be expected involving other building materials. In such enforcement actions, the FTC seeks civil penalties and injunctive relief.

Finally, Mr. Kohm described several consumer education products relevant to the construction industry. For instance, the FTC has issued guidance entitled "Sorting Out Green Advertising Claims." The agency's interactive website, *Saving Starts @ Home*, also offers tips to help consumers conserve energy and save money when they are purchasing insulation, heaters and similar building products.

These recent FTC initiatives with respect to green claims involving building products are not surprising. When the FTC announced the public workshops focusing on green claims involving building materials, it noted the increased demand for green construction and the fact that green marketing claims had become "prevalent for a wide range of building products including flooring, carpeting, paint, wallpaper, lighting, insulation, and windows." The FTC also mentioned that such claims are often supported by third-party certification programs that have grown substantially since the last revision of the Green Guides. The FTC's goal is to make sure that such claims and certifications are not misleading to customers.

The Danger of 'Greenwashing'

Until the FTC provides additional guidance, the construction industry and marketers of building products need to make certain that any claims about the green attributes of their products or services are clear, truthful and independently substantiated. If a company engages in "greenwashing," the term being used to describe vague or misleading green marketing claims, it may face more consequences than simply potential FTC enforcement.

Companies engaged in greenwashing could be subject to claims by consumers or competitors based on breach of contract, fraud, unfair competition or detrimental reliance. They could find themselves restricted from selling their products through retailers, such as Wal-Mart, which have announced plans to assess independently the green attributes of the products they sell. Such retailers could also experience consumer backlash and brand dilution if the green claims are perceived as bogus by the public. Consumer blogs are happy to point out and to rate green marketing claims. See, for example, http://www.greenwashingindex.com/

In summary, while consumer demand will continue to require building product and construction companies to advertise the green attributes of their products and services, they need to be sure that any such green claims are legitimate.

***Eric E. Boyd** (eboyd@seyfarth.com) is a Partner in the Environmental, Safety & Toxic Tort Practice Group at Seyfarth Shaw LLP in Chicago.

Federal Court Considers Ban on 'Formula' Businesses

*Matthew P. Seeberger**
*Anne E. Clinton***
Cox, Castle & Nicholson
Los Angeles, CA

This article examines a pair of cases challenging a zoning ordinance restricting "formula" retail stores and restaurants in Islamorada, FL, an incorporated village comprised of four islands in the Florida Keys. The U.S. Court of Appeals for the 11th Circuit (the "Court" or the "11th Circuit"; the 11th Circuit covers Florida, Georgia and Alabama) invalidated the portions of the ordinance that restrict development of chain retail stores as an unconstitutional violation of the Dormant Commerce Clause, and remanded the ban on chain restaurants to the lower court for further proceedings under an elevated standard of review.

Dormant Commerce Clause

The Commerce Clause is contained in Article I, § 8 of the U.S. Constitution, and grants to Congress the express power to regulate interstate commerce. Over the years, courts have interpreted this grant of power as evidence of the intent of the drafters of the U.S. Constitution to prevent local legislation that unfairly burdens or discriminates against interstate commerce, such as regulatory measures designed to benefit in-state businesses by burdening out-of-state competitors. This legal doctrine has come to be known as the Dormant Commerce Clause.

Courts apply two standards of review to determine whether a regulation violates the Dormant Commerce Clause. If a regulation is discriminatory on its face or has the effect of favoring in-state interests, a higher level of scrutiny is applied. Such a regulation will be struck down unless it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. If a regulation has only indirect effects on interstate commerce, then a lower level of scrutiny is applied. Such a regulation will be upheld if the local interest is legitimate and if the burden on interstate commerce does not exceed the local benefits.

Formula Retail

In the first case, the 11th Circuit found that the village of Islamorada's restrictions on formula retail were an unconstitutional violation of the Dormant Commerce Clause. *Island Silver & Spice, Inc., et al.* v. *Islamorada, et al*. (542 F. 3d 844, 11th Cir. [Fla.], Sept. 8, 2008, Rehearing and Rehearing en Banc denied, Oct. 31, 2008).

In 2002, Islamorada enacted a zoning ordinance that limited "formula retail" establishments to 2,000 square feet (sq. ft.) or 50 feet of frontage. The ordinance defined formula retail as retail sales establishments that were contractually required to maintain standardized features across locations, such as uniforms, services, merchandise, trademark, decor, architecture or layout.

When the ordinance was passed, the plaintiff, Island Silver, owned and operated an independent retail store in Islamorada. Six months later, Island Silver entered into a purchase and sale agreement with a buyer that was seeking to develop a Walgreen's drug store within the same footprint of the plaintiff's existing mixed-retail store building. After learning that use as a typical Walgreen's would be prohibited by the Islamorada ordinance, the prospective buyer challenged the formula retail restrictions through the local administrative process. When the buyer did not prevail, it terminated the purchase agreement.

Island Silver then sued Islamorada to invalidate the formula retail restrictions and to recover damages. The district court granted injunctive and monetary relief in favor of the plaintiff. The district court also invalidated the formula retail provisions of the zoning ordinance by finding that the provisions violated the Dormant Commerce Clause because they had a discriminatory impact on interstate commerce unsupported by a legitimate state purpose. Islamorada appealed the ruling of the district court, but the 11th Circuit affirmed the district court's ruling.

The circuit court found that while the Islamorada ordinance did not facially discriminate against interstate commerce, the ordinance had the effect of favoring in-state interests. The court based this determination on stipulations by the parties that the ordinance effectively prevented the establishment of new chain retail stores because premises limited to no more than 2,000 square feet or 50 feet of frontage cannot accommodate the minimum requirements of most nationally and regionally branded retail stores. Since the ordinance would have the practical effect of discriminating against interstate commerce by effectively eliminating any new interstate chain retailers, the circuit court applied the elevated scrutiny test.

The 11th Circuit affirmed the district court's holding that Islamorada failed to advance a legitimate local purpose for the ordinance. The ordinance's stated purpose was the preservation of "unique and natural" "smalltown" community characteristics; the encouragement of "small scale uses, water-oriented uses, [and] a nationally significant natural environment"; and the avoidance of increased "traffic congestion . . . [and] litter, garbage and rubbish offsite."

The 11th Circuit found that although preserving small-town community was a legitimate purpose, Islamorada could not demonstrate "that it has any small town character to preserve," as there were a number of pre-existing formula retail establishments; also, there was no historic district nor any historic buildings in the vicinity of the plaintiff's property. The 11th Circuit also agreed with the district court's assessment that the ordinance does not effectively serve its stated purpose to preserve

Islamorada's small-town character because the ordinance does not restrict formula retail stores smaller than 2,000 sq. ft. or with less than 50 feet of frontage, or large non-chain businesses.

The 11th Circuit also affirmed the finding of the district court that the ordinance's stated purpose of encouraging small-scale and natural uses was not a legitimate state interest because Islamorada failed to prove that it was "uniquely relaxed or natural," and that there was a "pre-dominance of natural conditions and characteristics over human intrusions." Finally, the 11th Circuit agreed with the district court's finding that existing regulations could adequately address the ordinance's stated purpose to limit traffic and garbage.

Since the court determined that the Islamorada ordinance does not provide a legitimate local purpose, the court did not reach the third prong of the elevated scrutiny test (whether or not Islamorada can show that no adequate, non-discriminatory methods were available).

Accordingly, the 11th Circuit struck down the restrictions on chain retail stores as an unconstitutional violation of the Dormant Commerce Clause.

Formula Restaurants

In the second case, the 11th Circuit considered the ban on formula restaurants contained within the same Islamorada zoning ordinance. *Joseph Cachia* v. *Islamorada* (542 F. 3d 839, 11th Cir. [Fla.], Sept. 8, 2008; Rehearing and Rehearing en Banc denied, Nov. 13, 2008), Plaintiff Joseph Cachia entered into a letter of intent to sell his property to a corporation planning to convert the property into a Starbucks coffee shop. When the prospective buyer learned that such use would be prohibited by the Islamorada zoning ordinance, the buyer terminated.

Cachia sued, among other things, to invalidate the ordinance as a violation of the Dormant Commerce Clause. The district court found that the prohibition on formula restaurants has only an indirect effect on interstate commerce because it does not bar all out-of-state restaurants—just those restaurants that operate multiple locations sharing common characteristics such as name, trademark, menu or style. Accordingly, the district court applied the lower level of scrutiny to the zoning ordinance, and found that the Islamorada ordinance was supported by a legitimate state interest (the economic protection of small, locally owned businesses) and the burden on interstate commerce does not exceed the local benefits. The district court found that Cachia failed to state a valid claim under the Dormant Commerce Clause because the ban on formula restaurants survives the lower standard of review.

The 11th Circuit disagreed with the district court. In particular, the 11th Circuit determined that the ban on formula restaurants has more than an indirect effect on interstate commerce. The 11th Circuit ruled that although the ordinance does not facially discriminate against out-of-state business, the ban on restaurants operating under the same name, trademark, menu or style effectively prohibits interstate restaurants from operating locally. Accordingly, the 11th Circuit held that the elevated scrutiny test should apply and remanded the case back to the district court for further proceedings under this higher level of review.

Relevance Elsewhere

While the 11th Circuit's decisions in *Island Silver* and *Cachia* are currently binding only on Florida, Georgia and Alabama, they may have relevance elsewhere, as they address a similar issue. This issue was presented in *Wal-Mart Stores Inc.* v. *City of Turlock* (138 Cal. App. 4th 273 [CA 5th District Court of Appeal], 2006) (which was reported on in the Fall/Winter 2006 issue of *Shopping Center Legal Update*) that is, the power of a municipality to control and organize development within its boundaries as a means of serving the general welfare. In *Wal-Mart*, the court held that a central California town's ban on discount superstores in excess of 100,000 square feet, devoting at least 5% of sales floor area to non-taxable items (such as groceries), was a valid exercise of such power because it reasonably implemented a legitimate policy choice of preferring neighborhood shopping centers equally dispersed throughout the city over big-box megastores.

The reason these decisions may have relevance elsewhere is that *Wal-Mart* was a state court decision, whereas the 11th Circuit's *Islamorada* opinions were based on the U.S. Constitution and the Dormant Commerce Clause, which were not at issue in *Wal-Mart*. Wal-Mart had also filed in federal court, alleging several constitutional violations; however, after the California 5th District Court of Appeal's decision, Wal-Mart did not appeal to the California Supreme Court (although the *Wal-Mart* case was approvingly cited by the California Supreme Court in *Hernandez* v. *City of Hanford* (41 Cal. 4th 279, 2006); nor did Wal-Mart continue with the federal case. Thus, it is not clear what might have transpired if Wal-Mart had gone further in federal court. There is now some authority that could be relied on that might support Wal-Mart, or another big-box retailer, if such an ordinance were to be challenged again.

***Matthew P. Seeberger**, a Partner in Cox, Castle & Nicholson's Los Angeles office, specializes in the leasing, development, acquisition and disposition of commercial real estate. He primarily represents private, public and institutional developers and landowners regarding all types and sizes of retail centers. He also has significant experience concerning office and industrial properties, as well as representing tenants with respect to various types of commercial properties. Mr. Seeberger is actively involved in ICSC and BOMA; has written for a variety of publications regarding real estate issues; and has lectured on retail, office and commercial leasing matters.

****Anne E. Clinton** is a Senior Associate in Cox, Castle & Nicholson's Los Angeles office.

Lessons for the Lessor as § 363 Takes Over the Bankruptcy Landscape

*Michael P. Richman**
Patton Boggs LLP
New York, NY

*Mark A. Salzberg***
Patton Boggs LLP
Washington, D.C.

*Melissa Iachan****
Patton Boggs LLP
New York, NY

Severe economic conditions and the tightening of the credit markets have led to a dramatic increase in the number of bankruptcy filings. In 2008, there were a total of 1,117,771 bankruptcy petitions filed, including 43,546 business filings (i.e., non-personal bankruptcy filings).[1] In contrast, there were a total of 850,912 bankruptcy petitions filed in 2007, of which 28,322 were business filings.[2] Bankruptcy filings are showing no signs of abating this year. Through the second quarter of 2009, there were 30,333 business filings, more than the entire year in 2007 and 64 percent more than the first two quarters in 2008.[3] Not surprisingly, retailers—both large and small—have been caught in the bankruptcy surge (e.g., Circuit City, Linens N' Things, Goody's LLC), putting extreme new pressure on lessors of commercial real estate.

This latest bankruptcy cycle has been accompanied by an explosive growth of fast-track business sales under § 363 of the Bankruptcy Code, compelling parties such as lessors to make significant economic and strategic decisions very early in a case, rather than more conventionally after many months under a Chapter 11 plan process. Section 363 allows a debtor, after notice and hearing, to sell property of the estate other than in the ordinary course of business.[4] The provisions of § 363 are not new; in fact, the ability to sell property outside the ordinary course of business predates the enactment of the Bankruptcy Code in 1978.[5] What is relatively new is the increased use of § 363 sales at the outset of the case, typically under an extremely abbreviated schedule. Indeed, it appears that in many cases the use of § 363 is supplanting the plan process (or leaving very little to be done in a plan except to distribute the sale proceeds).

Section 363 motions to sell assets are now more commonly filed on the first day of a Chapter 11 case. Typically, the debtor will file its bankruptcy petition, having already entered into an asset purchase agreement pre-petition with a purchaser, who becomes the stalking horse bidder at an auction and whose bid becomes the baseline bid. The Bankruptcy Court will be asked to approve bidding procedures establishing a due-diligence period during which other potential bidders are able to review the assets to be sold and to submit a competing bid that exceeds in value the baseline bid submitted by the stalking horse bidder. If competing bids are submitted, an actual auction will take place, and the debtor will seek to have the Bankruptcy Court approve the sale to the successful purchaser. If no competing bids are submitted, the stalking horse bid becomes the successful bid and the Bankruptcy Court is then asked to approve the sale to the stalking horse.

Given the trend toward accelerated § 363 sales, it is not surprising that the deadlines for submitting competing bids and the approval of the sale are likewise usually extremely short. For instance, in the recent GM Chapter 11 proceeding, the bankruptcy petition was filed on June 1, 2009; the bidding procedures were approved on June 2; the deadline to submit competing bids was June 22; and the hearing to approve the sale to the stalking horse bidder began on June 30, with an order approving the sale issued on July 5. Unfortunately for non-debtor parties, this kind of schedule is not unique.[6] But how does it impact commercial lessors?

When a lease is involved in the § 363 sale, meaning it is one of the assets to be sold to the stalking horse bidder or purchaser, it must be assumed by the debtor and then assigned. The lease must be assumed as a whole—the debtor-tenant cannot cherry-pick or modify the terms in assuming the lease. However, before an unexpired lease can be assumed by the debtor and assigned, the debtor must (a) cure, or provide adequate assurance that it will promptly cure, all monetary defaults; (b) compensate, or provide adequate assurance that it will promptly compensate, the non-debtor party for any actual pecuniary loss resulting from any default; and (c) provide adequate assurance of future performance under the lease or contract.[7]

Therefore, as part of the sale process, debtors will serve notices to non-debtor parties to unexpired leases identifying the lease or contract to be assumed and assigned and the amount necessary to cure any monetary defaults. The notice will provide a date certain by which objections to the proposed assumption and assignment of the lease or contract must be filed and typically provide that the failure to object will preclude the non-debtor party from raising any objection to the assumption and assignment of the lease or contract, including the cure amount. This is a very important point for lessors, which will be discussed below.

Where a shopping center is involved, there are additional rules. Adequate assurance of future performance of a lease of real property in a shopping center is treated differently from adequate assurance under other contracts or leases, providing debtor-tenants with higher standards that they must show for adequate assurance, and giving commercial lessors more safeguards. Section 365(b)(3) provides that the debtor must provide adequate assurance:

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
(B) that any percentage rent due under such lease will not decline substantially;
(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.[8]

Given that the § 363 sale process has the effect of fixing the rights of non-debtor parties to unexpired leases and executory contracts, it is crucial that these non-debtor parties take the appropriate action once they learn of a bankruptcy filing involving a § 363 sale. This means that commercial lessors must be prepared to act quickly.

First, lessors must be sure to monitor closely any tenant bankruptcy filings from the outset, particularly with respect to the debtor's proposed assumption and assignment of leases and the associated objection deadlines. As noted above, the failure to timely respond to a debtor's motion to assume and assign a lease will likely preclude the lessor from challenging the assumption and assignment, or the cure amount. Accordingly, it is crucial that either all filings be monitored on the Bankruptcy Court's public access system (http://www.pacer.gov) or that counsel file a notice of appearance and thereby receive service of all filed documents.

Second, lessors of unexpired leases should ensure that the cure amount is correct and has been calculated as of the date of the proposed assumption of the contract or lease. Under § 365, the cure amount must be calculated as of the date of the proposed assumption, and not an earlier date (e.g., the date that the sale motion was filed or the date of the assumption notice). The notice of intent to assume and assign usually references a cure payment calculated as of the date of the notice. Accordingly, it is crucial for a lessor to object to the extent that the amount of the cure amount is incorrect or will increase after the notice is served.

Third, any questions or concerns regarding the stalking horse bidder's ability to perform under the lease or contract must be timely raised. It is the debtor's burden to provide adequate assurance of future performance under the lease or contract, and the debtor should be held to that burden, especially the heightened burden imposed by § 365(b)(3).

The sale procedures order will also usually establish a schedule for provision of adequate assurance information as well as a deadline for objections. These are issues to which commercial lessors must pay particular attention because this is an opportunity for the lessor to be involved in negotiating to ensure that its future tenant will be able to pay, as well as be good for business and not damage the business in the surrounding shopping center or small retail tenancies.

Again, when a § 363 sale is the context, the deadlines involved will be very short, as will the ability to obtain cure payments and future assurances if no objection is filed on a timely basis. Any objection preserves the lessor's right to negotiate these important issues, and, if necessary, to litigate them.

Fourth, the Bankruptcy Code provides limited grounds to block the assumption and assignment of certain types of contracts and leases. For instance, § 365(c)(1) of the Bankruptcy Code provides that a debtor may not "assume or assign" an unexpired lease if non-bankruptcy law excuses a non-debtor party from accepting performance from or rendering performance to an entity other than the debtor. Section 365(c)(1) is most commonly applied to contracts that involve intellectual property rights, since U.S. patent and trademark law (i.e., the *Lanham Act*) provides that non-exclusive patent and trademark licenses are non-assignable without the licensor's consent.

If a lease is not included in the assets being sold in the § 363 transaction, the debtor-tenant has a total of 210 days after the bankruptcy filing to decide whether to assume or reject unexpired leases. (Any additional time would require the lessor's consent.) This may provide lessors with some leverage in negotiations with a debtor-tenant regarding the disposition of a lease. However, this limited time also requires debtor-tenants to make decisions regarding leases before they have a clear picture of whether it will be beneficial to assume, assign or reject the lease. If the lease is not assumed (or assumed and assigned as part of a § 363 sale) within the 210-day period,[9] the lease automatically will be deemed rejected and the debtor will have to quit the premises. Also, the lessor should be receiving post-petition rent for the time the debtor stays on the premises, as an administrative payment. If the debtor does reject the lease (whether deemed or express), the lessor should always file a proof of claim and then attempt to re-let the premises. (Note that the lessor's damage claims are also capped at the greater of one-year's rent, or 15 percent of the rent due over the remaining term of the lease.)

Conclusion

The current economic climate, in conjunction with the extremely tight credit market, will increase both the number of business bankruptcy cases filed and the number of cases in which all or substantially all of the debtors' assets are sought to be sold under § 363 at the outset of the case. In such proceedings, it is *crucial* that commercial lessors closely monitor the bankruptcy case; preserve any rights by filing objections and/or motions when necessary; and, particularly in the case of the more frequent expedited § 363 sales, pay close attention to the debtor's intended treatment of their leases.

* **Michael P. Richman** is a Bankruptcy Partner with Patton Boggs LLP in New York and Chair of its national Bankruptcy and Restructuring Practice Group, who has experience representing virtually every party in interest in Chapter 11 cases. Of recent note, he was lead counsel for the principal opponents (the Unofficial Committee of Family & Dissident GM Bondholders) of the GM sale engineered by the Government.
** **Mark A. Salzberg** is a Partner in Patton Boggs' Washington, D.C., office and a member of the firm's Bankruptcy and Restructuring Practice Group. He focuses his practice on bankruptcy, creditors' rights and debtor reorganizations.
***Melissa Iachan** is an Associate with Patton Boggs LLP in New York and a member of the firm's Bankruptcy and Restructuring Practice Group.

[1]http://www.abiworld.org/AM/TemplateRedirect.cfm?template=/CM/ContentDisplay.cfm&ContentID=57826

[2]*Id.*

[3]http://www.abiworld.org/AM/TemplateRedirect.cfm?template=/CM/ContentDisplay.cfm&ContentID=57801

[4]11 U.S.C. § 363(b)(1).

[5]*See Committee of Equity Sec. Holders* v. *Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1066-69 (2d Cir. 1983).

[6]*See also In re Chrysler, Inc., et al.,* Case No. 09-50002, U.S. Bankruptcy Court for the Southern District of New York (petition filed on April 30, 2009; bidding procedures approved May 7; May 20 deadline to submit competing bids; sale hearing held on May 27); *In re PMTS Liquidation Corp., et al.,* Case No. 08-11551, U.S. Bankruptcy Court for the District of Delaware (petition filed on July 23, 2008; bidding procedures approved Aug. 8; Sept. 5 deadline to submit competing bids; sale hearing held on Sept. 9); *In re DG Liquidation, et al.*, Case No. 08-10601, U.S. Bankruptcy Court for the District of Delaware (petition filed on April 1, 2008; bidding procedures approved April 26; June 3 deadline to submit competing bids; sale hearing held on June 6).

[7]11 U.S.C. § 365(b)(1).

[8]11 U.S.C. § 365(b)(3).

[9]The 210-day maximum lease decision period represents one of the major changes resulting from the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (BAPCPA). Before these amendments took effect, although debtors initially had only 60 days to assume or reject leases, they could seek an unlimited amount of extensions of this period from the Court. Cumulative extensions of years, over a lessor's objection, were not uncommon under pre-BAPCPA, but are no longer possible under BAPCPA, to a lessor's benefit.

Employment Law: Issues That Need Attention Sooner Rather Than Later

*Philip M. Keating**
Bean, Kinney & Korman, P.C.
Arlington, VA

We all have that list of projects that we know need attention, but always seem to be pushed aside due to more pressing concerns. Retailers and owners/managers of retail complexes need to be aware of these changes so that they can avoid potential liability for violations of which they may not even be aware. The following is a brief discussion of some of these issues that need to rise to the level of pressing concerns as a result of trends in employment law litigation and renewed enforcement efforts by government agencies.

Exempt Classifications and FLSA Compliance

The fastest growing area of employment-related litigation involves the *Fair Labor Standards Act* (FLSA). Major factors in this boom in litigation are the statutory award of attorney fees to plaintiffs' attorneys; the fact that the FLSA places all record keeping and compliance obligations on the employer; and the doubling and tripling, in some cases, of the damages awarded under the law.

Cases under the FLSA include those involving questions of what is and is not compensable time. These disputes may include questions of whether the time employees are preparing for and cleaning up after work is compensable, whether certain travel time is compensable, whether lunch breaks are compensable, and whether time spent away from the office but during which the employee is "on-call" is compensable. For example, there are many instances where building engineers and property management personnel are required to be on-call and able to report to their retail property within a specified period of time if an emergency arises. Depending on the precise terms of the on-call obligations, this time may be compensable under the FLSA. This, in turn, may have a significant impact if the on-call time pushes the non-exempt employee beyond 40 hours in a week and in to overtime.

The other major area of litigation involves whether employees are entitled to overtime payments for work in excess of 40 hours in a week. The FLSA is written such that employees are entitled to overtime unless they qualify for one of the designated overtime exemptions (professional, executive, administrative, outside sales). The standards for the overtime exemptions have been modified in recent years, and technology has changed certain types of jobs such that positions that once were formerly exempt no longer may be. Particular areas of dispute always include first-line supervisory positions where the employee has some supervisory functions, but also performs the job duties of the position being supervised.

Given this situation, it is important that employers take the time to review how they classify employees under the exempt classifications. It also is important to review and, if needed, modify time-keeping procedures so that accurate records exist. Finally, managers must understand the employer's policies on working hours, overtime and record-keeping.

Employee Handbooks and Policies

Employers have the right to set the policies and procedures that govern the workplace. Not only do handbooks and other policy documents serve an important human resources purpose, but they also are vitally important documents in the event of litigation. Employment discrimination litigation is, by definition, comparative in nature. Thus, the existence of an established policy that the employer can demonstrate it has followed consistently is a vital piece of evidence and may well be decisive in most discrimination cases.

What employers need to do, however, is to review their handbooks and policies periodically to be certain the policies are defined appropriately. Next, and more importantly, if you have policies that you are not following, change them now. Areas of particular concern include the interaction of various leave policies, and how to coordinate issues involving the *Americans With Disabilities Act, the Family and Medical Leave Act*, and any state and local laws on these topics. Furthermore, it is always important that employers review their sexual harassment complaint reporting and investigation procedures to be certain they are effective and being followed.

Non-solicitation and Non-distribution Policies

In the retail industry, where union organizing activity may occur, you need to consider your company policies concerning solicitation of employees and distribution of non-work literature by and/or to employees. Specifically, if a company allows employees to solicit fellow employees, or outside groups to solicit employees, for non-work causes such as PTA (Parent-Teacher Association) candy and wrapping paper sales, the company may well be unable to prohibit them from soliciting for union membership. The same is true for rules concerning outside groups soliciting on company property. If the *Employee Free Choice Act* becomes law, union organizing will become much easier, and more employers in a wider range of industries will confront these challenges.

The implementation and enforcement of non-solicitation and non-distribution policies is an extremely important issue for shopping center owners and managers, as there is an extremely legitimate business need to control the environment experienced by customers. However, it also is an area that has been the subject of much litigation before the National Labor Relations Board (NLRB) and in the federal courts.

In *Lechmere, Inc.* v. *NLRB,* 502 U.S. 527 (1992), the U.S. Supreme Court ruled that private property owners may prohibit union organizers from picketing or distributing literature unless the union can prove that there is no other reasonable means of access to the targeted employees or that the property owner was discriminating against union activity. However, in California, the U.S. Court of Appeals for the Ninth Circuit ruled that the California constitution mandates that free speech rights prevail over private property rights, and thereby allowed literature distribution by unions in shopping centers. *Glendale Associates, Ltd.* v. *NLRB*, 347 F. 3d 1145 (9th Cir., 2003). Unfortunately, this case makes it clear that what property owners or employers are, or are not, permitted to do, depends on location. Therefore, property owners and employers should review the current state of the law in the states in which they operate, and update their policies as needed.

Non-competition Agreements

Many companies regularly require new employees and, in some cases, existing employees to sign non-competition agreements that prevent the employee from working for a competitor for a specified length of time following separation from employment. Such agreements are an important means of protecting the legitimate business interest of the current employer, but these agreements are controversial. The degree to which these agreements are enforceable is a function of state law. Courts in many states will enforce the agreements if, and only if, the terms of the non-competition are very specific to the particular employee and narrowly tailored to fit the specific business situation of the employer. California, on the other hand, prohibits non-competition agreements, except in very narrow circumstances such as the sale of the goodwill of a business by a business owner.

I-9 Audits

The new emphasis of immigration enforcement by the U.S. Department of Homeland Security is on employers who are suspected of employing individuals who are not authorized for employment in the United States. The method of enforcement is not new; rather, it is a practice that has gone out of fashion for many years. That is, the U.S. Department of Homeland Security and the U.S. Department of Labor are now conducting a significant number of I-9 audits of employers pursuant to the *Immigration Reform and Control Act of 1986* (IRCA). Some of these audits are based on suspicion and ongoing investigations; some are random. Nonetheless, employers should take the time to self-audit their I-9 files and be certain they are in order.

An area of concern involving I-9 audits involves contractors and subcontractors. U.S. immigration law does not allow employers to avoid the obligations of IRCA by classifying individuals as contractors when they properly are considered employees. Furthermore, employers should take steps to require and verify that their contractors and subcontractors are complying with IRCA. In fact, many large retailers now typically impose I-9 obligations and even terms that permit independent audits of subcontractors both during and after the construction process.

Finally, companies that are federal government contractors now are required to utilize the E-Verify system as part of their hiring process as a supplement to the I-9 verification. This becomes complicated for companies that have both federal contract accounts and private sector accounts. Employees assigned to work on federal contracts must be cleared through the E-Verify process, regardless of their date of hire. As a result, there are examples of long-term employees who either are grandfathered under IRCA or who presented documentation that appeared genuine on its face, thereby allowing the employer to satisfy its I-9 obligations, but who are rejected by the E-Verify system. Assuming the rejection is not an error, the employer then has knowledge that the employee is not authorized for employment and cannot continue the employment unless the employee corrects the situation. A number of states also have laws requiring the use of the E-Verify system if a company is going to do business with that state.

Conclusion

A regular review of employment practices and policies should be a vital part of every employer's ongoing operations and human resources functions. Court and regulatory decisions, as well as the latest litigation trends, can have substantial impact on your retail business. Preparation and effective implementation are the key elements to successful outcomes.

*Philip M. Keating is a Shareholder with the Arlington, VA, firm of Bean, Kinney & Korman, P.C. He practices in the areas of labor, employment and immigration law, and has extensive experience in matters before the EEOC (Equal Employment Opportunity Commission); Department of Labor; U.S. Citizenship and Immigration Services,; and federal and state agencies.

Of Interest

Cases

Condemnation/Eminent Domain

A pair of New York State appellate cases involving "blight" condemnations of private property and subsequent transfer to private developers generate markedly different decisions. *Goldstein* v. *New York State Urban Dev. Corp. d.b.a Empire State Dev. Corp.*, 2009 WL 4030939 (N.Y.); *Kaur* v. *New York State Urban Dev. Corp.*, 2009 WL 4348472 (N.Y.App.Div.).

On Nov. 24, 2009, the NY State Court of Appeals upheld a lower court decision in *Goldstein*, validating Empire State Development Corporation's ("ESDC") exercise of its eminent domain power. The eminent domain action condemned certain private property and conveyed it to a group of private real estate development entities, collectively called Forest City Ratner Companies ("FCRC"), for a 22-acre mixed-use project in downtown Brooklyn, NY. ESDC had previously found that the areas were blighted and underutilized, thus justifying the taking on the ground of blight eradication.

The owners of the condemned property primarily argued that the taking was not for a public use, but rather for the benefit of a private party—FCRC. The court held that eradication of blight has been considered a public purpose and is expressly recognized by the NY State Constitution as a ground for condemnation. While there was argument as to whether the property was actually blighted, the court refused to examine the underlying determination and replace ESDC's judgment with its own.

In *Kaur*, decided on Dec. 3, 2009 (nine days after *Goldstein*), a lower NY State appellate court was faced with a factually similar case involving another ESDC taking based on blight and underdevelopment. Columbia University planned a 17-acre mixed-use development project in New York City's Manhattanville neighborhood. ESDC issued a determination that the area was blighted and underdeveloped—suitable for an eminent domain action that would ultimately convey the property to Columbia.

The *Kaur* court invalidated the taking on a number of grounds. Comparing the ESDC/Columbia plan against the elements that Justice Kennedy outlined in *Kelo* v. *City of New London*, the majority found that the plan did not have adequate safeguards against impermissible favoritism. The court examined the underlying blight determination and held that it was flawed and "mere sophistry." The court found not only the methodology suspect but also that the consultant (the same blight consultant from *Goldstein*), employed by both ESDC and Columbia, had a clear conflict of interest. The court also expressly rejected the idea that underutilization supports an eminent domain action—a concept relied upon in *Goldstein*.

Kaur will be heard by the Court of Appeals as an appeal of right, and the petitioners in *Goldstein* have recently petitioned the court for reconsideration pending the court's decision in the *Kaur* appeal.

Landlord/Tenant

A Michigan appellate court finds the use of the term "convert" as used in a co-tenancy rental modification clause to be unambiguous. *Rainbow USA, Inc.* v. *Seven Grand Associates, L.L.C.*, 2010 WL 23687 (Mich.App.Ct.).

Seven Grand Associates, L.L.C., was the landlord of a shopping center in which Rainbow USA, Inc., leased space for a retail store. The lease provided for a minimum annual rent of $84,501; separate provisions of the lease required Rainbow to pay Seven Grand 4 percent of its gross sales as well as paying its pro rata share of taxes, insurance and common area expenses ("CAM"). The lease also contained a co-tenancy clause that provided:

> In the event that Big Lots [Oak Foods,] or more than 15% of the [remaining gross leasable area of the Shopping Center] ever go dark for more than 90 days, *Tenant shall have the option to convert [its] total rental obligation to [4%] of gross sales* in lieu *of [all] rent.* [Emphasis added.]

In December 2005, Big Lots went out of business and Rainbow exercised its rent conversion option under the co-tenancy clause. Shortly thereafter, Nationwide Furniture moved into Big Lots' space, but also went out of business. Seven Grand sued, asserting that Rainbow's rent reverted back to the original rental terms during Nationwide's tenancy and that "all rent" did not include taxes, insurance and CAM. Rainbow argued that the rent did not revert to the original rental terms when Nationwide was in place, and that "all rent" included taxes, insurance and CAM. The trial court granted summary judgment in favor of Rainbow.

On appeal, Seven Grand argued that "convert" is ambiguous and could mean that the total rental obligation would vary based on changes in co-tenancy status. The court of appeals disagreed, holding that the dictionary definition, which it then applied, was unambiguous and did not allow for reversion to the original rental terms. The court found that Seven Grand's definition "would amount to a modification of clear and unambiguous language."

Regarding Seven Grand's assertion that "all rent" did not include operating costs, the appellate court held that "all rent" was unambiguous and included Rainbow's pro rata share of operating costs. The court found that, based on the language of the lease, these expenses were clearly within Rainbow's total rent obligation before Rainbow elected to convert under the co-tenancy clause. As a result, the court affirmed the trial court's grant of summary judgment.

A term tenant who became an at-will tenant after the expiration of a lease for term was held responsible for his pro rata share of operating expenses for the at-will period. *Radha Krishna, Inc.* v. *Desai*, 2009 WL 4802503 (Ga.App.Ct.).

In 1999, Radha Krishna, Inc. ("RK") and Nimish Desai executed a 60-month lease for space in a shopping center. The lease called for Desai to pay his pro rata share of the shopping center's operating costs, which included "real estate taxes and assessments associated with the Shopping Center." In 2001, the county was in the process of reclassifying the property from "undeveloped" to "developed" for appraisal and taxation purposes. RK was not able to determine operating costs accurately and, therefore, had not been billing Desai for his monthly share. RK explained the situation to Desai, and said that he would bill him for operating costs after the property classification issue was resolved. In 2003, the county began taxing RK based on the new classification. RK notified Desai, but did not begin billing him. Desai's lease expired on July 2, 2004, but he remained in the space for another two years and continued to pay the minimum monthly rent under the lease.

In December 2006, Desai gave notice of his intention to vacate. Shortly thereafter, RK presented Desai with a lump-sum bill for operating costs over the period when Desai occupied the space—just over $33,000. Desai refused to pay the amount billed, and RK sued Desai for breach of contract. The trial court found that Desai became an at-will tenant after the original lease term expired, was not responsible for operating costs after the expiration of the original term and the six-year statute of limitations barred claims for costs prior to June 2001. Thus, the trial court found that Desai owed RK only for operating costs between June 2001 and July 2004.

On appeal, the court of appeals reversed the trial court court based on Georgia precedent. It held that when Desai became an at-will tenant, the general terms of the lease, including rent (which included operating costs) still applied. Regarding the statute of limitations issue, RK asserted that no breach occurred until Desai refused to pay the lump-sum bill. The court held that there was a genuine issue of material fact with regard to this issue and also reversed the trial court on that issue.

A Delaware appellate court held that several tenant consent provisions in a lease served to divest a landlord of "actual control" over a parking area, despite its retaining some limited authority. *Scott* v. *Acadia Realty Trust*, 2009 WL 5177153 (Del.Super.Ct.).

Acadia Realty Trust et al. owned a shopping center in which a Target retail store was located. In 2006, Saida Scott, an employee of Target, in the scope of her employment, slipped in the icy Target parking lot and broke her knee. Scott sued Acadia as the property owner, alleging that Acadia owed her a duty to maintain the parking lot in a "reasonably safe condition" and, by failing to remove the ice, had breached that duty. Acadia brought Target in as a third-party defendant and they both filed a motion for summary judgment. Target argued that if Acadia's summary judgment motion was granted, Target's summary judgment motion must necessarily be granted because Acadia would have no claim against Target at that point. Scott did not sue Target because she received Worker's Compensation benefits and was precluded from suing her employer.

Scott argued that Acadia's lease with Target demonstrated that actual control over the parking lot was intended to remain with Acadia, and that Acadia retained ownership over the parking lot along with "numerous powers to direct activities" in the parking lot. Scott also asserted, in the alternative, that the relationship between Acadia and Target resembled that of a management company and a landlord.

In granting Acadia's summary judgment motion, the court held that although the lease was "not completely clear" on which party maintained actual control over the parking lot, other provisions in the lease indicated that "the parties did intend to give control over the Target parking lot to Target." For example, the parking lot was included in the definition of the "Tenant Site," but not in the definition of the "Landlord Site." The court recognized the conflict between the definitions of "Premises" and "Tenant Site," and proceeded to look at the lease in its entirety for provisions related to "actual control."

The court noted that Target's consent was required if Acadia wanted to make alterations to the common areas (of which the parking lot was included). Additionally, the insurance provision within the lease required Target to maintain insurance coverage over the parking lot, which it could obtain without input from Acadia. Finally, the lease allowed Target the use of the Target parking lot as "an 'extension' of its sales area" and to "designate employee parking in the Target Parking Lot without any input from Acadia."

The court held that even though Acadia retained some authority over the parking lot, the inquiry was "not whether control over the Target parking lot is 'exclusive,' but whether control is 'actual.'" The rights that Acadia retained were subordinate to those of Target because Acadia needed Target's consent to make any improvements or decisions with regard to the parking lot.

With regard to Scott's alternative argument that the relationship between Acadia and Target was akin to that of landlord-property manager, the court held that the lease did not indicate that Target was acting as Acadia's agent. Further, the court held that Target was not acting on behalf of Acadia when using the parking lot. Since the court granted Acadia's summary judgment motion, it granted Target's motion for summary judgment as well because Acadia's potential claim against Target was extinguished.

A federal district court relies heavily on course of performance when interpreting rent and sublease revenue provisions in a lease. ***Pathmark Stores, Inc.*** **v.** ***Gator Monument Partners, LLP,*** **2009 WL 5184483 (E.D.Pa.)**

In 1980, Supermarkets General Corporation, Pathmark Stores, Inc.'s predecessor in interest as tenant, entered into a lease with Superline Associates Limited Partnership, the predecessor-in-interest of Gator Monument Partners, LLP, for space in a shopping center. In 1990, the leased space was expanded by approximately 5,100 square feet. The lease had a primary term of 25 years, with six five-year option terms. Pathmark exercised the first option term in December 2005.

Gator acquired the shopping center in April 2008 and a month later served Pathmark with a default notice alleging defaults under several of the lease provisions. Pathmark sued, asking for injunctive relief to prevent Gator from taking possession and a declarative judgment that Pathmark was not in violation of the lease.

The lease provided for both a lump-sum rental payment and a per square foot rental. For 28 years, Supermarket/Pathmark paid the lump-sum rental payment. Pathmark argued that the course of performance required that only the lump-sum rental be paid, and that the presence of a square footage formula does not require that the rent be recalculated based on the size of the premises. Gator argued that the 1990 expansion should have caused the per square foot rent calculation to apply, and that the course of performance should not matter because neither party was an original party to the lease. The court held that general principles of contract interpretation and the course of performance (28 years) indicated that the rent should be based on the lump-sum amount, and thus granted Pathmark's summary judgment motion on that issue.

The lease also provided that, during the extended term, Pathmark owed Gator an amount equal to any sublease rent received by Pathmark in excess of Pathmark's total rental obligation. Pathmark argued that the course of performance dictated that Gator would not receive any sublease revenue until it exceeded Pathmark's total rental payment for all space in the premises, not just an allocated portion relating to subleased space. Gator asserted that the excess calculation applied to Pathmark's rental obligation for the space subject to subleases, not only to sublease rental collected in excess of Pathmark's total rental obligation for the entire leased premises. Again, the court granted Pathmark's motion for summary judgment, holding that the plain language of the provision and the three-year course of performance since the commencement of the extended term did not support Gator's contention.

A California court holds that an exclusivity provision applied to all buildings in a multi-building shopping center. ***Garcha*** **v.** ***Central Plaza-Union City, L.P.*****, 2009 WL 4981285 (Cal.App. 1 Dist.).**

Central Plaza-Union City, L.P. owned a shopping center that consisted of three buildings: Building A, referred to as "retail"; Building B, referred to as "office/showroom"; and Building C, referred to as "warehouse." Fortunato Enterprises leased space in Building A, operating a Quiznos franchise. Fortunato's lease had an exclusivity provision giving it the exclusive right to sell submarine sandwiches in the shopping center and prohibiting future tenants from deriving "more than 8 percent of their gross sales" from "delicatessen or submarine type sandwiches."

In early 2004, Central executed a lease with Majinder Sandhu for space in Building B for "computer services." In April 2004, Central and Sandhu amended the lease's use provision to include "café," eventually opening eMocha Café. eMocha's plans, which included a sandwich preparation area, were approved by Central. Some of the sandwiches sold at eMocha were similar to those sold at Quiznos; ultimately, sandwich sales accounted for 30–50 percent of eMocha's gross sales.

Satinder and Harleen Garcha bought the Quiznos franchise from Fortunato in December 2004 and extended the lease in December 2005. Central consented to Fortunato's assignment of the lease (which the Garchas extended in December 2005) but did not discuss eMocha's sandwich sales. The Garchas claimed a breach of the exclusivity clause in the Fortunato lease and sued. The trial court awarded the Garchas $37,724.87 for their losses and $85,537 in attorney fees. Both parties appealed—the Garchas from the fee award and Central from the trial court's judgment.

Central asserted on appeal that the exclusivity provision did not extend to eMocha in Building B. The court rejected this argument, holding that the express language of the exclusivity provision applied to the "shopping center," and that several provisions of the lease defined "shopping center" to include all three buildings. Further, the court held that the express language of the exclusivity provision required inclusion of Building B to give it the full force and effect that it specifically required. Further, the court found that the physical layout, signage and similar tenant mixes of Buildings A and B supported the conclusion that both buildings were part of the "shopping center." Finally, the court held that Central's own conversations with eMocha indicated its belief that both buildings were covered by the exclusivity provision.

Central also argued that the original lease was not extended, but rather was a new lease. The court also quickly rejected this argument, citing the express language of the lease extension and other supporting documentation.

From Canada

In Depth

Money Laundering and Terrorist Financing: New Responsibilities for the Real Estate Industry in Canada

*Fredric L. Carsley**
De Grandpré Chait LLP
Montréal, Québec, Canada

Introduction

As of Feb. 20, 2009, amendments to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act (Act)*[1] and its regulations (Regulations)[2] are in force and shall have an effect on the operations of a "real estate developer" (Developer) and "real estate broker or real estate sales representative" (Broker), as contemplated by the amendments to the *Act* and the Regulations.

The purpose of the *Act* is to help detect and deter money laundering and the financing of terrorist activities, as well as to facilitate investigations and prosecutions of money laundering and terrorist activity financing offences. The new amendments bring Developers and Brokers, among others, under the umbrella of the *Act*'s requirements.

Part 3 of the *Act* established the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), as an independent agency to administer the *Act*. FINTRAC has published extensive Guidelines on all relevant topics, including those applicable to the duties of Developers and Brokers. They are available on the Internet.[3]

Who in the Real Estate Process Is Subject to the Act?

Typically, in real estate transactions, depending upon the size and complexity, we would see any one or more of the following cast of characters: real estate developers, brokers and agents, lawyers, and, in the Province of Québec, notaries. Which of them is subject to the *Act*?

1. *Real Estate Developers*

According to § 1(i) of the Regulations:

> "real estate developer" means, on any given day in a calendar year, a person or entity who, in that calendar year and before that day or in any previous calendar year after 2007, has sold to the public, other than in the capacity of a real estate broker or sales representative,

(a) five or more new houses or condominium units;
(b) one or more new commercial or industrial buildings; or
(c) one or more new multi-unit residential buildings each of which contains five or more residential units, or two or more new multi-unit residential buildings that together contain five or more residential units. (*promoteur immobilier*).

The key operative word here is "new." The *Act* defines "new" as property constructed within two years of the sale and not previously occupied. So, for the typical commercial real estate transaction where a developer builds an industrial or commercial building for single or multi-tenant use, once the tenant takes occupancy, the property is no longer "new" for the purpose of this definition, and the *Act* and Regulations no longer apply to that transaction.

Conversely, if a builder was to build a commercial or industrial building that it sells within the two-year period to an investor, who then in turn leases the property to a third-party tenant, the property should be considered "new" at the time of the sale and the *Act* would apply.

However, assume that several multi-residential buildings that were leased for residential purposes are re-developed as co-operatives. The user buys shares in a corporation that owns the unit, and obtains an occupancy agreement that is similar to a residential lease. This does not appear to fall within the current definition of "real estate developer."

What Does "Sales to the Public" Mean?

Pursuant to § 39.5 of the Regulations, a sale, whether on the seller's own behalf, or on behalf of a subsidiary or affiliate of the seller, is a sale to the public. An affiliate is wholly-owned by the other entity or both entities, and wholly-owned by the same entity.

2. *Brokers and Agents*

Brokers and agents involved in the purchase or sale of real estate, whether it is land, buildings, houses, and so on are subject to the *Act*. The Regulations define "real estate broker or agent" as a "person or entity that is registered or licensed under the provincial legislation in respect of the sale or purchase of real estate." So for Québec, these parties would be considered licensed brokers and agents under the *Real Estate Brokerage Act*.[4]

According to FINTRAC's Real Estate Guideline 2, the Act does not apply to property management activities such as leasing.

3. *Lawyers and Québec Notaries*

Lawyers and Québec notaries were originally included in the process. The Federation of Law Societies of Canada, an umbrella organization of the Provincial Bar Associations and Québec *Chambre des notaires*, challenged this inclusion for lawyer/client confidentiality reasons. As pointed out in a letter to the Canadian Ministry of Finance on Sept. 30, 2005:

> Fundamental Canadian constitutional principles require that lawyers maintain undivided loyalty to their clients, consistent with the independence of the Bar and the integrity of the administration of justice. There is a strong presumption that all communications between lawyer and client, along with financial information arising from the solicitor and client relationship, are confidential and may not be disclosed to, or obtained by, government authorities without a court Order. The Supreme Court of Canada has affirmed that lawyers, who are bound by stringent ethical rules, must not have their offices turned into archives for the use of state authorities.
>
> These principles define a clear threshold between constitutional and unconstitutional requirements imposed on lawyers when it comes to the gathering of information from clients: A lawyer must obtain and keep all information needed to serve the client, but must not obtain any information which serves only to provide potential evidence against the client in a future investigation or prosecution by state authorities.

Clearly, as shown below, the reporting and monitoring process required by the *Act* is in direct contradiction to the duty of confidentiality that all lawyers and Québec notaries are bound by the various codes of professional ethics governing the practice of their respective professions.

What has resulted is a compromise. The Federal Government eliminated lawyers and Québec notaries from the reporting process.[5] The Federation adopted a model rule on client identification and verification requirements, better known as "Know Your Client." For these purposes, suffice it to say that under the model rule, where a lawyer, defined as including Québec notaries, is involved in certain matters, knows or ought to know that he or she is or would be assisting a client in fraud or other illegal conduct, the lawyer must withdraw from representation of the client.

While this may work in private practice, corporate counsel may have to resign, and be subjected to great economic hardship. This, however, is better than possibly aiding and abetting criminal activity and being subject to possible prosecution.

At this juncture, all of the Provincial Law Societies have adopted the model rule. In Québec, both the *Barreau du Québec* and *Chambre des notaires* have likewise adopted the model rule. We are informed that the *Barreau* has been through the process with the *Office des Professions*, that all has been approved and that the Rule is expected to come into force in Quebec as of July 1, 2010.

Note as well that many Canadian law society regulations prohibit lawyers from accepting in excess of $7,500, with limited exceptions. The Québec Bar is currently reviewing its policies on this matter.

General Duties of Developers and Brokers

The *Act* and Regulations now require Developers and Brokers to adopt and maintain various compliance measures. The principal obligations are:

Maintain receipt of funds records: This is required when a Developer receives any amount from a client, whether or not it is in cash.

Maintain client information records: This information varies if the client is an individual, entity or corporation.

Ascertaining identity: Where a Developer has the obligation to maintain a receipt of funds record or a client information record, the Developer is also required to verify the identity of everyone who conducts the transaction. In the case of a corporation, it must determine the names of the corporate directors.

Third-party determination: The Developer has to determine whether its client is acting on the instructions of a third party. It is not about determining who owns the money, but rather about who gives instructions to deal with the money.

Compliance regime: The Developer has the obligation to implement a compliance regime that will enable the Developer to meet its reporting, record keeping and client identification obligations. FINTRAC has the ability to examine the compliance regime and records, and provide feedback to the Developer.

Reporting Requirements

This article focuses on what the Developer must report to FINTRAC as to (1) suspicious transactions; (2) transactions involving properties owned or controlled by a terrorist or terrorist group; (3) "large cash transactions" defined to be cash of at least $10,000.

Suspicious Transactions

According to FINTRAC's Real Estate Guideline 2:

> A suspicious transaction is one for which there are reasonable grounds to suspect that this transaction is related to a money laundering offence or a terrorist activity financing offence. A suspicious transaction can include one that was attempted.

Indications

Guideline 2 lists, by category of business on a non-limitative basis, indicators for identifying suspicious transactions that are completed or attempted. A fairly obvious example is when the client negotiates a purchase for the market value or above the asking price and then requests a lower value in the deed and pays the difference "under the table."

Less obvious examples include the following: (1) situations in which the client exhibits a lack of concern regarding risk, commissions or other transaction costs; (2) the client does not close on the transaction, in seeming disregard of a contract clause forfeiting the deposit, or (3) situations involving anonymous transactions conducted by a lawyer with deposit cheques drawn on the lawyer's trust account.

Under the Know Your Client model rule, the lawyer should withdraw from the transaction rather than accept the cash. Failure to do so may result in the lawyer facing criminal prosecution for having participated in contravention of the *Act*.

Mortgage Loan Issues

The real estate business is capital-intensive. Subject to market conditions and funding availability, real estate acquisitions are generally leveraged through the mortgage loan process. The mortgage creditors should also beware of, and be prepared to report, suspicious transactions.

Schedule B to the Guideline 2 is a series of indicators for lenders regarding completed or attempted suspicious transactions. These range from unexpected loan payments, to suspicious foreign sources, to real estate transactions that do not make economic sense. The Guideline provides an example in which the client has significant assets and there does not appear to be a sound business reason for the transaction. This is not to suggest that every such transaction is done to launder money or finance terrorism; it is only a warning to be vigilant.

As organizations grow, whether they are Developers, Brokers, lenders or any other organization to which the *Act* applies, it becomes more important for those parties to maintain internal controls.

Sophisticated lenders are certainly cognizant of money laundering and anti-terrorist issues. Loan agreements often require assurance that the borrower has not, and will not, engage in any of these activities. Furthermore, when dealing with U.S. institutional lenders, these assurances are required not only by Canadian law, but also by U.S. statutes, such as the *Patriot Act*.

Terrorist Financing Activity

The Regulations define "terrorist activity financing offence" as an offence under any of §§ 83.02, 83.03 or 83.04 of the *Criminal Code* of Canada. These provisions, and their enforcement compliments, aim to freeze property owned by terrorists, so as to hamper terrorist activities as well as the financing of terrorist activities.

As FINTRAC points out in Guideline 2, any of the suspicious transaction indicators could lead to an indication of terrorist activities. In addition, the Federal Government has published lists of terrorist individuals, terrorist groups and terrorist activities. A question arises as to whether transactions that are found to have assisted in the financing of terrorists or terrorist activities can be annulled and, further, how that annulment might disrupt the sanctity of the title to the property.

Part of the title due-diligence process can be to determine if any person or entity on the chain of title appears on the Federal Government's terrorist lists. What would be the effect on title, say, if a name or an entity is not checked to see if it appears on the Federal Government's terrorist list or if the list is not all-inclusive, and it turns out that the buyer in good faith acquired property from a terrorist and the acquisition funds are directed toward terrorist activities?

It is perhaps a matter for the real estate bar, in conjunction with the title insurance industry, to see if title insurance and endorsements can better address this type of problem—not only for acquirers, but also for mortgage creditors whose security stands or falls on the validity and integrity of the borrower's title.

Under the ALTA (American Land Titles Association) and FATIC (First American Title Insurance Company) title policies, the freeze would be excluded from coverage under the "government power exclusion," unless the freeze is recorded or registered and the freeze is not carved out from this exclusion. These issues are currently under discussion with the claims underwriters groups, and more information should surface in the foreseeable future.

Large Transactions

Of the matters for which reporting is required, this is the easiest to identify: The amount of cash involved must be at least $10,000. Once this threshold is attained or surpassed, the cash must be reported if it is given to a Developer or Broker.

In reality, guilty parties will attempt to subvert the rules. Suppose, for example, the money launderer is well aware of the $10,000 cash minimum. So, the money launderer embarks on a series of property acquisitions, paying the Developer or Broker smaller amounts such as $8,500 or $6,250. This should signal a suspicious transaction that, if given to a Developer or Broker, must be reported.

How is this likely to occur in the context of the application to real estate? Suppose you are trying to sell units in a new condominium or development, and a speculator comes in and buys several units. The prospective buyer pays a portion of the purchase price for each unit in cash increments of less than $10,000. While none of these amounts is "a large transaction," as defined by the *Act* or Regulations, the transaction could very well, in the circumstances, be suspicious and ought to be reported as such. From a practical perspective, the vendor would prefer not to question the motives of such a good customer. However, the vendor will be much better-served if the proceeds are received by way of electronic transfer from a financial institution that is recognized by FINTRAC.

Conclusion

The new amendments to the *Act* and the Regulations will undoubtedly subject Developers and Brokers to arduous record keeping and reporting requirements. However, considering the objectives of the *Act*,[6] and recognizing how easily proceeds of crime can be hidden in real estate, the effort is well worth it.

***Fredric L. Carsley** is a Partner in the Montreal firm of De Grandpré Chait LLP, and heads the firm's Real Estate Practice group.

[1]S.C. 200, c. 17, as amended.

[2]SOR/2002-184

[3]http://www.fintrac-canafe.gc.ca/publications

[4]R.S.Q., Chapter C.-73.1.

[5]Section 71(1)(a) of the *Act* entitles the Governor in Council to describe in the Regulations the "business professions and activities" to which the reporting requirements will apply. These currently include British Columbia notaries and notary corporations and accountants/accounting firms.

[6](a) to implement specific measures to detect and deter money laundering and the financing of terrorist activities and to facilitate the investigation and prosecution of money laundering offences and terrorist activity financing offences, including

(i) establishing record keeping and client identification requirements for financial services providers and other persons or entities that engage in businesses, professions or activities that are susceptible to being used for money laundering or the financing of terrorist activities,

(ii) requiring the reporting of suspicious financial transactions and of cross-border movements of currency and monetary instruments, and

(iii) establishing an agency that is responsible for dealing with reported and other information;

(b) to respond to the threat posed by organized crime by providing law enforcement officials with the information they need to deprive criminals of the proceeds of their criminal activities, while ensuring that appropriate safeguards are put in place to protect the privacy of persons with respect to personal information about themselves; and

(c) to assist in fulfilling Canada's international commitments to participate in the fight against transnational crime, particularly money laundering, and the fight against terrorist activity.

From Canada

Leasehold Covenants—Do Leasehold Covenants Run With the Land?

*Natalie Vukovich**
Daoust Vukovich LLP
Toronto, Canada

Introduction

Many landlords and tenants believe that upon a sale of a property, the transferee of the landlord's interest is obliged to perform all of the landlord's covenants under the lease and to honour all of the rights granted to the tenant thereunder. Similarly, they believe that upon an assignment of a leasehold interest by the tenant, the assignee is obliged to perform all of the tenant's covenants under the lease and entitled to demand performance of all of the covenants of the landlord.

In Canadian common law jurisdictions, this is not necessarily the case. Leasehold covenants that attach only to the parties to the lease might not transfer to the assignee of either party—instead, they might fall away.

The Leasehold Covenant

Examples of covenants in leases include:

(a) *By landlord in favour of tenant*—to heat, to repair, to provide utilities, to insure, not to lease to competitors, to provide quiet enjoyment;
(b) *By tenant in favour of landlord*—to pay rent, to maintain, to carry on only a specified use, not to commit waste, to insure, not to assign or sublet, not to open another outlet within a certain radius of the premises (to protect percentage rent based on the tenant's sales).

Sometimes leasehold covenants, like contractual terms, can be void for uncertainty/ambiguity.[1] Other times, leasehold covenants have been held to be unenforceable for public policy reasons.[2] Some lease terms are actually considered to be separate agreements (e.g., an option to purchase[3]) or are not covenants at all but are mere conditions or qualifications on rights.[4]

Assuming the lease term is one that qualifies as a covenant, we turn to a consideration of whether it might be one that will "run with the land" (i.e., bind successors and assigns).

Covenants That Run With the Lease Vs. Those That Are Personal—The Law

Williams and Rhodes[5] sets out that the following propositions or rules are laid down in or deduced from the principles formulated in [Spencer's Case[6]]:

(1) All express covenants which touch or concern a thing *in esse*, being parcel of the demise at the time of the demise, whether "assigns" are named or not, run with the land;
(2) All express covenants which extend to a thing not *in esse* at the time of the demise, but which directly concern or benefit the land, being parcel of the demise, run with the land, if "assigns" are expressly named in the covenants;
(3) All implied covenants run with the land;
(4) Covenants under which the thing to be done is merely collateral to the land and **does not touch or concern the land** demised in any sort of way, do *not* run with the land, even though "assigns" are named.[7]

It is virtually impossible to find, from the case law, any meaningful guidance as to whether or when it is necessary/beneficial to import a reference to "assigns" to achieve or avoid a covenant that runs with the lease.

To displace doubts in relation to whether covenants ought to or will run with the leasehold interest, or not, it is widely accepted in the Canadian commercial leasing industry as a best practice by landlords, that special rights (such as rights to signage, exclusivity, expansion, co-tenancy protection, exclusive parking, no-consent transfers) should be qualified as only available to the named tenant, to ensure that they do not flow through to an assignee (if that is the deal).

In the case of *Merger Restaurants* v. *D.M.E. Foods Ltd*.,[8] a lease clause granting a tenant, its employees and invitees the right to use parking in common with others entitled thereto was held to be a covenant running with the land. In *Nylar Foods* v. *Roman Catholic Episcopal Corp. of Prince Rupert*,[9] the court held:

> If it is not entirely clear from the language that the parties intended to create an equity or correlative burden on the land, the restrictive covenant will be treated merely as a personal covenant between the parties who made it.

It follows that if a covenant is merely personal, then it will be enforceable as a matter of the law of contract, but not enforceable in accordance with the principles of real property. As noted earlier (footnote 7), an option to renew is an in *rem* covenant, concerns a thing *in esse* and runs with the land (and, correspondingly, the leasehold interest). A restriction against competitors concerns use and, therefore, touches and concerns land and is an *in rem* covenant.

Many leasehold covenants are not susceptible to easy analysis as to whether they are in *personam* vs. *in rem* covenants. The test, set down in *Rogers* v. *Hosegood*,[10] is that "the covenant must either affect land as regards mode of occupation, or it must be such as per se, and not merely from collateral circumstances, affects the value of the land."

Courts have held that the covenant not to build on adjoining land is a covenant *in rem* that runs with the land.[11] But landlord covenants that have been held by the courts as not being ones that touch and concern the land, include: the covenant to grant an option to purchase the lands,[12] the covenant to keep other properties (not the leased premises) in repair[13] and the covenant not to open a competitive enterprise within a radius from the leased premises.[14]

The following is a brief list of some tenants' covenants that have been held to "touch and concern" the land:

- To pay rent,[15]
- To pay taxes,[16]
- To repair,[17]
- To insure against fire,[18]
- Not to assign without the landlord's consent,[19]
- To buy particular goods from only the landlord[20] as well some tenant's covenants that have been held to NOT touch and concern the land,
- To pay a third party annually,[21]
- To pay taxes imposed on another property,[22]
- To replace personal property.[23]

The Case Law

In the case of *Re Dollar Land Corporation and Soloman*,[24] the tenant had paid a security deposit to the landlord. Dollar Land Corporation later purchased the property from the landlord, subject to all the leases pertaining to the property. At issue was whether Dollar Land Corporation was liable to the tenant for the security deposit. In finding that the new landlord was not liable to account for the security deposit, the court held that the covenant to repay the security deposit did not run with the land and was, therefore, not binding on the assignee. Although *Re Dollar Land* concerned a residential tenancy, it has since been followed in several cases concerning commercial tenancies.[25]

Devon Estates Limited v. *Royal Trust Co*.[26] concerned a tenant who occupied office space in Calgary. As the result of a refinancing by the landlord in 1991, Royal Trust became the trustee of bondholders and, in 1993, commenced foreclosure proceedings, took possession of the premises and executed a request to attorn to the tenant. The application by the tenant related to possible overpayments of so-called "additional rents"—as was to be determined by an arbitration then underway. These payments had been made to the former landlord. In finding Royal Trust not liable to account for the overpayments, MacLeod J. reviewed a number of cases (including *Re Dollar Land and Chiappino v. Bishop*[27]). The court held that the request to adjust the difference between estimated and actual operating costs was not an adjustment in the amount of rent; it was an obligation to repay a sum of money that was triggered by the arbitration process. The obligation to repay was, therefore, no different from the obligation to return a deposit.

Similarly, in *Canada Trustco Mortgage Co.* v. *Mundet Industries Ltd.*,[28] the court held that the tenant had no claim against the current landlord for the return of a GST payment made to the former landlord.

In *Brennan* v. *Dole*,[29] neighbouring townhouse owners engaged in a dispute over snow removal costs. The townhouse developer executed an agreement with each initial owner that provided for the sharing of costs of snow removal from a common right of way and for the resolution of disputes under the agreement by arbitration. A successor in title to one of the five original townhouse owners did not want to go to arbitration to settle the dispute. She argued that the arbitration clause was unenforceable because it was a positive covenant that did not bind her (as a successor in title who did not specifically assume the obligations of the covenant), and that it did not run with the land. The Court of Appeal agreed. Leasehold covenants are not of the same nature as terms in a cost-sharing agreement between landowners, yet Brennan was referred to in a commercial lease dispute, in the case of *678400 Ontario Inc.* v. *Roehampton Apartments Ltd*.[30] (where the landlord and tenant were disputing the rent to be paid for a renewal period). The original lease stipulated arbitration as the dispute resolution mechanism. The landlord and tenant were not the original parties to the lease. The tenant submitted that the agreement to arbitrate is a positive covenant that does not run with the land. The tenant relied on the decision in *Brennan*. The court rejected the tenant's argument, finding that the arbitration clause was not a collateral covenant to the lease.

Let's break down the three types of situations that one might encounter, in which a determination of whether the covenant ran with the land might become relevant:

1. Original landlord and successor tenant;
2. Successor landlord and original tenant;
3. Successor landlord and successor tenant.

An assignment by the original landlord or the original tenant does not affect the privity of contract between the original tenant and the original landlord (unless the parties expressly agree to a release). However, the assignment ends the privity of estate between the original tenant and the original landlord. (When a tenant enters into a lease with a landlord, there is not only privity of contract but also privity of estate between them. That is to say, the covenants of the landlord and of the tenant, which relate to the conveyance and the real property interest, or which touch and concern the land as distinct from being mere covenants of a personal nature, can be enforced as between them. Privity of estate and tenure are essentially the same thing, in that where they are found to exist, those who hold the estate together are liable to each other to perform the covenants which relate to the estate.) However, covenants of a personal nature (such as an option to purchase) cannot be enforced between parties that are merely connected by privity of estate. Privity of estate is always held by the then-current landlord and the then-current tenant.

Hence, an assignor of a tenant's interest remains liable in contract although it no longer has the estate (although a subsequent assignor will only remain liable in contract if it contracted to be bound, i.e., if it took on privity of contract in addition to the privity of estate that arose during its tenure).

The Solution? Assumption Agreements

An assumption agreement is a useful tool that serves to clarify the answer to "Does/Did the covenant run with the land/lease?"

It is common in Canadian commercial leasing practice to require that the assignee of a tenant's interest under the lease sign an agreement in which it covenants, in favour of the landlord, to perform the obligations of the tenant under the lease. This type of "assumption agreement" will create the privity of contract, whereas the assignment of the interest created the privity of estate—with the result that for the landlord, both a contractual and a property law relationship are available when considering remedies for unfulfilled lease terms. In this manner, a "gap in coverage" is avoided (if any covenants fail to attach to an assignee), i.e., the assignee picks up each and every covenant of the tenant, whether or not it would have otherwise run with the land.

It is also a common step in real estate conveyancing transactions that the vendor extracts from the purchaser an assumption of all leasehold covenants. But it is far less common in Canadian commercial leasing practice that a tenant obtains a covenant, from a purchaser of the landlord's interest in the lease, to perform and observe all of the terms and conditions of the lease.

In Ontario, pursuant to the *Commercial Tenancies Act*,[31] §§ 4–8, the common law rule that positive covenants do not run with the reversion was, by and large, reversed. Many other common law provinces have similar legislation.[32] Yet, it is not clear that these provisions will help the tenant in all disputes against a successor landlord over its failure to perform a lease covenant. An assumption agreement (by the successor landlord in favour of the tenant) would fill that gap.

Fundamentally, assumption agreements are useful and reliable as a means of confirming (1) which leasehold covenants transfer to a successor/assign and (2) who can enforce those covenants.

***Natalie Vukovich** is one of the founding partners of Canada's only commercial leasing boutique firm, Daoust Vukovich LLP (est. 1995), in Toronto. She can be reached at nvukovich@dv-law.com or (416) 597-8911.

[1]*Hirex Holdings Ltd., Chrysler Canada Ltd.* [1991] B.C.J. No. 669 (B.C.S.C.), and *Re: Spike et al. and Rocca Group Ltd. et al* (1979), 107 DLR (3d) 62 (PEISC).

[2]*B.A.C.M. Ltd. and Kowall Holdings Ltd. et al.* (1972), 28 D.L.R. (3d) 365.

[3]*Palmer* v. *Ampersand Investments Ltd.* (1984), 47 O.R. (2d) 275 (H.C.J.).

[4]E.g., a lease of shopping centre premises may contain a provision stipulating that if a certain number of stores are not continuously carrying on business for a set number of days or months, the rental rate will be reduced. This type of provision carries no promise of stores carrying on business; if the stores do not carry on business, the landlord is not in default and there can be no claim for damages or entitlement to other remedies. The failure to achieve the threshold level of occupancy is a condition that gives rise to an agreed set of outcomes (which typically include reduced rent and, after some time has elapsed without the occupancy levels being restored, a right of termination without liability). But there is no covenant by the landlord to maintain a certain occupancy level that would, if unfulfilled, give rise to a claim for breach. In a similar vein, a lease may contain a provision prohibiting the tenant from assigning the lease to a third party without the landlord's consent. The prohibition against assigning is a covenant and the landlord's consent might be considered a mere qualification, such that the landlord's failure to consent would not give rise to a claim for breach, although the courts have held otherwise. In *Cvokic* v. *Belisario*, [2008] O.J. No. 2766 and in *Lehndorff Canadian Pension Properties Ltd.* v. *Davis Management Ltd.* [1987] B.C.J. No. 1228, the landlord was liable for unreasonably withholding consent.

[5]*Williams & Rhodes,* M.J. Butkus (Toronto: Carswell, 1988).

[6]Spencer's Case (1583), 77 E.R. 72.

[7]an existing lease interest, a building on a property, not something that will exist in the future.) Williams & Rhodes gives examples of express covenants which touch or concern a thing *in esse*, including the covenant to pay rent, to render services in the nature of rent, to pay taxes, to repair and leave in repair, to repair and renew fixtures, to build a mill in place of an old one, to erect a building, not to erect a building in a prescribed area, to pay for improvements made by the tenant, to conduct business properly, to use the premises for a restricted purpose, to allow access by the landlord to supply utilities, to provide janitorial services, to heat, to insure, and many other covenants. An option to renew the term is a covenant by the landlord to grant the tenant a further term and, as such, is a covenant that touches or concerns a thing *in esse*. Hence, a covenant to renew binds the purchaser of the landlord's interest and is available to the tenant's assignee, whether or not there is any express statement to that effect.

[8][1990] M.J. No. 319 (Man. C.A.) (QL).

[9](1988), 48 D.L.R. (4th) 175 (B.C.C.A.).

[10][1900] 2 Ch. 388 at p. 395 (C.A.).

[11]*Dewar* v. *Goodman*, [1909] A.C. 72 (H.L.); *Ricketts v. Enfield Churchwardens*, [1909] 1 Ch. 544.

[12]*Woodall* v. *Clifton*, [1905] 2 Ch. 257 (C.A.).

[13]Supra, note 11.

[14]*Thomas* v. *Hayward* (1869), L.R. 4 Ex. 311.

[15]*Williams* v. *Bosanquiet* (1819), 1 Brod. & B. 238, 129 E.R. 714, *Parker* v. *Webb* (1963), 3 Salk. 5.

[16]*Mackinnon* v. *Crafts, Lee & Gallinger* (1917), 33 D.L.R. 684 (Alta. C.A.).

[17]*Perry* v. *Bank of Upper Canada* (1866), 16 U.C.C.P. 404.

[18]*Douglass* v. *Murphy* (1858), 16 U.C.Q.B. 113.

[19]*Goldstein* v. *Sanders*, [1915] Ch. 549; *Cohen v. Popular Restaurants Ltd.* [1917] 1 K.B. 480.

[20]*Rudd* v. *Manahan* (1913), 11 D.L.R. 37 (Alta. C.A.), affg 5 D.L.R. 565 (Alta. S.C.).

[21]*Mayho* v. *Buckhurst* (1617), Co. Jac. 438.

[22]*Gower* v. *Postmaster-General* (1887), 57 L.T. 527.

[23]*Gorton* v. *Gregory* (1862), 3 B & S 90, 122 E.R. 35.

[24][1963] 2 O.R. 269.

[25]See, e.g.: *Devon Estates Limited* v. *Royal Trust Co.*, [1995] 2 W.W.R. 293 (Alberta Queen's Bench) and *Canada Trustco Mortgage Co.* v. *Mundet Industries Ltd.*, [1996] O.J. No. 3746 (Ontario Ct. (Gen. Div.)).

[26]Supra, note 25.

[27][1988] O.J. No. 763 (Ontario Ct. (Gen. Div.)).

[28]Supra, note 25.

[29][2005] O.J. No. 3904 (C.A.).

[30][2006] O.J. No. 5021 (Sup.Ct.J.).

[31]R.S.O. 1990, c. L.7.

[32]**NWT and Nunavut**—*Commercial Tenancies Act, R.S.N.W.T. 1988* 1988, c. C-10 ss. 2(3),(4), s.3, s.4.
Yukon—*Landlord and Tenant Act,* R.S.Y. 2002, c. 131 s.2, s.3.
Manitoba—*Landlord and Tenant Act*,, R.S.S. 1978, c. L-6 s.3, s.4, s.5, s.6.
New Brunswick—*Landlord and Tenant Act*, R.S.N.B. 1973, c. L-1 ss. 2(1),(2),(3), s.3.
P.E.I.—*Landlord and Tenant Act*, R.S.P.E.I. 1988, c. L-4 ss. 2(1),(2),(3), s.3, s.4.

From Canada

The *Wal-Mart* Case: Supreme Court Ruling Upholds Employers' Right to Close Their Businesses

*Sébastien Beauregard**
Ogilvy Renault
Montreal, Canada

On Nov. 27, 2009, the Supreme Court of Canada handed down a judgment in *Gaétan Plourde* v. *Wal-Mart Canada Corp.*,[1] upholding a principle derived from a long line of Quebec cases, which recognized an employer's right to close its business, even for reasons relating to the unionization of its workforce.

Factual Background

Following the unionization of its Jonquière store, Wal-Mart and the newly certified union tried unsuccessfully to agree on the content of a collective agreement. The union then asked the Minister of Labour to initiate the dispute arbitration procedure that allows the terms of a first collective agreement to be determined by an arbitrator. On Feb. 9, 2005, an arbitrator was appointed for this purpose. On that same day, Wal-Mart notified the Minister that it would close its Jonquière store permanently on May 6, 2005. In fact, the closure took place on April 19, 2005, ahead of the designated date.

The appellant, Plourde, along with a number of other employees whose employment was terminated following the closure of the Jonquière store, filed a complaint against Wal-Mart under §§15 to 17 of the Quebec Labour Code (the Code),[2] alleging that he had lost his job because the store had been unionized. These sections set out a remedy for employees who have been dismissed, discriminated against, or subjected to reprisals or other sanctions because they exercised a right arising from the Code. One of the undeniable advantages of bringing a claim under §§15 to 17 of the Code is that the employee benefits from a reversal of the burden of proof. Once the employee shows that he or she was taking part in union activities, there is a presumption that his or her termination (or other sanction) resulted from the exercise of such right and thus that a violation of the Code occurred. In such a case, it will be up to the employer to demonstrate that it had a good and sufficient reason to proceed with termination.

The Quebec courts have always recognized that an employer that proceeds with a real and definitive closure of its business necessarily has a good and sufficient reason to terminate the employment of its workforce. The *Commission des relations du travail* (Labour Relations Board) asked to rule on Plourde's complaint, applied these authorities, and found that since Wal-Mart had shown that its store had been genuinely and permanently closed, there was no violation of §15 of the Code. The complaint was accordingly dismissed. The finding of the Labour Relations Board was confirmed by the Quebec Superior Court and the Court of Appeal.

The Decision of the Supreme Court

Before the Supreme Court, Plourde argued that the Court should reverse the Quebec case law on the question, in particular taking into consideration a recent decision by the Court, which recognized that the collective bargaining process had a constitutional dimension.[3] The Supreme Court, in a 6–3 majority decision, confirmed the current state of Quebec law and acknowledged that an employer is entitled to close its business, even if the closure is based on "socially reprehensible considerations."

The Scope of the Supreme Court Ruling

Accordingly, the Court has affirmed that an employer that proceeds with a real and definitive closure of its business is not required to justify its decision. The Court has thus acknowledged that employees alleging closure of a workplace for anti-union motives cannot benefit from the considerable advantage afforded by §17, namely, a reversal of the burden of proof.

The Supreme Court nevertheless points out that an employer that closes its business for anti-union motives may be the subject of an unfair labour practice complaint under §§12 to 14 of the Code, which provisions prohibit an employer from interfering with an association of employees or of using intimidation, threats or reprisals to prevent employees from exercising their rights under the Code. However, the Court emphasizes that in bringing such a complaint, employees will have to overcome the difficulties resulting from their burden to establish real anti-union conduct on the part of the employer; such a demonstration will not always be easy to make. Moreover, even in cases involving violation of §§12 to 14 of the Code, the Labour Relations Board will not be able to compel a business to reopen and reinstate the employees. As noted by the Court, the possible adverse consequences for the employer in such cases will be financial only, and may include compensating the employees for the losses suffered as a result of the closure of the business for anti-union motives.

Ogilvy Renault represented the *Conseil du patronat du Québec* (Quebec Business Council) in this matter, which intervened in the case before the Supreme Court in order to protect the interests of its members.

***Sébastien Beauregard** is resident in the Montreal office of Ogilvy Renault. He deals with all aspects of employment and labour law and can be reached at sbeauregard@ogilvyrenault.com.

[1]2009 SCC 54. On that same day, the Court also handed down judgment in a related case: *Desbiens* v. *Wal-Mart Canada Corp.*, 2009 SCC 55.

[2]R.S.Q., c. C-27 (the Code).

[3]Health Services and Support—*Facilities Subsector Bargaining Assn*. v. *British Columbia* [2007] S.C.R. 391.