# Report from Section 365 Land

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Preface

I. Landlord's Rights during Limbo or Abeyance Period: § 365(d)(3)

A. The Real Property Lessor's Predicament pre-1984

B. The "Solution"

C. Problems with the Solution

1. The Minority View

2. The Majority View

3. Fissures in the Majority Approach: Time of Payment of Administrative Claim - Let a Thousand Flowers Bloom

D. What Obligations Must a Debtor Pay?

1. Accrual Approach

2. Billing Date Approach

3. The Hybrid Approach: *Comdisco* and *HA-LO Industries*

4. The "Pure Proration" Approach: *In re Ames*

5. Stub Rent: The Next Frontier?

II. When Bambi (§ 365(h)(1)(A)(ii)) Meets Godzilla (§ 363(f))

A. The Basic Issue

1. Section 365(h)(1)(A)(ii)

2. Section 363(f)

B. Pre-*Qualitech* Case Law

1. *Taylor*

2. *Churchill Properties*

3. *Bedford Square*

C. *Qualitech*

**Preface**

It's a laugh a minute in section 365 land and it's an issue a minute as well. They just continue to bubble up. The following materials report on the latest developments involving nonresidential real property lessors and lessees.

## I. Landlord's Rights during Limbo or Abeyance Period: § 365(d)(3)

Section 365(d)(3) has proven a fertile source of litigation. We hope to shed light on three issues here:

> (1) a landlord's right to collect tax obligations that become due postpetition but are allocable to prepetition periods, when the lease is ultimately rejected;
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> (2) a landlord's claim for rent for the post-rejection portion of a month when the lease is rejected after the date on which rent is otherwise due in advance for the month; and
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> (3) a landlord's claim for rent for the prepetition and postpetition portions of the month in the context of a mid-month bankruptcy filing.

The path to enlightenment requires some preliminary discussion of section 365(d)(3)'s mottled history and case law.

### A. The Real Property Lessor's Predicament pre-1984

As initially enacted, section 365 was harsh on nondebtor real property lessors. The chapter 11 debtor-lessee had until plan confirmation to decide whether to assume or reject a real property lease. That could be a long time. And during that time,

> estate representatives were not required to make rental payments during the postpetition, pre-rejection period.... In effect, a commercial landlord was forced to lease property rent free to the bankruptcy estate postpetition while awaiting a decision from the estate representative on lease assumption or rejection..... [1]

The lessor, unlike any other creditor in bankruptcy, was "forced to provide current services--without current payment."[2] Courts did recognize "administrative rent" claims but they "were ... subject to adjustment, in abrogation of the lease terms, to reflect the reasonable value of the estate's use and occupancy, and, if paid at all, were eventually paid with other administrative claimants on a pro rata basis."[3] The time-consuming formalities associated with obtaining an administrative expense, limiting it to "the *reasonable value* of the DIP's *actual* use and occupancy of the premises," and the court's discretion to delay payment until the end of the case "imposed a heavy economic burden on landlords who were forced to provide ongoing services and space to the estate without receiving timely payment to

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1 *In re* PYXSYS, 288 B.R. 309, 312 (Bankr. D. Mass. 2003).

2 H.R. REP. NO. 882, 95th Cong. 2d Sess. 130 CONG. REC. S8, 994-95 (daily ed. June 29, 1984) (statement of Sen. Hatch), reprinted in 1984 U.S.C.C.A.N. 576.

3 *Id.*

satisfy their own cash obligations."[4]

## B. The "Solution"

Congress amended section 365(d) to alleviate the plight of nonresidential nondebtor-lessors. It added section 365(d)(4) to require commercial real property lessees to assume or reject within 60 days of the order for relief unless the court, for cause, extended the time to decide. Failing a decision or an extension of time to decide, section 365(d)(4) deems the lease rejected "and the trustee shall immediately surrender such nonresidential real property to the lessor."

Section 365(d)(3) provides:

> The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.... Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

Senator Hatch explained that the amendments would reduce the lessor's

> problems by requiring the trustee to perform all the obligations of the debtor under the lease of nonresidential real property at the time required in the lease. This timely performance requirement will insure that debtor-tenants pay their rent, common area and other charges on time, pending the trustee's assumption or rejection of the lease....[5]

## C. Problems with the Solution

Courts agree on two things concerning section 365(d)(3).[6] First, they agree Congress enacted it to protect lessors. Second, they agree section 365(d)(3) requires debtor-lessees to timely pay their lease obligations. They *dis*agree about everything else.

The disagreement begins with a lessor's "remedy" for debtor non-compliance with section 365(d)(3).

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[4] Joshua Fruchter, *To Bind or Not to Bind -- Bankruptcy Code § 365(d)(3): Statutory Minefield*, 68 AM. BANKR. L.J. 437, 437 (1994) (emphasis in original).

[5] H.R. REP. NO. 882, 95th Cong., 2d Sess., 130 CONG. REC. S8, 994-95 (daily ed. June 29, 1984) (statement of Sen. Hatch), reprinted in 1984 U.S.C.C.A.N. 576.

[6] We think they will agree on a third if other cases bubble up on the issue. In Einstein/Noah Bagel Corp. v. Smith (*In re* BCE West, L.P.), 319 F.3d 1166 (9th Cir. 2003), a case of first impression, the Ninth Circuit held § 365(d)(3) is limited to debtor-lessees. Therefore, a nondebtor-sublessee was not entitled to administrative priority for damages it suffered as a result of the debtor-lessor's breach of its lease agreement during the postpetition, pre-rejection period.

**1. The Minority View**

According to the minority view, if a lessor fails to act pre-rejection to insist on the lessee's timely performance of all postpetition lease obligations, section 503(b) governs the lessor's entitlement to administrative expense priority for the lessee's failure to perform its postpetition, pre-rejection lease obligations. *In re Mr. Gatti's*[7] provides the best explanation of the minority view. The debtor, Mr. Gatti's, was a sub-lessor. The sub-lessee ceased business operations and notified the shopping center lessor it was abandoning the premises. Everyone agreed the sub-lessee had vacated the premises four days *after* the debtor had filed. The locks were changed. The debtor never entered on or actually used the premises.[8] Ultimately, it rejected the lease. The debtor paid the lessor nothing during the postpetition, pre-rejection period. It agreed it owed the lessor four days administrative rent. The lessor demanded the full rent owing from the date of the petition until the date the court approved rejection.[9]

The court began by observing that section 365(d)(3) fails to set out the lessor's remedy in the event the lessee fails to do what the statute requires.[10] Pre-1984, the

> estate's liability for unpaid rent was limited to the reasonable value to the estate of the actual occupancy and use of the premises.... This claim for use and occupancy was given administrative status and was therefore sometimes known as administrative rent.[11]

The lessor could also move to compel the debtor to decide. But that was about it in terms of a lessor's remedies with the exception of the occasional court that recognized a lessor's entitlement to adequate protection.[12] The *Gatti* court adopted the approach of a mysterious Ninth Circuit BAP opinion, *Orvco*.[13] The *Gatti* court held the lessor had to prove its claim to administrative rent once a lease was rejected.[14]

Section 365(d)(3)'s failure to state an express remedy did not mean the lessor was remediless in the face of lessee non-compliance. The Code provided lessors with several general remedies: dismissal, appointment of a trustee, conversion and relief from the automatic stay for cause.[15] The court believed the strongest argument in support of the majority view was that failure to recognize an administrative claim might encourage debtors to ignore section 365(d)(3). But, reasoned the court, section 362(f) gives relief from the stay to prevent irreparable injury and 363(e) also provides lessors with immediate relief if

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7 *In re* Mr. Gatti's, Inc., 164 B.R. 929 (Bankr. W.D. Tex. 1994).

8 *Id.* at 930.

9 *Id.* at 930-31.

10 *Id.* at 933.

11 *Id.* at 934.

12 *Id.*

13 Great Western Savings Bank v. Orvco, Inc. (*In re* Orvco, Inc.), 95 B.R. 724 (9th Cir. BAP 1989), *rev'd in part sub nom*. Towers v. Chickering & Gregory (*In re* Pacific-Atlantic Trading Co.), 27 F.3d 401 (9th Cir. 1994).

14 *Id.* at 936.

15 *Id.*

needed: "The landlord's rights just under these two remedy provisions appear to sufficiently counterbalance any gamesmanship on the part of the debtor-lessee ...."[16] Finally, section 365(d)(3) was not in inescapable conflict with section 503(b)(1): "365(d)(3) ... imposes a duty on the debtor without any expressed remedy for its breach.... [Section 503(b) is] a provision conferring administrative status for claims that meet certain criteria."[17]

Arguably, the court couldn't bring itself to give the lessor an administrative claim for postpetition, pre-rejection rent when the estate had used the premises for all of 4 days. Other courts adopting the minority view faced similar facts - little to no benefit to the estate.[18]

**2. The Majority View**

Most courts read section 365(d)(3)'s language "notwithstanding section 503(b)(1) of this title" to mean section 365(d)(3) confers upon the nonresidential real property lessor, by operation of law, an administrative expense claim for lease obligations arising after the order for relief and before lease rejection.[19] So, even if the estate does not benefit from the lease, the lessor still has an administrative

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[16] *Id.* at 944.

[17] *Id.* at 945.

[18] *See, e.g., In re* K-Fabricators, 135 B.R. 654, 658-59 (Bankr. W.D. Wash. 1992) (debtor used part of premises, portion of warehouse, to store some personal property entitling lessor to administrative claim for fair and reasonable rental value of property estate actually used and valued as used, i.e., valued as storage, not manufacturing, space); *In re* Daisy/Cadnetix Inc., 126 B.R. 87, 88 (Bankr. N.D. Cal. 1991) (debtor vacated premises prepetition and hence no benefit to estate); *In re* Tammey Jewels, 116 B.R. 292, 294 (Bankr. M.D. Fla. 1990) (leased premises were portion of mall walkway rather than enclosed leased premises in orthodox sense, debtor never occupied the space and no evidence suggested landlord suffered economic damage); *In re* Patella, 102 B.R. 223, 224 (Bankr. N. N.M. 1989) (debtor did not occupy premises at time of its chapter 7 petition and estate did not use them).

[19] *See, e.g.,* Temecula v. LPM Corp. (*In re* LPM Corp.), 300 F.3d 1134, 1138 (9th Cir. 2002) ("We agree with the vast majority of the courts that have considered the issue that post-chapter 11 rent claims have administrative priority and are entitled to payment under § 365(d)(3), unless the case is converted to a Chapter 7. In that event, the claims are paid as specified in 11 U.S.C. § 726."); Thinking Machines Corp. v. Mellon Fin Servs. Corp. (*In re* Thinking Machines Corp.), 67 F.3d 1021 (1st Cir. 1995); Towers v. Chickering & Gregory (*In re* Pacific-Atlantic Trading Co.), 27 F.3d 401 (9th Cir. 1994) (By providing for timely performance of *all* lease obligations, "notwithstanding section 503(b)(1)," statute has already granted priority payment status for full amount of rent due under nonresidential leases); *In re* Pudgie's Dev., Inc., 239 B.R. 688, 692 (S.D.N.Y. 1999) (clause "notwithstanding §503(b)(1)" means "irrespective of whether payments required under lease meet usual requirements for administrative status, reasonableness and benefit to estate, they are unconditionally due"); Norritech v. Geonex Corp. (*In re* Geonex Corp.), 204 B.R. 684, 691 (D. Md.) (price of lessor's administrative claim represents price trustee pays for opportunity to take 60 days, or in this case 120 days, to decide whether lease is beneficial to estate and should be continued), *aff'd*, 120 F.3d 261, 1997 WL 471105 (4th Cir. 1997); *In re* Federated Dep't Stores, Inc., 131 B.R. 808, 814 (S.D. Ohio 1991) (date of rejection is significant because until rejection, lessor entitled to rent as postpetition administrative expense); *In re* Florida Lifestyle Apparel, Inc., 221 B.R. 897, 900 (Bankr. M.D. Fla. 1997) (trustee must pay all normal rental payments in commercial space until lease rejected); *In re* Trak Auto Corp., 277 B.R. 655, 665 (Bankr. E.D. Va. 2002) (lessor does not need to prove benefit to estate to have administrative claim); *In re* International Ventures, 215 B.R. 726, 728 (Bankr. E.D. Ark. 1997) (lessor

expense claim for postpetition, pre-rejection rent.[20] The lessor does not need to obtain a court order authorizing an administrative claim. The lease, not historic use/occupancy/benefits tests, determine the amount of the lessor's administrative claim.

### 3. Fissures in the Majority Approach: Time of Payment of Administrative Claim - Let a Thousand Flowers Bloom

Although most courts agree the lessor has an administrative claim equal to the lessee's lease obligations during the postpetition, pre-rejection [abeyance] period, they do not agree on when payment is due and if paid, whether the payment is subject to subsequent disgorgement. Some courts hold the debtor must pay the lessor immediately even if that results in a de facto superpriority claim because the estate is or turns out to be administratively insolvent.[21] At the other extreme, courts tell the lessor to queue up with all the rest of the administrative claimants for payment at the end of the case.[22] Others order

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entitled to administrative claim for full amount of debtor's rental obligation during postpetition, pre-rejection period without regard to benefit to estate: requiring lessor to show a benefit would make language "notwithstanding § 503(b)(1)" meaningless.); *In re* Lunn, 129 B.R. 476, 477 (Bankr. N.D. Ohio 1991) ("To strike a balance of equities, Congress enacted 11 U.S.C. §§ 365(d)(3) and (d)(4) permitting the administrative expense claim for rental, according to the terms of the lease, during the 60-day period without the notice and hearing otherwise required by 11 U.S.C. § 503(b)(1).... [A]ny requirement of reasonableness or benefit to the estate is inapplicable to 11 U.S.C. § 365(d)(3)."); *In re* Worths Stores Corp., 135 B.R. 112, 115 (Bankr. E.D. Mo. 1991) (even though debtor vacated premises one day before bankruptcy petition and moved to reject on day it filed, lessor holds administrative claim for lease obligations until rejection: the "obligation is made expressly independent of the normal standards for administrative expense claims under Section 503(b)(1)(A) and constitutes an administrative expense payable without notice and a hearing."); *In re* Virginia Packaging Supply Co., 122 B.R. 491, 493-94 (Bankr. E.D. Va. 1990) (even though estate only used 20% of building, lease governs lessor's postpetition, pre-rejection claim: "This is not because of any presumption of fairness; rather, it is because of the operation of § 365(d)(3) which mandates the debtor-in-possession's immediate duty to perform all obligations due under the lease "notwithstanding section 503(b)(1)."); *In re* Gillis, 92 B.R. 461, 465 (Bankr. D. Hawai'i 1988) (lessor automatically entitled to all amounts due and owing under lease for 60-day period).

[20] *In re* Florida Lifestyle Apparel, Inc., 221 B.R. 897, 901 (Bankr. M.D. Fla. 1997).

[21] *In re* Telesphere Communications, Inc., 148 B.R. 525, 530 (Bankr. N.D. Ill. 1992) (§ 365(d)(3) payments are not payments of administrative expenses pursuant to section 503(b)(1) but "operational payments," and as such, not subject to disgorgement).

[22] *See, e.g.,* Great Western Sav. Bank v. Orvco, Inc. (*In re* Orvco, Inc.), 95 B.R. 724, 728 (9th Cir. BAP 1989) (having concluded § 365(d)(3) does not give lessor automatic administrative expense claim equal to rent obligation, court held bankruptcy court did not err in deferring payment pending determination of amount of lessor's claim and estate's ability to pay all administrative claimants.), *rev'd* in part *sub nom*. Towers v. Chickering & Gregory (*In re* Pacific-Atlantic Trading Co.), 27 F.3d 401 (9th Cir. 1994); *In re* PYXSYS, -- B.R. --, 2003 WL 103208 (Bankr. D. Mass. 2003) (§ 365(d)(3) does not afford *automatic* superpriority status to postpetition, pre-rejection rent claims); Pasadena Town Square v. Tobago Bay Trading Co. (*In re* Tobago Bay Trading Co.), 142 B.R. 528, 533 (Bankr. N.D. Ga. 1991) (ordinarily debtor should pay lease obligations concurrently with other administrative expenses but if it appears estate will be unable to pay all administrative claims in full, payment may be deferred because lessor is only entitled to its pro rata share); *In re* Joseph C. Spiess Co., 145 B.R. 597, 607 (Bankr. N.D. Ill. 1992) (no superpriority for such claims by ordering their immediate payment because that would put lessor ahead of other administrative creditors); *In re* Virginia Packaging Supply Co., 122 B.R. 491, 495 (Bankr.

payment subject to subsequent disgorgement.[23] And yet others go their own separate way.[24]

## D. What Obligations Must a Debtor Pay?

Section 365(d)(3) requires the debtor to "timely perform *all obligations ... arising from and after the order for relief* ... until such lease is assumed or rejected ...." Courts are split on whether section 365(d)(3) requires the debtor to pay all lease obligations that become due postpetition, pre-rejection, even if all or a part of the obligation is properly allocable, in an economic sense, to the prepetition or post-rejection period. Courts that adopt the so-called "billing date" approach emphasize section 365(d)(3)'s directive to timely perform *all* obligations.[25]

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E.D. Va. 1990) (payment requires showing that all § 503(b) claims will be paid in full or lessor's claim will be paid on equal basis with other § 503(b) claims); *In re* Alloy Metal Wire Works, Inc., 60 B.R. 21, 22 (Bankr. E.D. Pa. 1986) (lessor had administrative claim for postpetition rent due under the contract but no payment until it is clear estate can pay all administrative claims or it is clear what proportionate share estate can pay).

[23] *See, e.g.,*Trizechahn 1065 Avenue of the Americas v. Thomaston Mills, Inc., 273 B.R. 284, 289 (M.D. Ga. 2002) (if estate turns out to be administratively insolvent, trustee has right to seek recovery of all or part of payment); *In re* Microvideo Learning Sys., Inc., 232 B.R. 602 (Bankr. S.D.N.Y. 1999) (same); *In re* Tel-Central Communications, Inc., 212 B.R. 342 (Bankr. W.D. Mo. 1997) (same); *In re* Buyer's Club Mkts., Inc., 115 B.R. 700 (Bankr. D. Colo. 1990) (same); *In re* Cardinal Indus., Inc., 109 B.R. 738 (Bankr. S.D. Ohio 1989) (same); *In re* Alloy Metal Wire Works, Inc., 60 B.R. 21, 22 (Bankr. E.D. Pa. 1986) (lessor has administrative claim for postpetition rent at contract rate but no payment until it is clear estate can pay all administrative claims or what proportionate share estate can pay).

[24] *In re* New Almacs, Inc., 196 B.R. 244, 250 (Bankr. N.D.N.Y. 1996) (lessor's rent claim for first 60 days is "an administrative expense ... on the same basis as other administrative claimants" and lessor's claim for unpaid lease obligations beyond that 60-day period is entitled to superpriority).

[25] HA-LO Indus., Inc. v. Center Point Props. Trust. (*In re* HA-LO Indus., Inc.), 342 F.3d 794, 800 (7th Cir. 2003) (entire month's rent is postpetition administrative claim when lease is rejected after rent falls due under lease); Centerpoint Properties v. Montgomery Ward Holding Corp. (*In re* Montgomery Ward Holding Corp.), 268 F.3d 205, 212 (3d Cir. 2001) (debtor must fulfill all obligations that arise postpetition under non-residential lease so it must pay 20 months of taxes because obligation arose during 8 week postpetition, pre-rejection period); *In re* Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir. 2000) (entire month's rent is postpetition administrative claim when rent is due on first of month and debtor rejected on second day of month); Montgomery Ward, LLC v. Western Land Props. (*In re* Montgomery Ward, LLC), 302 B.R. 478 (D. Del. 2003) (right to reimbursement for taxes and insurance premiums allocable to prepetition period "arose" when lessor billed debtor postpetition); Urban Retail Props. v. Loews Cineplex Entm't Corp. (*In re* Loews Cineplex Entm't Corp.), 2002 U.S. Dist. LEXIS 6186 (Apr. 9, 2002) (lessor's right to reimbursement of construction costs incurred by prepetition was postpetition obligation under lease); Bullock's Inc. v. Lakewood Mall Shopping Ctr. (*In re* R.H. Macy & Co.), 1994 U.S. Dist. LEXIS 21364, at *12, 1994 WL 482948. at *13 (S.D.N.Y. Feb. 23, 1994) (postpetition reassessment of delinquent prepetition taxes by local taxing authority gave rise to an "obligation" under lease requiring timely performance by debtor-lessee); *In re* R.H. Macy & Co., 152 B.R. 869, 873 n.3 (S.D.N.Y. 1993) (§ 365(d)(3) "represents a form of special legislation somewhat out of sync with other policy considerations in the Code"); *In re* Duckwall-ALCO Stores, 150 B.R. 965, 976, n.23 (D. Kan. 1993) (statute clearly imposes duty on lessee to comply with all postpetition lease obligations: lease did not provide for payment of taxes to lessor as they accrued); *In re* Operating Partners, L.P., 2004 Bankr. LEXIS 884, at *17-18 (Bankr. N.D. Tex. Jun. 16, 2004) (lessee not required to escrow funds for future taxes when obligation to pay taxes under lease arises only upon receipt of bill from lessor); *In re*

Courts adopting an accrual or proration approach read section 365(d)(3) to require performance only of obligations *arising after the order for relief*.[26]

### 1. Accrual Approach

Courts following an accrual approach find section 365(d)(3)'s language ambiguous: did Congress intend to require the debtor to pay all obligations arising postpetition under the lease or all postpetition, pre-rejection obligations arising under the lease? An obligation can arise when it becomes due and payable, or when it accrues.[27] The ambiguity permits resort to the legislative history and pre-amendment

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Comdisco, Inc., 272 B.R. 671, 675-76 (Bankr. N.D. Ill. 2002); *In re* DiCicco of Montvale, Inc., 239 B.R. 475, 484 (Bankr. D.N.J. 1999); *In re* Florida Lifestyle Apparel, Inc., 221 B.R. 897, 901 (Bankr. M.D. Fla. 1997) ("Because rent is payable on the first day of each month, the claim will include the full rental payment for both June and July."); *In re* Krystal Co., 194 B.R. 161, 164 (Bankr. E.D. Tenn. 1996) (debtor must perform lease obligations including reimbursement of taxes paid at time they come due according to lease terms); *In re* Appletree Mkts., Inc., 139 B.R. 417, 420 (Bankr. S.D. Tex. 1992) (§ 365(d)(3) did not mandate payment of monthly, quarterly and yearly rent obligations due January 1 when petition date was January 2).

[26] *In re* Handy Andy Home Improvement Ctrs., 144 F.3d 1125 (7th Cir. 1998) (proration or accrual approach when prepetition property taxes fell due postpetition); El Paso Props. Corp. v. Gonzales (*In re* Furr's Supermarkets, Inc.), 283 B.R. 60 (B.A.P. 10th Cir. 2002); Equitable Life Assurance Society v. Pretrie Retail, Inc. (*In re* Pretrie Retail, Inc.), 233 B.R. 256 (S.D.N.Y. 1999); Newman v. McCrory (*In re* McCrory Corp.), 210 B.R. 934, 939-40 (S.D.N.Y. 1997) (billing date approach drastically alters Code's priority and distribution scheme, radically departs from pre-amendment practice and would result in windfall to lessor or debtor depending on facts); Child World, Inc. v. The Campbell/Mass. Trust (*In re* Child World, Inc.), 161 B.R. 571 (S.D.N.Y. 1993); *In re* Ames Dep't Stores, Inc., 306 B.R. 43 (Bankr. S.D.N.Y. 2004) (collecting cases and adopting proration approach); *In re* Troutman Inv. Co., 2004 Bankr. LEXIS 1040 (Bankr. D. Or. Apr. 13, 2004); *In re* Nat'l Refractories & Minerals Corp., 297 B.R. 614 (Bankr. N.D. Cal. 2003); *In re* Phar-Mor, Inc., 290 B.R. 319 (Bankr. N.D. Ohio 2003); *In re* Trak Auto Corp., 277 B.R. 655, 663 (Bankr. E.D. Va. 2002) (postpetition bills must be prorated so debtor pays as administrative expense only those charges that accrued during postpetition, pre-rejection period); *In re* NETtel Corp., 289 B.R. 486 (Bankr. D.D.C. 2002); *In re* Travel 2000, Inc., 264 B.R. 444 (Bankr. W.D. Mich. 2001); *In re* GC Cos., Inc., 261 B.R. 594, 597 (Bankr. D. Del. 2001) (§ 365(d)(3)'s legislative history indicates Congress intended to give landlords current payment for current services and accrual approach conforms with pre-amendment practice); *In re* Oscar Hornsby, Inc., 2001 Bankr. LEXIS 1062 (Bankr. E.D. Ky. Jan. 26, 2001); *In re* Learningsmith, Inc., 253 B.R. 131, 134 (Bankr. D. Mass. 2000) (Code does not define obligation but if it coincides with entire amount that matures and becomes payable on a certain date regardless of whether any part accrued prepetition, it would conflict with and constitute exception to provisions governing claims: § 365(d)(3) expressly indicates it constitutes exception to Code provisions governing administrative expenses. It does not state it is meant to constitute exception to provisions governing claims. Therefore, the language is ambiguous, justifying courts in looking to legislative history); Santa Ana Best Plaza, Ltd. v. Best Prods Co., Inc. (*In re* Best Prods. Co.), 206 B.R. 404, 407 (Bankr. E.D. Va. 1997) (when an obligation arises under a lease is ambiguous and legislative history indicates Congress sought only to insure landlords current payment for current services); *In re* Victory Mkts., Inc., 196 B.R. 6 (Bankr. N.D.N.Y. 1996); *In re* Warehouse Club, Inc., 184 B.R. 316 (Bankr. N.D. Ill. 1995); *In re* Almac's, Inc., 167 B.R. 4 (Bankr. D.R.I. 2994); *In re* All for A Dollar, Inc., 174 B.R. 358 (Bankr. D. Mass. 1994); *In re* Ames Dep't Stores, Inc., 150 B.R. 107 (Bankr. S.D.N.Y. 1993); Daugherty v. Kenerco Leasing, Inc. (*In re* Swanton Corp.), 58 B.R. 474 (Bankr. S.D.N.Y. 1986).

[27] *Learningsmith*, 253 B.R. at 134.

practice. Both support a proration approach. Moreover, such an approach seems more consistent with Bankruptcy's priority and distribution rules.[28]

The Seventh Circuit's opinion in *In re Handy Andy Home Improvement Centers, Inc.*[29] is instructive. In *Handy Andy*, the lease agreement required the lessee to pay all real estate taxes during the lease term. The county billed taxpayers after taxes were assessed. The taxes were billed to the owner of the property, the lessor. The lease provided that the lessor would either transmit the tax bill to the lessee or pay the taxes and bill the lessee for reimbursement, with payment due with the next rental payment. The second installment of 1994 taxes was not sent to the lessor until September of 1995. An involuntary petition was filed against the debtor-lessee the next month. Two weeks after that, the lessor paid the taxes and billed the debtor. Shortly after that, the court entered an order for relief against the debtor. The next February, the lessor received the first installment of the 1995 taxes. It paid the taxes and then billed the debtor. The debtor rejected the lease in April.[30]

The lessor argued that both sets of taxes were due under the lease during the abeyance period. Therefore, the full amount was a section 365(d)(3) administrative claim. The court acknowledged the billing date approach was a possible reading of section 365(d)(3) "but it is neither inevitable nor sensible."[31] The debtor's duty to pay may not have crystallized but realistically it had "arisen piecemeal every day of 1994," [32] and became "fixed irrevocably when the last day of the year having come and gone, the lease was still in force."[33] As a policy matter, the accrual approach made sense because it gave postpetition creditors a high priority: "in economic terms, the prioritizing of postpetiton debt enables the debtor ... to ignore sunk costs—treat bygones as bygones—and continue operating as long as the debtor's business is yielding a net economic benefit."[34] The court characterized the past taxes as a sunk cost which should not affect the debtor's current operations. Therefore, the obligation to reimburse the landlord for them was a prepetition obligation.[35] According to the court, there was no indication that Congress intended to give landlords more favorable treatment regarding prepetition debts.[36] Moreover, a billing date approach would "make the rights of creditors turn on the happenstance of the dating of tax bills and

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[28] Santa Ana Best Plaza, Ltd. v. Best Prods Co., Inc. (*In re* Best Prods. Co.), 206 B.R. 404, 407 (Bankr. E.D. Va. 1997); *In re* All for A Dollar, Inc., 174 B.R. 358, 361 (Bankr. D. Mass. 1994).

[29] 144 F.3d 1125 (7th Cir. 1998).

[30] *Id.* at 1126.

[31] *Id.* at 1127.

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.* at 1128.

[36] *Id.*

the strategic moves of landlords and tenants."[37]

**2. Billing Date Approach**

In *Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*,[38] the Third Circuit adopted the billing date approach on facts essentially indistinguishable from those in *Handy Andy*. The lease in *Montgomery Ward* required the debtor-lessee to reimburse the landlord for all tax expenses attributable to the premises. The debtor petitioned for bankruptcy relief on July 7, 1997. The lessor sent three tax invoices to the debtor on July 11, 1997. The debtor only remitted a prorated portion of the tax bill. The lessor sought payment of the full amount.

The lessor argued all the invoices were payable immediately "as obligations of the debtor arising from the lease."[39] The court framed the issue as "what Congress meant when it referred to obligations of the debtor arising under a lease after the order for relief.'"[40] Did it require payment of all amounts that first became due and enforceable postpetition or did it require proration based on when the lessor's obligation to pay the taxes accrued?

> We believe that to state these questions is to answer them. The clear and express intent of § 365(d)(3) is to require the trustee to perform the lease in accordance with its terms. To be consistent with this intent, any interpretation must look to the terms of the lease to determine both the nature of the "obligation" and when it "arises." If one accepts this premise, it is difficult to find a textual basis for a proration approach. On the other hand, an approach which calls for the trustee to perform obligations as they become due under the terms of the lease fits comfortably with the statutory text.
>
> The term "obligation" is not defined in the code, and it is thus apparently used in its commonly understood sense.... In the context of a lease contract, it seems to us that the most straightforward understanding of an obligation is something that one is legally required to perform under the terms of the lease and that such an obligation arises when one becomes legally obligated to perform.[41]

The court rejected the argument that "obligation" means "claim" and "claim" includes unmatured right to payments:

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[37] *Id. See also In re* Trak Auto Corp., 277 B.R. 655, 663 (Bankr. E.D. Va. 2002) (adopting method under which debtor's liability turns solely on when bills are issued has potential to create windfall for landlord who decides to manipulate when it bills debtor for taxes and CAM charges: court will encourage this type of manipulation of debtor's expense which can only harm a debtor's efforts at achieving a successful reorganization).

[38] 268 F.3d 205 (3d Cir. 2001).

[39] *Id.* at 208.

[40] *Id.* at 209.

[41] *Id.*

> First, ... Congress chose "obligation" and not "claim." ... Second, this reading would render § 365(d)(3) superfluous. Unmatured rights to payment under a lease exist from the date the lease is executed, and no right to payment would ever arise under an unexpired lease after the order for relief. Finally, understanding "obligation" to be the corollary of "claim" does not produce the result for which those making the suggestion contend. Including unmatured rights to payment provides no analytical foundation for prorating the obligation to reimburse the landlord for taxes based on the date of the order and whether the landlord's obligation to pay those taxes accrued before or after the order was entered .... [Such] an obligation ... clearly does not arise under the lease.[42]

In short, section 365 describes obligations arising *under the lease*. The lease

> does not require proration. Therefore, proration is inconsistent with section 365(d)(3)'s fundamental text and tenet. The terms of the lease determine the obligation and when it arises.[43]

The court reached its conclusion reluctantly. It noted that its decision created a conflict among the circuits. It observed that Congress might well have preferred some aspects of the proration approach. Finally, it understood that a billing date approach might encourage strategic maneuvering. "It is not our role, however, to make arguably better laws than those fashioned by Congress."[44]

The dissent castigated the majority for holding that "because a billing took place within the eight-week administrative period between entry of an order for relief and expiration of the lease ... the entire twenty months' worth of tax obligations `arose' during the eight-week period."[45] That approach elevated the happenstance of the billing date over the "economic reality of the accrual, and thereby inappropriately burdens the administration of the bankrupt estate and unfairly favors landlords over similarly situated pre-petition creditors."[46] The dissent maintained the "true 'fundamental tenet' of § 365(d)(3) is that landlords, like other post-petition creditors, should receive full and timely payment for post-petition services."[47] According to the dissent, section 365(d)(3) commands the debtor to timely perform all obligations arising under the lease. It says nothing about "how to determine *when* the obligation arises."[48]

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42 *Id.* at 209-10.

43 *Id.*

44 *Id.* at 211.

45 *Id.* at 213 (Judge Mansmann).

46 *Id.*

47 *Id.*

48 *Id.* at 215.

Another court justified adoption of the billing date approach because Congress specifically excepted a tenant's lease obligations from the administrative expense procedure because landlords and their solvent tenants were especially vulnerable under the old procedures.[49]

> Rather than forcing the landlord to take the initiative, apply for and wait for an administrative expense allowance ..., Congress intended § 365(d)(3) to shift the burden of indecision to the debtor: the debtor must now continue to perform all the obligations of its lease or make up its mind to reject it before some onerous payment comes due during the pre-rejection period.[50]

Some courts have applied the billing date approach to hold that a lessee must pay the full month's rent if the rent falls due during the abeyance period. This is so even if rejection occurs shortly after that.[51] So, if rent is due in advance on the first of the month and the lease is rejected on the second of the month, the lessor holds a section 365(d)(3) administrative rent claim for the whole month. But the billing date approach is a double-edged sword. If rent falls due on the first of the month, and the debtor files for bankruptcy on the second, the landlord is out of luck.[52]

### 3. The Hybrid Approach: *Comdisco* and *HA-LO Industries*

By 2002, it appeared the battle lines had been drawn. Section 365(d)(3) was either ambiguous, or clear. It either abrogated the pre-1984 practice of proration, or left the practice undisturbed. Debtors' counsel in the Third and Sixth Circuits knew they had better wait to file until after they got the tax bill, and they had better reject before the next rental payment came due. Debtors' counsel in the Seventh Circuit weren't worried either way. After all, they had *Handy Andy*, right?

Not so right. In *In re Comdisco, Inc.*,[53] the debtor-lessee obtained a court order authorizing it to reject its leases upon ten days' notice. On August 1, the debtor sent the lessor notice that it intended to reject the lease, effective August 11. Relying on *Handy Andy*, the debtor paid only a prorated share of the August rent. The lessor protested and demanded full payment, as an obligation arising during the

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[49] *In re* Krystal Co., 194 B.R. 161, 164 (Bankr. E.D. Tenn. 1996).

[50] *Id. See also In re* DeCicco of Montvale, Inc., 239 B.R. 475, 480-81 (Bankr. D.N.J. 1999) (§ 365(d)(3) is clear on its face: moreover, payment of these obligations is not designed to preserve estate but to protect vulnerable landlords).

[51] *See, e.g., In re* Koenig Sporting Goods, Inc., 203 F.3d.986, 989 (6th Cir. 2000) (because rent was payable in advance on first day of month, lessor's administrative claim includes full December rent even though rejection was effective December 2: policy considerations, equity and common sense do not compel adoption of proration because debtor alone was in position to control lessor's entitlement to December rent); *In re* Florida Lifestyle Apparel, Inc., 221 B.R. 897, 901 (Bankr. M.D. Fla. 1997) (because rent payable in advance on first day of each month, lessor's administrative claim will include full rental payment for both June and July even though rejection was effective July 9).

[52] *See, e.g., In re* Appletree Mkts., Inc., 139 B.R. 417 (monthly, quarterly and yearly rent due January 1, debtor filed January 2).

[53] 272 B.R. 671 (Bankr. N.D. Ill. 2002).

postpetition, pre-rejection period. The bankruptcy court agreed with the lessor, no doubt to debtors' counsel's bewilderment.

*Handy Andy* did not deal with rent payable in advance. It dealt with a pass through obligation to reimburse the landlord for real estate taxes incurred in the past, before the reimbursement obligation was payable under the lease. The Seventh Circuit held that, regardless of the terms of the lease, taxes (and presumably other charges relating to past occupancy) are prorated, so that only charges attributable to occupancy in the post-order for relief/pre-rejection period are payable under section 365(d)(3). The court reached that result by looking at the underlying economic reality of such charges. It determined that expenses incurred by the landlord before the order for relief are sunk costs, that is costs incurred in the past that have no present relevance to the debtor's operations.[54]

Cried debtors' counsel: "What relevance can post-rejection rental obligations possibly have to the debtor's operations when the debtor's right to occupy the premises terminates immediately upon rejection?" Quoth the court:

> rent is not a sunk cost that relates to a time before the bankruptcy case, but a charge for the consumption of a resource during the administration of the case. Another principle of bankruptcy is that costs of administration must be paid. Of course the principle that debtor in possession obligations must be paid is usually limited by the requirements of § 503(b)(1) that the expenses be "actual" and "necessary." Under § 503(b)(1), therefore, proration would be appropriate; the expense of the right to occupy space after the rejection date is not necessary. Unfortunately for the Debtor and its creditors and equity security holders, Congress plainly intended to remove the claims of commercial landlords from the strictures of § 503(b)(1). Section 365(d)(3) requires payment of current lease obligations "notwithstanding section 503(b)(1)."[55]

"Reasonable and necessary aside," sputtered debtor's counsel, "how can the obligation to pay rent *arise* in the first place if the premises are not actually occupied?" Pulling out its *Black's Law Dictionary*, the court responded:

> That the obligation relates to a future event does not mean that it does not arise immediately. Rent is the consideration for the right to occupy in the future and the landlord's covenant of quiet enjoyment and promise to provide other services during that period. [*Black's*] defines "arise" to mean "to spring up, originate, come into being…." An obligation related to a past event may be said to originate when that event occurs, but an obligation to pay for the promise of future consideration originates or comes into being, not when the future consideration is provided, but when the payment is due.[56]

"But what about policy? Ratable distribution? Equality is equity?" With a heavy heart, the court concluded it was for Congress, not the courts, to make the rules: "Although there is contrary authority at

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[54] 272 B.R. at 674.

[55] *Id.* at 674-75.

[56] *Id.* at 676 (internal citation omitted).

lower levels … this Court is persuaded that the Debtor's sensible policy arguments are overridden by the plain language of § 365(d)(3)."[57]

A bankruptcy court across town reached the same result a few months later, which the Seventh Circuit affirmed. In *HA-LO Industries, Inc. v. Center Point Properties Trust (In re HA-LO Industries, Inc.)*,[58] the debtor-lessee obtained authorization to reject an unexpired lease upon 30 days' notice to the lessor. On October 3, the debtor notified the lessor that it would vacate the premises effective November 2. The debtor included a payment of $60,031 for two days' rent. The lessor moved to compel payment of the $600,311 balance remaining for the month. The Seventh Circuit adopted *Comdisco*'s distinction of *Handy Andy*, to which it added: "Congress passed § 365(d)(3) to relieve landlords of the uncertainty of collecting rent fixed in the lease 'in full, promptly, and without legal expense' during the awkward postpetition pre-rejection period."[59] Invoking *Koenig Sporting Goods,* the court noted that the purpose of § 365(d)(3) was to prevent lessors from being "left in doubt concerning their status vis-à-vis the estate." The court rejected the debtor's equitable arguments.

> [HA-LO] alone controlled CenterPoint's entitlement to payment of rent for November 2001. If HA-LO had rejected the lease effective October 31, rather than November 2, it would not have been obligated to pay rent for November under []§ 365(d)(3). Instead, it elected to reject the lease one day after its monthly rent obligation to Center-Point [sic] would arise. Under these circumstances, we agree with the Sixth Circuit that equity as well as the statute favors full payment.[60]

This focus on the debtor's control of the means by which to trigger an administrative expense is consistent with the *Handy Andy* court's concern about "strategic moves" of landlords who may delay transmission of the tax bills precisely to trigger an administrative expense claim against the estate.[61] The court was concerned with keeping self-interested third parties out of the driver's seat, but would not intervene to protect the debtor from its own folly. But is the fact that the debtor could have avoided the unnecessary $600,000 administrative burden on the estate a sufficient justification for imposing that burden on creditors and stakeholders who had no control over the timing of the rejection? At least one court thinks not.

### 4. The "Pure Proration" Approach: *In re Ames*

The Seventh Circuit's *HA-LO* decision introduces a new level of conceptual complexity to section 365(d)(3)'s saga. It exposed the poverty of the terms "accrual approach" and "billing date approach" as accurate descriptors of what was really going on in the courts. Accordingly, as his first

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57 *Id.* (internal citation omitted).

58 342 F.3d 794 (7th Cir. 2003).

59 *Id.* at 799.

60 *Id.* at 800.

61 144 F.3d at 1128-29.

order of business in *In re Ames Department Stores, Inc.*,[62] Judge Gerber introduced some new terminology: "prepetition proration" (what the Seventh Circuit allowed in *Handy Andy*) and "post-rejection proration" (what the Seventh Circuit refused to allow in *HA-LO*). Only the latter issue was before the court. Nevertheless, Judge Gerber articulated a powerful argument for what we will call a "pure proration" approach to section 365(d)(3).

The landlords in *Ames* wanted to have their cake and eat it too. The debtor filed its petition after missing its rental payments for the month, and, believing that section 365(d)(3) so required, submitted a prorated payment to the landlords for the "stub rent" (rent which fell due prepetition but covered a period of postpetition occupancy). When the debtor subsequently rejected its leases mid-month, it similarly prorated its final months' rent payment. The landlords moved to compel full payment, citing *Koenig* and *HA-LO*. After a thorough analysis of the cases that had considered post-rejection proration, the court concluded that the Sixth and Seventh Circuits had simply got it wrong.

> First, 365(d)(3) is ambiguous with respect to post-rejection obligations. Section 365(d)(3) does not exist in a vacuum, and must be read *in pari materia* with other provisions of the Bankruptcy Code. Section 365(g)(1) provides that rejection of an unexpired lease constitutes a prepetition breach of the lease. Similarly, section 502(g) provides that a claim arising from rejection under section 365 "shall be determined, and shall be allowed … or disallowed … the same as if such claim had arisen before the date of the filing of the petition." Courts regarding section 365(d)(3) as unambiguous have typically stated that they find either or both of the words "obligation" and "arise" to be unambiguous. However, such analysis misses the mark, as (1) "arise" can be understood in either an absolutist or an accrual sense, and (2) it is the *modifiers associated with* "obligations"—modifiers describing *which* obligations are the subject of the [sic] section 365(d)(3)'s coverage and to what the clause beginning refers, rather than the word "obligations" itself—that create the ambiguity. The clause "until such lease is assumed or rejected" is of critical importance to any analysis, in this Courts [sic] view, particularly in light of sections 365(g) and 502(g) which treat failures to honor lease obligations after rejection as pre-petition claims.[63]

Having identified an ambiguity in the statute, the court looked to the legislative history and concluded that

> section 365(d)(3) was enacted to fix the amount to be paid by debtor-tenants pending assumption or rejection at the amount provided in the lease; to require payments to be made at the time required under the lease (and not after confirmation); and to remove the bankruptcy court's power to review the amount to be paid as administrative rent for reasonableness.[64]

In short, the pre-amendment practice of prorating post-rejection rental obligations does not conflict with either the statute's language or the purposes for which it was adopted. Congress' purpose for adopting

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62 306 B.R. 43 (Bankr. S.D.N.Y. 2004).

63 *Id.* at 67 (emphasis in original).

64 *Id.* at 69.

the language "notwithstanding section 503(b)(1) of this title"

> plainly was *not* to do away with the hardly-offensive concept of prorating…. As the remarks of Senator Hatch make clear, there was an unmistakable intention on the part of Congress … to do away with prejudice to landlords, but there is no indication of a corresponding intention to grant landlords a windfall, especially at the expense of other creditors. And since a failure to apply Post-rejection Prorating could in other cases actually *prejudice* landlords—as it would, for instance, when taxes, common area maintenance, or, particularly, percentage rent obligations must be collected in arrears (after the amount to be billed becomes known), and the debtor has already rejected—the absence of any Congressional intent to bring about such a result must also be noted.[65]

In what will no doubt become the manifesto of proraters everywhere, Judge Gerber articulated five interrelated considerations that compelled him to apply post-rejection prorating. First was the need to implement sections 365(g) and 502(g) so as not to elevate the claims of landlords for the post-rejection period over the claims of all the estate's other creditors.[66]

Second was "the illogic of the Landlords' position" that payment of post-rejection rent was necessary to provide current payment for current services.

> A landlord would not be providing "current services" after a debtor rejects a lease, for at that time the debtor would have no right to continued occupancy, or to services from the landlord.... Indeed, requiring payment, as an administrative expense, for the post-rejection period while, at the same time, the landlord would be free to re-rent the premises, could result in a double recovery for the landlord.[67]

Third, the court was concerned that declining to apply post-rejection prorating "could just as easily be unjust to a landlord in the next case to come down the pike"—for example, percentage rent payable in arrears.

Fourth was "the reality that the literalistic approach proves too much, and leads to near-absurdity when obligations billable to the tenant are allocable to periods going far in advance." For example, what if the lease obligation is payable in advance on a bi-annual or annual basis?

> Cases wrestling with this have come out different ways, with those adopting the literalistic approach saying or implying that the courts can address inequitable situations when they arise, or that different rules might apply with respect to rental obligations, on the one hand, or tax

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65 *Id.* at 70.

66 This consideration is only relevant to the extent that rent "arises" on a per diem basis irrespective of the performance date under the lease, a conclusion that the court reached later in its opinion. If advance rent is truly lump sum consideration for the landlord's promise to provide the premises in the future and covenant of quiet enjoyment (as the *Comdisco* court had concluded), then sections 365(g) and 502(g) would seem not to apply.

67 *Id.* at 71.

> obligations, on the other. But such efforts to disregard the problems resulting from the literalistic approach are inconsistent with a principled analysis of the law. The Court sees no principled distinction between rental obligations and tax payment obligations, insofar as section 365(d)(3) requires such to be satisfied, or any indication that section 365(d)(3) creates different rules for obligations payable in advance or in arrears, or depending upon the *extent* to which they are due in advance or in arrears…. This Court's rejection of the literalistic approach … avoids any and all problems of this type.[68]

Fifth, and finally, was the court's conclusion, based upon thorough consideration of *In re NETtel Corp.*,[69] that rent "arises" on a per diem basis irrespective of the time at which it becomes payable under the lease.[70] In short, the nature of the obligation should have no bearing on the manner in which it is deemed to "arise" for purposes of section 365(d)(3).[71]

At the end of the day, the court concluded that courts that had come out the other way had not done their homework:

> This Court does not reject the decisions at the Court of Appeals level lightly, even when those decisions are not binding upon it. But this Court nevertheless believes, with respect, that the analyses in *Koenig* and *HA-LO* are flawed, and lack the depth of analysis of *Handy Andy* and, particularly, *NETtel*.[72]

**5. Stub Rent: The Next Frontier?**

Predictably enough, whether a debtor must pay "stub rent" (that is, rent allocable to a postpetition period of occupancy but due prepetition) under section 365(d)(3) generally turns on the approach a particular court employs. Although the case law dealing with this precise issue is limited, the fragmentation of the accrual/billing date dichotomy evidenced by *HA-LO* suggests it could become a heavily litigated issue in the near future.

As noted above, under a billing date approach, the debtor should not be obligated to pay stub rent because it did not "arise" during the abeyance period. *In re* Appletree Markets,[73] provides a graphic example. The debtor was the lessee under a variety of leases calling for monthly, quarterly, and annual

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68 *Id.* at 72 (emphasis in original).

69 289 B.R. 486 (Bankr. D.D.C. 2002).

70 Id. at 72, 75 (noting that *NETtel* contained "by far the most thorough analysis of the subject").

71 Cf. Montgomery Ward, 268 F.3d at 212 ("Tax reimbursement obligations are only a small constellation in the universe of obligations coming within the scope of § 365(d)(3) and there is no basis in the text for distinguishing them from rent and numerous other obligations of tenants.").

72 Ames, 306 B.R. at 78.

73 139 B.R. 417 (Bankr. N.D. Tex. 1992).

payments of rent, taxes, and common area maintenance charges. Payments under the leases were due January 1, but the debtor skipped them and filed bankruptcy on January 2. Debtor later "advised a number of its lessors that it would be paying 'market rent' beginning February 1." To make matters worse for the lessors, the court extended the debtor's time to decide to assume or reject until June 30. The lessors moved to compel payment of postpetition rent. After all, they were providing current services, either without current payment or, at best, in exchange for payment that reflected the reasonable benefit to the estate rather than the contract rate. Finding no support for the proration approach in the statutory language, the court refused to intervene to help the lessors.

> Considering the date of filing and the potential harm, especially in light of quarterly and annual rents which fell due on January 1, the equities clearly lie with the lessors. However, when Congress directs the result pursuant to statutory language, my equity jurisdiction does not extend beyond the statutory boundaries.[74]

"Pure" proraters would disagree about the extent of the court's equity jurisdiction in this matter. They wouldn't need to get Senator Hatch on the phone to figure out that the debtor's end run around section 365(d)(3) in *Appletree* frustrated almost every stated Congressional purpose.[75]

Two recent cases indicate courts can reach disparate results even within an established billing date or prepetition proration jurisdiction. In *In re Travel 2000, Inc.*,[76] a Michigan bankruptcy court concluded that stub rent was payable despite the controlling authority in *Koenig Sporting Goods* that seemed to indicate that rental obligations do not accrue on a per diem basis. The court confined *Koenig* to its facts. In a stub rent context, literal application of the statutory language might conflict and disturb the Code's overall purpose and function. What's worse—it might even be unconstitutional (fasten your seat belt):

> Had a trade creditor of Travel 2000 sent a bill for goods on the first of the month, with the goods arriving on the third; when Travel 2000 filed bankruptcy on the second the creditor would have the option of awaiting payment or demanding return of the goods. The creditor would not be required to both forfeit the goods and make the payment. If the trade creditor decided to continue dealing with the debtor post-petition, it would do so voluntarily and thus knowingly assume the risk of not being fully compensated. The landlord, on the other hand, is forced, involuntarily, to deal with the debtor/tenant until the debtor rejects the lease. Under the performance date approach of § 365(d)(3), the landlord would not be paid. We believe this result constitutes an iniquitous application of the Bankruptcy Code. It may also be a step toward violating the involuntary servitude prohibition of the Thirteenth Amendment to the United States Constitution.[77]

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74 *Id.* at 420-21.

75 *See, e.g., In re* Victory Mkts., Inc., 196 B.R. 6 (Bankr. N.D.N.Y. 1996) (stub period tax obligations).

76 264 B.R. 444 (Bankr. W.D. Mich. 2001).

77 *Id.* at 448-49 (internal footnote omitted).

Although the court did not have to resolve "the lurking constitutional question" at that juncture (phew!), it did see "certain similarities between a victim forced to work involuntarily for no pay and the position of a landlord, forced to involuntarily provide services for a debtor, and remaining unpaid until the performance date."[78]

In the other case, *In re UAL Corp.*,[79] Judge Wedoff provided a novel justification for refusing to compel payment of stub rents in what had appeared, after *Handy Andy*, to be an established "prepetition proration" jurisdiction. He began by noting that

> [t]he substantive impact of § 365(d)(3) is twofold. First, section 365(d)(3) defines *what* lease obligations must be performed by the trustee or the debtor in possession—the obligations that "arise" during the option phase. Second, it sets out *when* that performance must take place—requiring that the trustee perform the obligations "timely."[80]

He pointed out that the bulk of the reported case law (i.e., the proration/performance date debate) deals with situations in which the payment obligation came due during the postpetition, pre-rejection period. Accordingly, it is concerned primarily with determining *what* lease obligations the trustee must perform. However,

> [t]he pending motions present a different situation, one in which a payment obligation, though related in part to a period within the option phase, became due before the option phase began. This situation implicates the second aspect of § 365(d)(3)—*when* an obligation must be satisfied. At least two published decisions [*Travel 2000*, *Victory Markets*] hold that proration is required in this context. However, the plain language of § 365(d)(3), its legislative history, and its context, all indicate that the requirement of "timely" performance cannot apply to a payment obligation that became due before the bankruptcy case was filed.[81]

Moreover, the court concluded, no basis exists for establishing any other time of payment than the performance date under the lease.

> Section 365(d)(3) is designed to operate without judicial intervention; it expressly directs the trustee or debtor in possession to perform lease obligations notwithstanding the provisions of § 503(b), which allows payment of administrative expenses only after notice and a hearing. Yet, without a court order directing payment by a particular date, there would be no method by which a trustee or debtor in possession could know when to pay obligations that were due under the lease before the case was filed…. Although it is possible for a trustee to make a timely, prorated payment of a sum coming due within the bankruptcy case—as *Handy Andy* requires for tax liabilities that relate to periods prior to the operational phase—it is not possible for a trustee to

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78 *Id.* at 450.

79 291 B.R. 121 (Bankr. N.D. Ill. 2003).

80 *Id.* at 124 (emphasis in the original).

81 *Id.* at 125-26 (emphasis in the original; internal citations omitted).

make a timely payment of a lease obligation that was past due at the time the bankruptcy case was filed.[82]

To soften the blow to the lessors, Judge Wedoff noted that nothing in section 365(d)(3) required any change in the pre-1984 practice of allowing prorated administrative expense claims for stub rent under section 503(b), to the extent that use of the rental property benefited the estate. It just prevented lessors from compelling immediate payment thereof.

We live in interesting times.

## II. When Bambi Meets Godzilla: the Relationship between § 365(h)(1)(A)(ii) and § 363(f))

### A. The Basic Issue

Assume Debtor leases Blackacre to Lessee. Lessee is in possession of Blackacre at the time Debtor petitions for chapter 11 relief. If Debtor rejects Lessee's lease, section 365(h)(1)(A)(ii) says Lessee can retain its rights under the lease, including its right to possession, for the balance of the lease term to the extent its "rights are enforceable under applicable nonbankruptcy law." What if Debtor does not assume or reject Lessee's lease? Instead, it obtains court authorization to sell Blackacre? According to section 363(f), the trustee can sell Blackacre free and clear of all interests if one of five conditions described in section 363(f) is met. Does a court-ordered sale under section 363 divest Lessee of its section 365(h)(1)(A)(ii) rights?

The Seventh Circuit (the only circuit-level court to rule on the issue) thought the issue was straightforward: a section 363(f) sale extinguishes a lessee's section 365(h)(1)(A)(ii) rights.[83] We think the issue is a *little* more complicated than the Seventh Circuit would have us believe.

#### 1. Section 365(h)(1)(A)(ii)

According to 11 U.S.C. § 365(h)(1)(A)(ii), if the trustee rejects a lease of real property when the debtor is the lessor,

> if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

Bankruptcy affects a debtor's *in personam* obligations. Generally, it does not disturb a nondebtor party's *in rem* rights. Section 365(h)'s purpose is consistent with this principle:

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[82] *Id.* at 126 (internal citation omitted).

[83] Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537, 540 (7th Cir. 2003).

> A lease is part contract and part conveyance. It creates an estate in the subject property, which vests in the lessee. Where the debtor is the lessor under an unexpired lease of real property, rejection of that lease only results in the termination of covenants that require future performance by the debtor. Rejection does not divest the lessee of its estate.[84]

To the extent a lessee's leasehold estate is a vested property interest, bankruptcy must accommodate it:

> The desire to effect a feasible plan of reorganization cannot override the vested rights of third persons who are not creditors of the debtor. Insofar as the lessee's leasehold is concerned he is as much a stranger to the reorganization as one who purchased, received and paid for goods of the debtor prior to reorganization.[85]

According to the legislative history, section 365(h)(1)(A)(ii)

> permits the lessee to remain in possession of the leased property or to treat the lease as terminated by rejection. The balance of the term of the lease … will include any renewal terms that are enforceable by the tenant, but not renewal terms if the landlord has an option to terminate. Thus, the tenant will not be deprived of his estate for the term for which he bargained. If the lessee remains in possession, he may offset the rent reserved under the lease against damages caused by rejection, but does not have any affirmative rights against the [bankruptcy] estate for any damages after the rejection that result from the rejection.[86]

Section 365(h) attempts to accommodate the competing interests of debtor-lessor and nondebtor-lessee. It allows the debtor-lessor to reject an undesirable lease. It simultaneously protects the nondebtor-lessee's property rights.[87]

Section 365(h) codifies "a delicate balance" between the rights of a debtor-lessor and those of its

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[84] *In re* Sok Jun Kong, 162 B.R. 86, 95 (Bankr. E.D.N.Y. 1993) (internal citations omitted); *see also In re* Taylor, 198 B.R. 142, 158 (Bankr. D.S.C. 1996) ("Clearly a lease of real property creates an estate in land that vests in the lessee."); *In re* South Andrews Realty Assocs., 1994 Bankr. LEXIS 1721, *8 (Bankr. S.D. Fla. October 11, 1994) ("The leasehold is not a lien but, like a fee or a life estate, is an interest in the property."); *In re* Chestnut Ridge Plaza Assocs., L.P., 156 B.R. 477, 485 (Bankr. W.D. Pa. 1993) ("The obligations under the lease and rights associated with the tenant's leasehold interest do not just vanish because a debtor has rejected the lease. The leasehold interest remains intact and the lease remains operative between the parties."); *In re* Lee Road Partners, Ltd., 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993) ("rejection by a debtor-lessor does not terminate the lease so completely as to divest the lessee of his estate in property").

[85] *In re* Huff, 81 B.R. 531, 539 (Bankr. D. Minn. 1988).

[86] 1978 U.S.C.A.A.N. 5787, 5846.

[87] *Sok Jun Kong,* 162 B.R. at 96, *quoting* LHD Realty Corp. v. Metropolitan Life Ins. Co. (*In re* LHD Realty Corp.), 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982).

tenants.[88] It seeks to protect the prepetition expectations of parties to real property transactions.[89] It seeks to prevent forcible evictions whenever possible.

**2. Section 363(f)**

Section 363(b) allows the trustee, after notice and a hearing, to sell property of the estate outside the ordinary course of business. According to section 363(f), such a sale can be "free and clear of any interest in such property of an entity other than the estate" if:

(1) applicable nonbankruptcy law permits such a sale,
(2) the nondebtor entity consents,
(3) the nondebtor's property interest is a lien, and the sale price exceeds the value of all liens encumbering the property,
(4) the nondebtor's property interest is in bona fide dispute, or
(5) the nondebtor entity could be compelled, at law or equity, to accept a money satisfaction of its property interest.

Section 363(**e**) interacts with section 363(f). According to section 363(e), upon request by a nondebtor entity with an interest in the property to be sold, the bankruptcy court must either prohibit the sale or condition it "as is necessary to provide adequate protection of such interest." Adequate protection in a section 363 sale context usually means a lien in the sales proceeds equal to the value of the interest divested by the sale.[90]

On its face, section 363 seems to allow a debtor-lessor to conduct a sale free and clear of a lessee's leasehold interest, whether the lease is (1) in limbo pending assumption or rejection; (2) assumed; or (3) rejected with the lessee electing to remain in possession pursuant to section 365(h). A lessee's leasehold estate is an "interest" in property. Assuming section 363(b) is properly invoked, and one of the conditions set forth in section 363(f) is satisfied, a sale order should cut off a nondebtor lessee's right to possess the leased premises. For many courts, the analysis ends here.[91] Other courts have struggled to protect the nondebtor-lessee's rights in the face of section 363(f)'s seemingly absolute and unqualified language.[92]

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88 *Huff*, 81 B.R. at 536.

89 *In re Upland/Euclid, Ltd.*, 56 B.R. 250, 253 (9th Cir. 1985); *Huff*, 81 B.R. at 538-39.

90 *Qualitech Steel*, 327 F.3d at 548.

91 *See, e.g.*, *Qualitech* (§ 363 sale cuts off § 365(h) rights, but lessee may seek adequate protection of leasehold interest); *In re* Hill, 307 B.R. 821 (Bankr. W.D. Pa. 2004) (§ 363 sale cuts off lessee's purported § 365(h) right); Cheslock-Bakker & Assocs. v. 19 West Hotel LLC (*In re* Downtown Athletic Clubs), 2000 U.S. Dist. LEXIS 7917 (S.D.N.Y. June 9, 2000) (pre-rejection § 363 sale cut off lessees' leasehold interests; § 365(h) right only arises upon rejection); Sugarhouse II Corp. v. Riverfront Concepts, Inc., 1996 Bankr. LEXIS 1955 (Bankr. E.D. Pa. May 9, 1996) (order approving sale free and clear of leasehold interests, including § 365(h) rights), *aff'd per curiam*, 118 F.3d 1578 (3d Cir. 1997) (table), related proceeding at Ultimate Sportsbar, Inc. v. United States, 48 Fed. Cl. 540 (2001) (regulatory takings claim brought by lessee).

92 *See, e.g., In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996); *In re* Churchill Properties III, L.P., 197 B.R.

## B. Pre-*Qualitech* Case Law

### 1. *Taylor*

In *In re Taylor*,[93] the lessees made an interesting argument to avoid the section 363(f) behemoth. Section 363(b) only permits sales of property of the estate. According to the lessees,

> the Debtor conveyed leasehold estates to the lessees thereby dividing the interest in the property between the landlord and the tenant. As a result, the [lessees] hold the leasehold estate and possession of the premises and [Debtor] only holds, as property of the estate, the reversion. Therefore, the Debtor may only sell that reversionary interest.[94]

If a debtor-lessor can only sell its reversionary interest, a purchaser should take subject to the leases, or at least, so the lessees argued.

Unfortunately for the lessees, the court disagreed. Yes, the leasehold estates were vested interests in land. Yes, the lessor retained only a right of reversion for the duration of the lease terms. But, the lessor's title to the land, as well as the bundle of rights it held with respect to the unexpired leases prior to assumption or rejection, was a sufficient property interest to qualify the land itself as property of the estate. If the underlying property to be sold was property of the estate, it did not matter if competing interests in the property were not. Therefore, section 363(b)'s "property of the estate" threshold was met.

Continuing on with its section 363 analysis, the *Taylor* court concluded no subsection of section 363(f) was satisfied, e.g., applicable nonbankruptcy law did not permit a sale of the property free and clear of the leases, the lessees did not consent to a sale free and clear of their interests, there was no bona fide dispute, etc., etc. The court could have stopped at that point, but it felt the need to express its concern about section 363(f)'s potential for evil in other cases:

> [T]he legislative history regarding § 365 evinces a clear intent on the part of Congress to protect a tenant's estate when the landlord files bankruptcy: thus, the tenant will not be deprived of his estate for the term for which he bargained. To be able to circumvent the provisions of § 365 by alleging that a leasehold interest is in bona fide dispute [i.e., while not having to prove that the leasehold is, in fact, invalid] … and therefore allow a sale free and clear of that interest pursuant to § 363(f)(4) would seem to be in direct contravention of the lessee protections specifically afforded by § 365.[95]

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283 (Bankr. N.D. Ill. 1996).

93 198 B.R. 142 (Bankr. D.S.C. 1996).

94 *Id.* at 158.

95 *Id*. at 165.

The existence of a right to demand adequate protection did not budge the court from its position. If the court accepted the debtor-lessor's arguments, a debtor-lessor could dispossess a nondebtor-lessee. That "result ... would appear to be in contravention of Congressional intent."[96] The *Taylor* court concluded section 365 alone governed the parties' rights:

> *Even though there appears to be no express statutory provision that excludes the use of section 363(f)* by [the debtor-lessor], ... to recognize the apparent intentions of the drafters of the Bankruptcy Code as expressed so specifically in § 365(h), this Court agrees that § 365 is the necessary avenue which this Debtor must follow before this Court could authorize a transfer of the real property which [Lessee] has leased.[97]

**2. *Churchill Properties***

A month later, an Illinois bankruptcy judge reached the same conclusion for the same reason - the specific controls the general. In *In re Churchill Properties III, L.P.*,[98] the debtor had filed a liquidating plan proposing to reject all executory contracts and unexpired leases and to consummate a section 363 sale of its principal asset, a 227-unit apartment complex. C&H was the lessee under a lease agreement to operate the laundry concession at the apartment complex for a period of 19 years. Owing to improper notice of the debtor's motion to reject unexpired leases, the section 363 sale was approved and consummated prior to the debtor's formal rejection of C&H's lease. When the court later approved rejection of the lease over C&H's objection, C&H asserted its section 365(h) right to remain in possession of the leasehold. The purchaser contended the sale order had transferred the property free of C&H's leasehold or other interest.

The court noted that sections 363 and 365 were "innocuous" when read and applied separately. When read together, though, each provision seemed to provide an exclusive right that overrode the other.

> For instance, if the sale … divested C&H of its leasehold, regardless of the existence of Section 365, *C&H would lose the benefit of a 19 year lease and Section 365 would be rendered meaningless*. On the other hand, if the Court decided that C&H has the right to retain possession, the language of the Sale Order may be compromised. In that event the [purchaser] might seek to have the sale set aside, thereby throwing the whole affair into chaos.[99]

The court opted for chaos. Invoking the "accepted principle of statutory construction … that the specific prevails over the general," the court concluded section 365 must carry the day:

> Section 365(h) is clear and specific in providing for certain rights and remedies available to the lessee after rejection of its lease. Since Congress decided that lessees have the option to remain

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96 *Id.* at 167.

97 *Id.* (emphasis added).

98 197 B.R. 283 (Bankr. N.D. Ill. 1996).

99 *Id.* at 286-87 (emphasis added, internal footnote omitted).

in possession, it would make little sense to permit a general provision, such as Section 363(f), to override its purpose. The Code is not intended to be read in a vacuum.[100]

### 3. *Bedford Square*

In *In re Bedford Square Associates, LP*,[101] the debtor was a shopping center owner-lessor. It wished to sell a ground lease and some adjoining property to Wal-Mart, the shopping center's anchor tenant. Using the property purchased from the debtor-lessor, as well as another adjoining property for which Wal-Mart held a separate option to purchase, Wal-Mart planned to expand its general merchandise store into a "super center" which would include a supermarket. Wal-Mart's renovation plan called for expansion of the parking lot in front of the store. The lease agreement between the debtor and the secondary tenant of the shopping center, Kroger (a supermarket chain), included a negative covenant prohibiting improvements or alterations to the parking areas without Kroger's consent. Not surprisingly, Kroger refused to consent to Wal-Mart's proposed "alterations" and "improvements." Again, not surprisingly, the court found that Kroger's "reasons [were] clearly not because of dissatisfaction with the changes to the [parking] Lot per se, but to attempt to avoid the competition it *envisions* will be created by the presence of the supermarket in the 'super center.'"[102] Apparently Kroger was just being pessimistic. Later, the court found no evidence that the proximity of another supermarket would hurt Kroger's business. In fact, "[g]rocery customers are likely to take advantage of 'specials' at both proximate stores in single shopping trips."[103] But Kroger's delusions were the least of the court's concern, at least after Wal-Mart took the stand:

> Wal-Mart's witness testified that its definitive goal is to build a "super center" somewhere in Bedford, if not in the Center, then in the vicinity of the Center. Thus, he indicated that, if the Agreement or other suitable arrangements to expand its present location in the Center are not consummated shortly, Wal-Mart will build elsewhere and close its store in the Center, even though its present lease runs for approximately six additional years. The Debtor and [secured lender] rationally fear that this scenario will result in the anchor of the Center "going dark" and the ultimate demise of the Center as a profitable enterprise.[104]

So, the debtor was behind the sale, the secured lender was behind the sale, Wal-Mart was holding the reorganization hostage but Kroger wouldn't cooperate. Debtor moved to reject the lease, and for authorization for a section 363(f) sale to Wal-Mart free and clear of the restrictive covenant. Kroger objected, arguing section 365(h) prevented the debtor from divesting it of its rights under the negative covenant. Section 363(f) had to bow to section 365(h)'s more specific provisions.

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100 *Id.* at 288.

101 247 B.R. 140 (Bankr. E.D. Pa. 2000).

102 *Id.* at 142 (emphasis added).

103 *Id.* at 145.

104 *Id.* at 142.

The court chose to distinguish *Taylor* and *Churchill* rather than take them on. Both cases had involved the sale and dispossession of an objecting lessee's *entire* leasehold interest. Here, the debtor simply sought to dispossess the lessee of one (teeny-weeny) twig from its large bundle of section 365(h) sticks. According to the court, "neither the Debtor nor Wal-Mart [was] seeking to disturb Kroger's *tenancy interests* in any way."[105] Even though restrictive covenants enforceable at state law survive a section 365(h) rejection,

> [t]he narrow range of rights allowed to the rejected lessee should not include a power to block reasonable actions necessary to preserve itself which the [] landlord takes which have not been proven to have any real detrimental effect on the tenant.[106]

The court applied a balancing test to resolve the dispute before it which obviated the need to reconcile sections 363(f) and 365(h). Weighing the debtor's interest in maximizing its use of its property against the harm, if any, Kroger might suffer, the court concluded that

> [i]n these circumstances, § 365(h)(1) does not enhance the tenant's rights such that they overcome the right of a debtor lessor to sell a portion of its property in a transaction which slightly, and not to the tenant's detriment, alters the parking lot.[107]

The court did its best to sidestep reconciliation of section 363(f) and 365(h), which it described as "no easy task." It did not reject the reasoning of *Taylor* and *Churchill.* It created an exception. The court recognized the policy objectives underlying section 363(f) and section 365(h) were sufficiently important to warrant independent consideration when they seemed to be on a collision course. The court invoked a balancing test (without support in either section 363 or 365) presumably because allowing Kroger to use its section 365(h) rights to veto the debtor's plan of reorganization just did not sit right with the court.

## C. *Qualitech*

### 1. Introduction

In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*,[108] the Seventh Circuit did not pussy foot around. It did not duck the issue or create an exception. Section 363(f)'s plain language meant the sale order extinguished the lessee's possessory interest.[109] *Qualitech* is the only circuit-level opinion to decide the issue. For a variety of reasons explained below, it may not be the final "word" on a debtor-lessor's right to extinguish a nondebtor-lessee's leasehold rights through a section 363 sale.

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105 *Id.* at 145 (emphasis added).

106 *Id.* at 146, *quoting In re* Carlton Rest., Inc., 151 B.R. 353, 356 (Bankr. E.D. Pa. 1995).

107 *Id.* at 141.

108 Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537 (7th Cir. 2003).

109 *Id.* at 540.

## 2. *Qualitech* Facts

The *Qualitech* facts are significantly more complicated than our introductory hypo. It is impossible to gauge the effects of these twists and turns on the outcome. Three facts, in particular, merit emphasis:

#1. The nondebtor lessee did not record its lease even though state law required it;
#2. The parties did not dispute that one of section 363(f)'s five conditions was met; and
#3. The lessee did not object to the section 363 sale.

These three unusual facts, properly understood, make *Qualitech's* precedential value questionable. The court's holding may be questionable on other grounds as well.

In *Qualitech*, the debtor (Debtor) owned and operated a steel mill on a 138-acre tract of land. Pursuant to an "Integrated Supply Agreement," Debtor had leased a portion of its land to Precision (Lessee). Lessee agreed to construct a warehouse on the land and provide Debtor with on-site supply services. In exchange for nominal rent ($1 per year), the lease granted Lessee exclusive possession of the warehouse and all other improvements for a 10-year lease term. In the event of early termination, Lessee had the right to remove all improvements and fixtures from the property. Otherwise, Debtor had the right, at the end of the lease term, to purchase for $1 the warehouse, its fixtures and other improvements. When the parties executed this agreement, all Debtor's real property was subject to mortgages securing $200 million of debt. Although state law required recordation of leases whose term exceeded three years, Lessee never recorded its lease. Moreover, Lessee did not obtain a nondisturbance agreement from Debtor's mortgagees.

In its chapter 11 case, Debtor did not assume or reject Lessee's lease or supply agreement. Instead, it moved for a section 363 order authorizing the sale of substantially all of its assets free and clear of "all liens, claims, encumbrances, and interests." Debtor gave proper notice of the proposed sale. Lessee did not object. The court authorized the sale. The order reserved to the prospective purchaser the debtor's right to assume, or assume and assign, its executory contracts and unexpired leases.

Debtor's senior secured lenders submitted the high bid for Debtor's assets, a credit bid of $180 million. They transferred their interest in the assets (including the reserved rights to assume and assign) to Qualitech Steel SBQ (New Qualitech), a company formed shortly after the auction. New Qualitech and Lessee negotiated about terms to assume the lease and supply agreement. The deadline to assume or reject was extended four times. The parties never reached agreement. As a consequence, Lessee's lease and supply agreement were de facto rejected.

Lessee vacated the premises and padlocked the warehouse. Shortly thereafter, New Qualitech changed the locks and took over the building. Locked out of what Lessee thought was its building, Lessee filed suit against New Qualitech in federal district court for trespass, conversion, wrongful eviction, breach of implied contract, and estoppel. New Qualitech had the case referred to the bankruptcy court for clarification of the scope and effect of its sale order.

### 3. *Qualitech*: The Bankruptcy Court

The bankruptcy court did not render a written opinion. Therefore, what we know of the bankruptcy court's holding and reasoning, we know from the opinions of the district court[110] and the circuit court.[111]

The bankruptcy court concluded "the original sale order had unambiguously extinguished [Lessee's] interest in the leased property, and [its] failure to file a timely objection to the sale order precluded any further challenge to the sale order's terms."[112] The court order authorizing the sale stated the purchaser was entitled to the protection of 11 U.S.C. § 363(m).[113] In short, Lessee was barred from asserting any interest in the real estate sold.

### 4. *Qualitech:* The District Court

On appeal, the district court first had to address New Qualitech's argument that the bankruptcy court lacked jurisdiction to determine the validity of Lessee's lease. After all, the assets had already passed out of the estate pursuant to the court's own order, the debtor was not a party to the dispute and resolution of Lessee's rights vis-à-vis New Qualitech would not affect distribution to Debtor's creditors. The district court concluded the bankruptcy court had jurisdiction to interpret and enforce its own order.[114]

Turning to the merits, the court examined section 365(h)(1(A)(ii) and Section 363(f) in light of the parties' arguments. According to Lessee, section 365(h)(1)(A)(ii) controlled. It permitted a lessee, post-rejection, to retain its possessory interest in leased premises despite prior recorded liens enjoying priority over the lessee under state law and despite a bankruptcy court order authorizing a section 363 sale free and clear of all liens and interests.[115]

New Qualitech argued a trustee's rights under section 363 trump a lessee's section 365(h) rights. It noted that section 363(f)(1) authorizes a trustee to sell property free and clear of any interest in the property if "(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest." Moreover, section 365(h)(1)(A)(ii) permits a lessee to retain "its rights under a rejected unexpired lease [only] '*to the extent that such rights are enforceable under applicable nonbankruptcy law*.'"[116] According to New Qualitech, Indiana's priority statute and its foreclosure sale laws were the

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110 2001 U.S. Dist. LEXIS 8328.

111 327 F.3d 537 (7th Cir. 2003).

112 2001 U.S. Dist. LEXIS at *3.

113 *Id.* at *10.

114 *Id.* at *18.

115 *Id.* at *30-31.

116 *Id.* at *32-35 (emphasis added).

relevant applicable nonbankruptcy law for both section 363(f)(1) and section 365(h)(1)(A)(ii). Had a foreclosure sale occurred, the sale would have extinguished Lessee's subordinate and unrecorded lease because the proceeds would not satisfy the prior recorded mortgages.[117] So, a foreclosure sale would vitiate Lessee's interest. Lessee would have no enforceable rights under applicable nonbankruptcy law. Therefore, the section 363 sale was free and clear of Lessee's interest. In fact, the bankruptcy court order was premised on that reasoning. According to the bankruptcy court, the senior mortgages were recorded more than 2 years before execution of the lease. The subordinate lease could not survive a sale that generated substantially less than the debt owed to the mortgagees.[118]

According to the district court, it was not possible to reconcile the two provisions by resort to the statute alone. Each seemed exclusive of the other. Accordingly, it reviewed the relevant case law and commentary. That review provided strong arguments for both positions. Ultimately, the district court concluded section 365(h) trumped section 363(f):

> [t]he focus of Section 365(h)(1)(A)(ii) is very specific—it defines a lessee's post-rejection rights. The statute expressly states that, after rejection of an unexpired lease, a non-debtor lessee may elect to retain possession of the property for *the balance of the term* and for any enforceable extensions of the term. The available legislative history … also indicates that Congress intended to preserve the lessee's estate in the event of rejection by a bankrupt landlord. Finally, the statute does not expressly cross-reference any other provision of the Bankruptcy Code by way of limitation. For these reasons, this court holds that the more specific Section 365(h) overrides Section 363(f) in this case.… There is no statutory basis for allowing the debtor-lessor to terminate the lessee's possession by selling the property out from under the lessee, and thus limiting the lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of its property.[119]

What of New Qualitech's argument that a foreclosure sale would have extinguished Lessee's interest? What might happen in a foreclosure sale was not relevant. A section 363 sale is *not* a foreclosure sale.[120]

> By purchasing assets rather than going through a foreclosure sale, the buyer obtained a going business and some important benefits, including the right to have the debtor assume any favorable contracts and leases and assign those to the buyer. Having chosen that form of transaction, the buyer must take the bitter with the sweet.[121]

Well, what about Lessee's failure to record its lease? Wouldn't that invalidate its lease and

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117 *Id.*

118 *Id.* at *34-35.

119 *Id.* at *46.

120 *Id.* at *47.

121 *Id.* at *47.

permit a sale free and clear of Lessee's interest even if section 363(f)(1)'s reference to applicable nonbankruptcy law meant the law governing common land transactions rather than state foreclosure law? Wouldn't New Qualitech, as a good faith purchaser, have priority over Lessee's prior, unrecorded lease? The district court said it would *if New Qualitech had purchased in good faith*. The bankruptcy court's order stating New Qualitech was entitled to the protections of section 363(m) did not establish its good faith purchaser status for purposes of the state priority statute. New Qualitech would qualify as a good faith purchaser and take free of Lessee's interest only if it did not have actual or constructive notice of Lessee's unrecorded lease.[122] The question of notice was a question of fact the bankruptcy court needed to determine on remand.[123]

In the alternative, New Qualitech argued Lessee's failure to object to the original sale order precluded it from later claiming its possessory interest survived under section 365(h).[124] The court rejected that argument for several reasons. First, the sales order left Lessee's lease (and all other leases) intact because it preserved for the purchaser the right to assume, or assume and assign, all executory contracts and leases.[125] Second, the sale order approved the sale pursuant to sections 363 and 365. Because the two provisions are difficult to reconcile, the sale order was ambiguous. If section 365(h) trumps section 363(f), the sale was subject to Lessee's post-rejection right to possess the premises. If section 363(f) controls, the sale extinguished Lessee's interest. Lessee could reasonably believe the sale order did not extinguish its interest. And, it had no cause to complain until it knew New Qualitech would not assume its lease.[126]

> By approving a sale "pursuant to" both of these sections… and by failing to provide expressly for unexpired leases that were not assumed and assigned, the Sale Order in effect perpetuated the tension between the underlying statutes. The plain language of the Sale Order does not unambiguously conflict with or confirm either party's proposed interpretation.[127]

According to the district court, "the Sale Order did not put [Lessee] on notice that New Qualitech could take the property free and clear of its possessory interest …."[128] Therefore, Lessee was not precluded from arguing the sale did not extinguish its interest.

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122 *Id.* at *49.

123 *Id.* at *6.

124 *Id.* at *57.

125 *Id.* at *59-60.

126 *Id.* at *64.

127 *Id.* at *61.

128 *Id.* at *66.

### 5. *Qualitech:* The Seventh Circuit Court of Appeals

For the Seventh Circuit panel, the issue was "straightforward."[129] First, the court dismissed any claim of res judicata: "[r]es judicata is not ... a doctrine that affects our jurisdiction to determine whether the bankruptcy court was authorized to permit the sale of [Debtor's] land free and clear of [Lessee's] possessory interest ...."[130] It went on to hold that Lessee's right to possess the property was an interest for purposes of section 363(f).[131] Congress intended to give the term "interest" a broad reading.

Next it "considered" (breezed over?) section 363(f).

> Although the statute conditions such a sale on the satisfaction of one of five conditions, the parties before us do not dispute that at least one of those conditions was satisfied.[132]

The court dropped a footnote explaining that New Qualitech had asserted in its brief that, considered alone, i.e., without the which-section-trumps-the-other-issue, it was undisputed that Debtor was authorized to sell the property free and clear of [Lessee's] unrecorded lease.[133] In that same footnote, the court noted Lessee's response brief did not take issue with that assertion.[134]

We do not know why New Qualitech thought one of section 363(f)'s subsections was met nor do we know which one or ones or why Lessee agreed. Perhaps Lessee's failure to record its lease made the lease subject to a bona fide dispute and therefore within section 363(f)(4)? Maybe the parties assumed applicable nonbankruptcy law would permit a sale free of lessee's interest? The latter explanation is a tad hard to believe given the district court's remand to the bankruptcy court to determine whether New Qualitech had notice of Lessee's unrecorded lease. In any event, section 363(f) does not authorize a sale free and clear of interests unless one of its subsections is met. It is unclear if the *Qualitech* facts satisfied any of section 363(f)'s subsections. A court's ability to authorize a sale free and clear of interests without independently determining if section 363(f) is met is also unclear. Finally, does an entity's silence or failure to object satisfy section 363(f)(2)'s requirement of consent or is affirmative consent required?

What section 363(f) means or requires was not an issue because the parties conceded it was met. That left the "perceived" conflict between section 363(f) and section 365(h)(1)(A)(ii). According to the court, "the terms of section 365(h) do not supersede those of section 363(f)." First, the provisions themselves do not suggest that one supersedes or limits the other, even though each contains cross-

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129 Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537, 543 (7th Cir. 2003).

130 *Id.*

131 *Id.* at 546.

132 *Id.*

133 *Id.*

134 *Id.*

references indicating its provisions are subject to other statutory mandates. Second, section 365(h)(1)(A)'s plain language suggests it only applies to one event, lease rejection. It "focuses on a specific type of event -- rejection ... and spells out the rights of the parties affected by that event. It says nothing at all about sales of estate property, which are the province of section 363."[135] Finally, section 363 provides a mechanism to protect those whose interests might be adversely affected by a sale. Section 363(e) gives all those with an interest in property the right to demand adequate protection. Therefore, lessees are "not without recourse in the event of a sale free and clear of their interests."[136] They have the right to seek adequate protection. Lessee failed to do so.

For the court, it was quite simple.

> Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee's possessory interest--provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.
>
> We are persuaded that it is both reasonable and correct to interpret and reconcile sections 363(f) and 365(h) in this way. It is consistent with the express terms of each provision, and it avoids the unwelcome result of reading a limitation into section 363(f) that the legislature did not inscribe onto the statute. Congress authorized the sale of estate property free and clear of "*any* interest," not "any interest *except* a lessee's possessory interest." This interpretation is also consistent with the process of marshaling the estate's assets for the twin purposes of maximizing creditor recovery and rehabilitating the debtor which are central to the Bankruptcy Code.... Basil H. Mattingly*, Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy,* 4 AM. BANKR. INST. L. REV. 431*,* 451-52 (1996).[137]

Because section 363 authorized the sale free and clear of all interests and Lessee neither objected nor sought adequate protection of its interest, the sale extinguished its possessory interest in the property.

### 6. Postscript

One court has relied on the Seventh Circuit's opinion in *Qualitech* to conclude a section 363 sale extinguished whatever possessory interests the lessee had.[138] According to the court, the sale order was "without limitation" and no one objected.[139] The court described the Seventh Circuit's opinion as

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135 *Id.* at 547.

136 *Id.* at 548.

137 *Id*. at 548.

138 Hill v. MKBS Holdings (*In re* Hill), 307 B.R. 821, 826 (Bankr. W.D. Pa. 2004).

139 *Id.*

"exhaustive and persuasive." The court did not engage in its own analysis of the issue. To be fair, though, the lessee's alleged interest in *Hill* was sketchy at best.

### D. So, Who Has the Better Argument?

Just as the courts are divided on the issue, commentators disagree. The Seventh Circuit quoted from an article by Basil H. Mattingly.[140] Mr. Mattingly's article addresses section 363 sales free and clear of restrictions and covenants. He does not address section 365(h) and its relationship with section 363(f). His basic position is enforcement of restrictions and covenants may prevent the highest and best use of property and thereby undermine one of bankruptcy's fundamental goals -- maximization of the estate for the benefit of the unsecured creditors.[141]

More on point is an article by Steven R. Haydon & Nancy J. March.[142] The authors basically argue that courts who hold section 365(h) overrides section 363(f) are imposing an implied limitation on section 363(f). They are reading section 363(f) to say a debtor may sell real estate property free and clear of any interest, *except for real property leases*.[143]

Michael St. Patrick Baxter's recent article makes a very strong case against the *Qualitech* holding.[144] He fears not only for nondebtor-lessees but intellectual property licensees. He describes the *Qualitech* holding as permitting a stealth rejection of leases in an attempt to extinguish unwanted leaseholds.[145]

Mr. Baxter notes that Congress may have defined "interest" broadly, but the section 363(f) power to sell free and clear is very narrow. It is limited to one of the five circumstances listed in section 363(f). As noted, the Seventh Circuit spent no time analyzing whether any 363(f) subsection applied because the parties never made it an issue. (Bad lawyering can make law just as bad as bad facts. The district court *did* focus on the limited circumstances permitting a section 363 sale free and clear of all interests. It wanted the bankruptcy court to determine if New Qualitech qualified as a good faith purchaser so as to take free of Lessee's interest. Did New Qualitech have notice - actual or constructive - of Lessee's unrecorded lease? If so, it would have taken free of Lessee's leasehold interest under applicable nonbankruptcy law.)

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140 *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy,* 4 AM. BANKR. INST. L. REV. 431, 451-52 (1996).

141 *Id.* at 431.

142 *Sale of Estate Property Free & Clear of Real Property Leasehold Interests Pursuant to § 363(f): An Unwritten Limitation?*, 19-AUG. AM. BANKR. INST. J. 20 (2000).

143 *Id.* at 20.

144 *Section 363 Sales Free & Clear of Interests: Why the Seventh Circuit Erred in* Precision Industries v. Qualitech Steel, 59 BUS. LAW. 475 (2004).

145 *Id.* at 477.

Mr. Baxter challenged the Seventh Circuit's assertion that neither provision supersedes the other. He points to section 363(*l*) which, he argues, subordinates section 363 to section 365.[146] Section 363(*l*) provides that section 363(b) and (c) sales are subject to section 365.[147] According to Mr. Baxter,

> Two basic types of sales are permitted under § 363: sales outside the ordinary course of business under § 363(b), and sales in the ordinary course of business under § 363(c). Free-and-clear sales under § 363(f) are a subset or category of these sales. Thus, a free-and-clear sale under § 363(f) also must be a sale under either § 363(b) or § 363(c). Therefore, any limitation on sales under § 363(b) or § 363(c) is also a limitation on free-and-clear sales under § 363(f). Sales under § 363(b) and § 363(c) are limited by §§ 363(d), (e), and (*l*). Section 363(*l*) provides that sales in or outside the ordinary course of business are "[s]ubject to the provisions of section 365 ... notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor." As a result, sales in or outside the ordinary course of business--including free-and-clear sales under § 363(f) -- are expressly subject to the provisions of § 365, in its entirety, by virtue of § 363(*l*). In other words, a free-and-clear sale under § 363(f) is subject to the provisions of § 365, and, therefore, is also subject to § 365(h).[148]

Mr. Baxter observed *Qualitech* never discussed section 363(*l*).

He further criticized the court for making an artificial distinction between lease rejection and a sale of property which results in lease repudiation. According to Mr. Baxter, section 365(h)'s prefatory language "if the trustee rejects an unexpired lease" does not signify Congress' intent that rejection represents a special event triggering lessee protection. Rather, it reflects the reality that a lessee does not need special protection if the debtor assumes the lease.[149]

He also took the court to task for asserting that section 363(e) protects lessees. As he correctly points out, a debtor cannot cramdown a lessee. 11 U.S.C. § 1123(b)(2) makes the requirements for cramdown expressly subject to section 365.[150] Moreover, even assuming adequate protection applied,[151] how would a court value a lessee's possessory rights? And, even if adequate protection were adequate, "it is not an appropriate substitute for possession."[152] As Mr. Baxter notes, the rights and interests of

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146 *Id.* at 482.

147 *Id.* at 483.

148 *Id.* at 482-83.

149 *Id.* at 487.

150 *Id.* at 491.

151 It is unclear if adequate protection even applies to lessors or lessees. Section 361, discussing adequate protection, states: "When adequate protection is required under section 362, 363 or 364 of this title of an interest of an entity in property ...." Section 361 does not mention section 365.

152 *Id.* at 492.

lessees in need of protection are much different from the rights and interests of secured creditors, who, after all, just want to get paid. Lessees have bargained for possession of premises.[153]

Mr. Baxter's biggest concern is the effect of the *Qualitech* holding. It gives courts "license to [create] stealth rejections," de facto rejections without section 365's procedural and substantive protections.[154]

**E. What to Do If You Represent a Nondebtor-Lessee Who Wants to Remain in Possession**

Mr. Baxter makes the following recommendations for lessees in the post-*Qualitech* world.

1. Argue against *Qualitech* if you are outside the Seventh Circuit. (Argue to reverse it inside the Seventh Circuit.)

2. Object to a section 363 sale because it does not satisfy any of the five stated requirements permitting a sale free and clear of all interests.

3. Move to compel assumption or rejection and give notice of the lessee's intent to exercise its section 365(h)(1)(A)(ii) rights if the lessor rejects the lease.

4. Demand adequate protection and argue adequate protection requires the lessee to remain on the premises.[155]

We would add - direct the court's attention to section 363(*l*) and argue Congress *did* make section 363 subject to section 365.

Mr. Baxter notes ruefully that all of his recommended actions are defensive. There is nothing a lessee can do affirmatively to insulate itself from section 363(f). Nondisturbance and subordination agreements protect a nondebtor lessee from being dispossessed if a mortgagee forecloses. They have no effect on a section 363 sale.

We think the story of the relationship between section 365(h)(1)(A)(ii) and section 363(f) is far from being told. The next time the question rears its head, we suspect everyone - the parties and the court - will have a clearer idea of the issues, the arguments and the strategies.

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153 *Id.*at 492.

154 *Id.* at 496.

155 *Id.* at 499-500.

## III. Right to Assume Some But Not All Leases Scheduled under a Master Lease

### A. Introduction

As every schoolchild knows, a debtor must assume or reject an executory contract or unexpired lease in its entirety. No cherry picking allowed. The rule against cherry picking terms in an executory contract or unexpired lease prevents debtors, "ostensibly under the auspices of § 365, from unilaterally rewriting the terms of a contract."[156] "Recently, property owners have used this all-or-nothing principle ... to hedge against bankruptcy risks when leasing multiple properties by executing a single 'lease.'"[157] The following discussion suggests this strategy will meet with only limited success.

### B. The Statute

Section 365(a) permits assumption of unexpired leases subject to the requirements set forth in subsections (b), (c) and (d). Only subsection (c) contains anything by way of an express limitation on a debtor's right to "cherry pick" leases under a master lease agreement. According to paragraph (c)(4), the trustee may not assume a lease of nonresidential real property

> under which the debtor is the lessee of an aircraft terminal or aircraft gate at an airport at which the debtor is the lessee under one or more additional nonresidential leases of an aircraft terminal or aircraft gate and the trustee, in connection with such assumption or assignment, does not assume all such leases or does not assume and assign all such leases to the same person, except that the trustee may assume or assign less than all of such leases with the airport operator's written consent.

Translation? Airline debtors cannot pick and choose among the individual leases contained in their package deal with a given airport unless the airport operator consents. By negative implication, non-airline debtors *can*. Or, at the very least, nothing in the Code expressly says they can't. If a nondebtor-lessor objects to a non-airline debtor's proposed piecemeal assumption of leases under a master lease, it will have to resort to something other than section 365's plain language to make its case.

### C. Case Law

As noted, a debtor must assume an unexpired lease *cum onere*.[158] It cannot pick and choose among terms within a single lease.[159] But therein lies the rub. What constitutes a *single* lease?

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156 *In re* Storage Technology Corp., 53 B.R. 471 (Bankr. D. Col. 1985).

157 Gregory G. Hesse, *Bankruptcy's Effect on Multiple Property Leases*, 21-APR. AM. BANKR. INST. J. 18 (2002).

158 *In re* Café Partners/Wash. 1983, 90 B.R. 1, 6 (Bankr. D.D.C. 1988).

159 *In re* David Orgell, Inc., 117 B.R. 574, 576 (Bankr. C.D. Cal. 1990).

### 1. Single Lease

What constitutes a "single lease" is a matter of state law. The question is fact-specific. It does not take much creativity to imagine how this plays out in the case law. The words may differ, but the music stays the same. The nondebtor lessor will say something like --

> Your honor, property and contract rights are defined by applicable nonbankruptcy law. Leases A and B, which Debtor claims are separate, are in reality inseparable parts of a single transaction respected as such at state law. Section 365 does not permit "cherry picking." Thus, Debtor may not [assume] [reject] [extend the time within which to assume or reject] Lease *A* without [assuming, curing defaults under] [rejecting] [timely performing its obligations under] Lease B.

### 2. Single Lease -- Integrated Agreement?

The courts have adopted a fairly uniform approach to analyzing these objections. They follow the Supreme Court's directive in *Butner*: state law defines property rights in bankruptcy unless some federal interest or policy requires a different result.[160] So, courts first analyze the rights of the parties outside of bankruptcy. Then they consider whether bankruptcy policy requires a different result.

Applying the state law of contracts, courts focus on the parties' intent, as objectively evidenced in the language of their agreements and the circumstances surrounding the transaction(s). If multiple instruments evidence the agreements, the court must determine first whether state law would consider the instruments integrated, i.e., are they parts of a single transaction? Under general contract law principles, courts will construe instruments together if the same parties executed them contemporaneously, for the same purposes, and as part of the same transaction.[161] Courts construe them as integrated even if the instruments do not explicitly refer to one another.[162] According to one court, "the essential test is whether the parties assented to all the promises as a single whole, so that there would have been no bargain whatever if any promise or set of promises were struck out."[163]

If state law would not recognize the agreements as integrated, the analysis ends there. Section 365(a) plainly permits the debtor to treat each agreement separately. The debtor can assume one and reject the other.

### 3. Single Integrated Agreement But Severable?

If the agreements are integrated, either explicitly within the same instrument or within the broader

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160 Butner v. United States, 440 U.S. 48, 54-55 (1979).

161 Clayton v. Howard Johnson Franchise Sys., 954 F.2d 645, 648 (11th Cir. 1992).

162 *E.g., Clayton*, 954 F.2d at 648-50; *In re* Gardinier, Inc., 831 F.3d 974, 976 (11th Cir. 1987); Pieco, Inc. v. Atlantic Comp. Sys., Inc. (*In re* Atlantic Comp. Sys., Inc.), 173 B.R. 844, 851 (S.D.N.Y. 1994); *In re* Plitt Amusement Co., 233 B.R. 837, 841 (Bankr. C.D. Cal. 1999).

163 Bethea v. Investors Loan Corp., 197 A.2d 448, 450 (D.C. 1964).

transaction by operation of state law, the court must then determine whether the agreement at issue is severable from the other parts of the instrument or transaction.[164] Generally speaking, "severability requires a determination of whether a part of a contract or lease, or part performance thereunder, can be separated and treated as an independent legal obligation."[165] Essentially, if the failure to perform one promise does not put the promisor into breach of the entire agreement, the promise is severable.

Many courts refer to and rely on *Byrd v. Gardinier, Inc. (In re Gardinier, Inc.)*[166] as the guidepost.[167] *Gardinier* required the court to decide if an agreement to pay a brokerage commission was separate and distinct from the purchase and sale agreement. A single document memorialized both agreements. The court concluded the parties had intended to make two separate contracts.[168] According to the court,

> the nature and purpose of the agreements are different. One agreement addresses the sale of property and the other contemplates an employment contract related to the sale of the property.... [T]he consideration for each agreement is separate and distinct. Burley agreed to pay Gardinier in excess of $ 5 million in consideration for the Goldstein tract. Gardinier separately agreed to pay Kilgore a commission as consideration for services rendered in making the sale of the property. There was no consideration flowing from the broker and the buyer.... Finally, the obligations of each party to the instrument are not interrelated. Gardinier obligated itself to deliver the deed to Burley upon payment of the purchase price, and it obligated itself to pay a commission to Kilgore upon completion of the broker's responsibilities. There are no promises running between the broker and the purchaser; their only relation is that each has separate contractual rights with the seller.[169]

So, too, a lease and non-competition agreement were severable because they were supported by different consideration, covered different subject matters, involved different parties and were intended to accomplish different objectives.[170] Therefore, the debtor could assume one and reject the other.

**a. Case Law Factors regarding Severability**

No set test governs severability. Nevertheless, the courts have identified the following

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164 *Plitt Amusement*, 233 B.R. at 839.

165 *In re* Integrated Health Servs., Inc., 2000 Bankr. LEXIS 1310 at *8-9.

166 831 F.2d 974 (11th Cir. 1987).

167 *See, e.g.,*Campground R.V. Park & Marina, Inc. v. Pollock (*In re* Pollock), 139 B.R. 938, 940 (9th Cir. BAP 1992); *In re* Plitt Amusement Co., 233 B.R. 837, 846, n.10 (Bankr. C.D. Cal. 1999).

168 *Id.* at 976.

169 *Id.* at 976.

170 *In re* Integrated Health Servs., Inc., 2000 Bankr. LEXIS 1310, at *10 (Bankr. D. Del. 2000).

considerations in evaluating severability:

- apportionment of consideration to different obligations under the master agreement;
- failure to refer to or incorporate terms of other agreements;
- inclusion of a severability clause, which provides for continuity of the agreement in the event one or more of its provisions is nullified by operation of law;
- inclusion of a condemnation/destruction clause, which provides for continuity of the agreement, and appropriate adjustment in rental obligations, in the event one or more leased properties is rendered unavailable;
- permissive assignment/subletting of some, but not all, leased premises;
- interrelatedness of obligations due under the agreement, i.e., whether an agreement makes "economic sense" if it is not considered with the other components of the transaction;
- whether the obligations within the transaction are coterminous.

**b. Integrated & Nonseverable at State Law But Severable according to Federal Law?**

Courts articulate the above factors differently to reflect the particular "test" the governing state law employs. If an obligation is severable from others within the same agreement according to applicable state law, the bankruptcy analysis is simple. Section 365 allows the debtor to do as it wishes. If the obligation is not severable at state law, the court must decide whether the letter or spirit of the Bankruptcy Code requires treating it as severable as a matter of federal law.

Courts have invoked bankruptcy policy primarily in two contexts: (1) to invalidate cross-default clauses contained within multiple agreements, and (2) to allow separate treatment of leases under a master lease when the individual leased premises are separate "business establishments" of the debtor.

**i. Cross-Default Clauses**

Cross-default clauses are enforceable at state law. They are probative of the parties' intent to create an integrated, indivisible transaction. Nevertheless, bankruptcy courts discount them heavily in the overall severability analysis.[171] The reasons are twofold. First, to the extent default of a monetary lease obligation indicates a debtor's poor financial condition, cross-default clauses may represent *ipso facto* provisions which are invalid under section 365(e)(1)(A). Second, enforcement of cross-default clauses may operate as a *de facto* restriction on assumption and assignment that interferes with a debtor's exercise of its section 365 rights.[172]

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[171] *See, e.g., In re* Convenience USA, Inc., 2002 WL 230772 *7 (Bankr. M.D.N.C. Feb. 12, 2002); *In re* Plitt Amusement Co., 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999).

[172] *In re* Convenience USA, Inc., 2002 WL 230772, at *7; *In re* Sambo's Rests., Inc., 24 B.R. 755, 757-58 (Bankr. C.D. Cal. 1982).

But, what if the parties, rather than drafting cross-defaulted agreements, simply memorialize their bargain in a single instrument? As the court in *Plitt Amusement Co.* noted:

> Bankruptcy is not subject to artful drafting. Business lawyers are accustomed to working with statutes that can be superseded by agreement of the parties…. Bankruptcy is otherwise. Its chief purpose is to relieve debtors of their improvident agreements. At the same time, it permits the trustee or debtor in possession to take advantage of those agreements that are beneficial, for the benefit of creditors. A trustee or debtor in possession may be permitted to pick and choose, to make this determination authorized by section 365.[173]

**ii. Separate Treatment of Leases Under a Master Lease**

In *Plitt*, the court permitted rejection of one lease separate from two other leases and a related installment purchase of the businesses at the three locations. Although the court concluded applicable state law supported separate treatment of the lease under section 365, the court gave an independent bankruptcy justification for its result:

> Consider a business consisting of 666 retail establishments, each operated on leased property. Suppose that the debtor has purchased the entire business from a third party, who has retained a lessee or sublessor interest in each of the properties. Further suppose that, in consequence of intervening circumstances, many but not all of the leases have turned out to be improvident. By artful drafting the seller could try to prevent the debtor from assuming the profitable business locations, and rejecting the unprofitable, and argue that the debtor could only assume or reject the entire 666-store transaction. In the section 365 context, such an argument would make no sense: it would altogether frustrate the ability of a debtor to rehabilitate the business by assuming the profitable portions of the business. Where a debtor has purchased multiple business establishments from a seller in the same transaction, artful drafting of the sales documents cannot be permitted to circumvent section 365.[174]

The *Plitt* court concluded a trustee or debtor in possession could assume or reject independently as to each "business establishment" that was property of the estate.[175] The court went on to define "business establishment" as "what the business community ordinarily treats as a business entity or as a unit of commerce." Two or more geographically separated locations are not separate business establishments unless each site constitutes a business that can, and typically does, operate separately. The court concluded the lease in question, a commercial lease for a movie theater, was inherently severable. The lease concerned "a location separate from that of the other two leases."[176]

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[173] 233 B.R. at 847; s*ee also In re Sambo's Rests., Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982).

[174] *Plitt Amusement,* 233 B.R.at 847-48.

[175] *Id.* at 847. *Cf. In re* Cafeteria Operators, L.P., 299 B.R. 384, 391 (Bankr. N.D. Tex. 2003) ("This type of agreement, which addresses numerous independently operated restaurant facilities scattered across multiple states, inherently lends itself to being divisible.").

[176] *Id.* at 848.

We suspect courts will follow the lead of *Plitt* and when possible, err on the side of severability. Such an approach gives the debtor greater freedom and flexibility, which, in turn, promotes its chances of successfully reorganizing.

## IV. The Treatment of Obligations to Restore Leased Premises to their Original Condition

Rejection often leaves the lessor saddled with restoring the premises to a tenantable condition. The lessor might have to repair, clean and/or remove abandoned property from the premises. These expenses arise postpetition. Given the breadth of section 365(d)(3)'s "timely perform all obligations" language, nondebtor-lessors naturally seek administrative expense priority for these costs.

A well-drafted lease will require the lessee to: (1) maintain the premises in good repair throughout the lease term; (2) restore the premises to their original condition upon termination or expiration of the lease, and/or (3) return the premises "broom clean" and free of personal property and fixtures. Lessors have used these provisions to make a variety of arguments for administrative expense status. For example, a lessor can argue the debtor's failure to maintain the premises in good repair amounts to a violation of section 365(d)(3)'s timely performance requirement, thereby entitling the lessor to an immediately payable administrative expense claim. So, too, lessors have argued that shouldering the debtor's contractual duties postpetition amounts to a transaction with the debtor in possession that benefited the estate in the amount of the costs the debtor avoided. Therefore, the lessor is entitled to a "classic" section 503(b) administrative expense. Finally, lessors have argued that by leaving property on the premises, the debtor has failed to vacate the premises post-rejection. Consequently, the debtor is liable to the lessor, as a holdover tenant, for post-rejection use and occupancy charges, which are also entitled to administrative expense priority.

Before exploring each such claim in turn, we note the judicial inclination to view all such claims with a jaundiced eye. As Judge Gerber explained in *Ames Department Stores, Inc.*:

> Like so many matters in chapter 11 cases in this Court, this controversy is not in economic reality a controversy between creditors (here the Landlords) and a debtor. Rather, it is a controversy between one group of creditors (the Landlords) and the Debtors' *other* creditors, with respect to the allocation of the Debtors' limited resources to satisfy the losses that many creditors will suffer. The controversy raises the issue of the extent to which the Debtors' contractual breaches on the lease obligations here should be treated differently than the Debtors' countless other breaches of obligations—both payment and otherwise—to their creditor community as a whole.[177]

If the court accepted the landlords' position, they would receive full satisfaction or nearly so. The unsecured creditors would receive little to no distribution on their claims.

Bankruptcy courts basically speak with one voice on this issue. As the cases make clear, the

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[177] *In re* Ames Dep't Stores, 306 B.R. 43, 55-56 (Bankr. S.D.N.Y. 2004).

question is rarely *whether* the court will deny the landlord's request for administrative expense status. The question is *how* the court will go about denying it.

*In re National Refractories & Minerals Corp*.[178] is instructive because the lease contained all three of the above lease provisions and the lessor made all three arguments for administrative expense priority. The debtor-lessee in *National Refractories* occupied the leased premises for six months postpetition before it vacated the premises and rejected the lease. Almost a year after recovering possession of the leased premises, the lessor (Centerpoint) filed a request for payment of an administrative expense. It claimed $180,248 for repair and cleanup of the leased premises, including removal of abandoned property and hazardous waste. It also sought payment, as an administrative expense, of $54,391 representing post-rejection "holdover rent" for the 60 days it took to restore the premises to leaseable condition. At the time of the lessor's request, the estate was administratively insolvent.

The court gave short shrift to the lessor's claim for holdover rent. First, section 365(d)(3)'s automatic administrative expense treatment only applies to postpetition, pre-rejection lease obligations. Any claim based on post-rejection use and occupancy has to qualify as an administrative expense under section 503(b). Section 503(b) only confers administrative expense status if the debtor's use of the leased premises benefitted the estate. The lessor's "holdover rent" claim would not qualify under section 503(b) because the alleged holdover period was fictional. The debtor did not actually occupy the leased premises for the 60 days in question. As a result, there could be no benefit to the estate. The result might have been different had the debtor not abandoned the personalty it left behind. If, post-rejection, the debtor were using the premises for storage, the lessor might have been entitled to an administrative expense claim for reasonable storage value. (To avoid this liability, the prudent lessee will move to abandon the property at the same time that it moves to reject the lease.)

Turning to the lessor's claims for repair and cleaning costs. According to the court, the lessor's right to an administrative expense for those costs depended on *when* the events giving rise to the costs had occurred. The evidence suggested the bulk of the damage was done postpetition when the debtor moved out, but the parties were still in discovery. Because the debtor had limited resources, the parties had requested an advance ruling covering both scenarios. The court held the debtor's failure to repair the damage and remove its personal property would violate section 365(d)(3) and would give rise to an administrative expense *if* the damages occurred postpetition or the debtor first brought the items onto the premises postpetition, pre-rejection.[179]

Centerpoint pushed even harder. It maintained it was entitled to an administrative claim even if the relevant events had occurred prepetition. As Centerpoint saw it, every day the debtor occupied the premises postpetition, the debtor had a contractual duty to maintain the leased premises in good condition. It breached that duty each and every day that it failed to repair the damages.

The court could find no authority precisely on point. It looked to the line of cases concerning prepetition proration.

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178 297 B.R. 614 (Bankr. N.D. Cal. 2003).

179 *Id.* at 619.

> The Court follows the majority and adopts the proration or accrual approach. In other words, whether Centerpoint is entitled to an administrative claim for the Repair Costs depends on when the damage occurred…. Following the reasoning of the *Handy Andy* court, once the damage to the Leased Premises was done, the Debtor's obligation to repair it became fixed. If the lease had been terminated just prior to the filing of the bankruptcy petition, the Debtor's liability for the Repair Costs would have been no different than those asserted in [Centerpoint's] Motion. Thus, to treat them as administrative claims would be contrary to the real world situation to which the language [of section 365(d)(3)] pertains.[180]

Accordingly, the lessor was entitled to administrative priority only to the extent it could prove the relevant events occurred during the abeyance period.

As more courts consider this precise issue, they may well divide into the proration and performance date camps. Under the latter approach, section 365(d)(3)'s "timely performance of all obligations" language will require the debtor to make full payment of all cleanup/repair costs.

The lessor in *National Refractories* also claimed administrative expense status for damages representing the debtor's failure to restore the leased premises to their original condition upon lease termination. However, neither the court nor the parties devoted much energy or thought to that claim. Everyone seemed pre-occupied with the lessor's claims for holdover rent and breach of the continuous repair and maintenance obligation. *In re Ames Department Stores, Inc.*[181] fills the analytical void.

In *Ames*, the debtor rejected a number of leases and vacated the leased premises. It left behind shelving, racks, bins and similar trade fixtures that someone had to remove or clean up. Each lease required the tenant, at termination, to leave the premises clean and free of goods and effects.

The court did not find any section 365(d)(3) entitlement to the post-termination cleanup expenses. First, the removal/repair obligations that were breached only arose upon lease *termination*. The lease did not impose any ongoing obligation on the lessee. The obligation arose upon lease termination. The lease was terminated only upon or after its rejection. Thus, had the landlord, pre-rejection, sought payment of cleanup expenses as an unsatisfied obligation under section 365(d)(3), there would have been nothing to ask for. Similarly, section 365(d)(3) compels performance of obligations only *until* the lease is rejected.

Second, the cleanup expenses were treated as general unsecured claims by operation of sections 365(g) and 502(g), which provide that rejection claims are prepetition claims.

> And the claims in question here are plainly a species of rejection claims; like contractual claims for the rent that would be paid after rejection, these are contractual claims for the damages the Landlords suffered after (and upon) the Debtor's rejection and removal from the premises. The point is not that the Landlords have had no legally cognizable injury when the Debtors failed to remove their shelving and racks … but rather that Congress has made a legislative determination

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180 *Id.* at 619-20 (internal citations omitted).

181 306 B.R. 43 (Bankr. S.D.N.Y. 2004).

that rejection claims are pre-petition claims, with no priority over the claims of other unsecured creditors, who also suffered legally cognizable injury.[182]

Third, the court believed that recognizing these claims as postpetition expenses would "seriously undercut the entire purpose of the rejection process." Rejection enables a debtor to relieve itself of burdensome obligations contained in prepetition contracts and leases. Ames' promise to clean up the premises upon lease termination was a promise made prepetition. It was one such burdensome obligation. Compliance would subject the estate to the expense, to be paid in postpetition dollars, of removing the shelving the debtors had abandoned.[183]

Another court found an alternative route to the same conclusion. In *Doral Commerce Park, Ltd. v. Teleglobe Communs. Corp (In re Teleglobe Communs. Corp.)*,[184] the court held rejection did not terminate a lease. Rejection constituted *breach* of the lease. Because the lease obligated the lessee to restore the premises to their original condition "upon termination," the obligation was never triggered. Because it was never triggered, the debtor could not breach it.

*In re Treesource Industries, Inc.*,[185] from the Ninth Circuit, appears to be the first opinion on this issue at the circuit-level. The lease, like the lease in *National Refractories*, required the lessee to keep and maintain the premises and return them to the lessor in the same condition as they were in at commencement of the lease. It also required the debtor, upon lease termination or expiration, to remove all fixtures, equipment, improvements, debris and to regrade the premises to their natural contours.[186] Needless to say, the debtor did not perform all of its obligations. The lessor made the following argument. A commercial lessee is required to timely perform all postpetition, pre-rejection obligations. Every claim under a nonresidential real property lease that arises postpetition and pre-rejection is an administrative expense. The removal obligation arose during that time period. Therefore, it was entitled to an administrative expense claim for the lessee's failure to satisfy its removal obligation.[187]

The court began by explaining why it had adopted a bright-line rule giving administrative expense priority to all claims arising postpetition, pre-rejection. Such a bright-line rule ensured prompt performance of postpetition lease obligations. It eliminated disputes.[188] The issue, according to the court, was *when* the lessor's claim arose. According to the lease, the obligation arose upon termination or expiration of the lease. Consequently, the lessor's damage claim represented a general, prepetition

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182 *Id.* at 60.

183 *Id.*

184 304 B.R. 79, 82-83 (D. Del. 2004).

185 363 F.3d 994 (9th Cir. 2004).

186 *Id*. at 995.

187 *Id.* at 997.

188 *Id.* at 997.

unsecured claim.[189] The court distinguished the removal obligation from tax or rent obligations, noting that the removal obligation did not accrue over time. It accrued instantly -- at the moment of lease termination.

The lessee's obligation to keep and maintain the premises suffered a similar fate. It was only breached when the lessee rejected the lease. The lease required the lessee to return the premises in the same condition they were in when lease commenced. If the lessee's maintenance during the lease term was sub par, still the lessor's claim would only arise when the premises were returned, i.e., after the lessee had rejected the lease.

In short, drafting an ongoing lease obligation may not give the lessor its desired administrative expense priority. As the case law suggests and Judge Gerber pointed out, why should courts treat a debtor-lessee's contractual breaches differently from the debtor's "countless other breaches of obligations—both payment and otherwise—to [its] creditor community as a whole."[190]

## V. Effective Date of Rejection

Section 365(d)(3) orders the trustee to timely perform its lease obligations "until such lease is assumed or rejected." Rejection signals the end of a debtor's section 365(d)(3) duties and the end of a lessor's section 365(d)(3) administrative rent claim (if the court recognizes one). The date rejection occurs "is significant because until rejection, the lessor is entitled to rent as a postpetition administrative expense."[191] A debtor-lessee's lease obligations can be substantial. From the debtor's perspective and that of other creditors of the estate, the sooner they end, the better, if the debtor does not want to assume the lease.

According to section 365(a), "the trustee, subject to court approval, may assume or reject any ... unexpired lease of the debtor." Given the stakes, it is not surprising that some courts have held a rejection is effective when the debtor unequivocally notifies the lessor of its intent to reject the lease. Most courts hold rejection is not effective until the court approves the debtor's motion to reject. The courts frame the issue as whether court approval is a condition precedent or a condition subsequent to an effective rejection.

### A. Rejection Effective When Debtor Moves to Reject

*In re Joseph C. Spiess Co*.[192] illustrates the minority approach.[193] The debtor petitioned for

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189 *Id.* at 998.

190 *In re* Ames, 306 B.R. 43, 55-56 (Bankr. S.D.N.Y. 2004).

191 *In re* Federated Dep't Stores, Inc., 131 B.R. 808, 814 (S.D. Ohio 1991).

192 145 B.R. 597 (Bankr. N.D. Ill. 1992).

chapter 11 relief on December 23. It ceased business operations on January 31 after conducting a going-out-of-business sale. By February 17, it had removed all fixtures and vacated the premises. It requested an extension of time to assume or reject which the court granted. Less than two weeks later, on February 29, the debtor served the lessor with notice of its intent to reject. The court heard and approved the debtor's motion to reject on March 9. It reserved ruling on whether the debtor's rejection should apply retroactively.[194]

The court concluded rejection did not expressly require prior court authorization. Section 365(a)'s "plain language ... treats court approval not as a condition precedent to an effective assumption or rejection, but rather as a safeguard subjecting the decision of the trustee (and its business judgment) to review and possible reversal."[195] The court noted that prior to the 1984 amendments, courts permitted rejection and assumption without prior court approval.[196] Then the court got to the heart of the matter:

> By requiring court approval as a condition precedent to the rejection of an unexpired lease, [the lessor] hopes to collect an administrative expense for the non-use of the premises while awaiting court approval. According to the definition of an administrative expense, however, [the lessor] should not recover such a priority expense because the rent accrued was not an actual, necessary cost or expense of preserving the estate. Thus, the policy underlying the payment of administrative expenses justifies the retroactive approval of a trustee's rejection of an unexpired non-residential lease.
>
> ... It is difficult for this Court to fathom why Congress would have intended an unwarranted windfall, like payment of rental expenses as an administrative expense when the debtor had abandoned use of same, to befall a lessor by virtue of his status. Absent something more, the Court is not persuaded that [the lessor] should receive as an administrative expense the rental expense accrued post-petition for the non-use of the Premises.[197]

According to the court, the lessor should bear some of the loss occasioned by dealing with an insolvent tenant:

> This Court appreciates the desire to protect lessors, but there is simply no indication that Congress intended to protect lessors from all problems incident to a tenant's filing a petition ... All creditors -- including landlords-- should expect some loss, delay or inconvenience. Whatever the loss may be from the delay between a debtor's rejection and court approval of same would constitute the landlord's cost from doing business with an insolvent tenant-- a cost to be borne by

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193 *See also* By-Rite Distrib., Inc. v. Brierly (*In re* By-Rite Distrib, Inc.), 55 B.R. 740, 742 (D. Utah 1985); *In re* 1 Potato 2, Inc., 58 B.R. 752, 755-56 (Bankr. D. Minn. 1996).

194 *Spiess*, 145 B.R. at 599.

195 *Id.* at 600-01.

196 *See, e.g.,* Benevides v. Alexander, 670 F.2d 885 (9th Cir. 1982).

197 *Spiess*, 145 B.R. at 603.

the landlord, not the other creditors. Nothing in the Code remotely suggests that landlords should be absolved of *all* loss from dealing with insolvent or bankrupt tenants. If the lessor truly is concerned about incurring costs due to the tenant's delay, the lessor always has the option of filing a motion requesting the debtor to assume or reject, thus bringing the issue before the court for prompt resolution.[198]

### B. Rejection Effective When Court Approves It

Most courts have concluded rejection is not effective until the court grants the debtor's motion even though that means section 365(d)(3) "charges" continue to accrue.[199] As one court observed, "[t]he court order authorizing rejection ... would be meaningless if the effective date of rejection was the date the debtor gave unequivocal notice to reject the lease."[200] Moreover, making rejection effective at the time of the debtor's motion would not help the lessor. No rational lessor would attempt to re-let the premises until court approval. The minority approach "places the burden created by the debtor's indecision on the lessor and contravenes clear Congressional intent that the debtor timely perform all of its obligations until rejection or assumption."[201] Finally, making rejection effective as of the date the court approves it creates "a degree of factual certainty in determining the actual date of rejection."[202] Court approval substitutes for the pre-Code practice that required courts to examine the parties' words, conduct and circumstances to determine if rejection had occurred.[203]

### C. Rejection Effective When Court Approves It But Retroactive to Date of Debtor's Motion

Some courts (including two Circuits) think they have found a way to serve both masters. They hold rejection only occurs upon court approval *but*, based on the equities, the court can make the rejection retroactive.[204] In *In re Amber's Stores*,[205] for example, the debtor, prepetition, had vacated the premises

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198 *Id.* at 605. *See also In re* 1 Potato 2, Inc., 58 B.R. 752 (Bankr. D. Minn. 1986).

199 *See, e.g., In re* Federated Dep't Stores, Inc., 131 B.R. 808 (S.D. Ohio 1991); *In re* Four Star Pizza, Inc., 135 B.R. 498 (Bankr. W.D. Pa. 1992); *In re* Worths Stores Corp., 130 B.R. 531 (Bankr. E.D. Mo. 1991); *In re* Virginia Packaging Supply Co., 122 B.R. 491 (Bankr. E.D. Va. 1990); *In re* Revco D.S., Inc. 109 B.R. 264 (Bankr. N.D. Ohio 1989); *In re* National Oil Co., 80 B.R. 525 (Bankr. D. Colo. 1987).

200 *In re* Florida Lifestyle Apparel, Inc., 221 B.R. 897, 900 (Bankr. M.D. Fla. 1997), quoting *Worths Stores*, 130 B.R. at 533-534.

201 Pasadena Town Square v. Tobago Bay Trading Co. (*In re* Tobago Bay Trading Co.), 142 B.R. 528, 532-33 (Bankr. N.D. Ga. 1991).

202 *In re* Revco D.S., Inc., 109 B.R. 264, 269 (Bankr. N.D. Ohio 1989).

203 *Id.*

204 *See, e.g.,* Pac. Shores Dev., LLC v. At Home Corp. (*In re* At Home Corp.), 392 F.3d 1064 (9th Cir. 2004); Thinking Machs. Corp. v. Mellon Fin. Servs. Corp (*In re* Thinking Machs. Corp.), 67 F.3d 1021, 1028 (1st Cir. 1995); Stonebriar Mall Ltd. P'ship v. CCI Wireless, LLC (*In re* CCI Wireless, LLC), 297 B.R. 133 (Bankr. D. Colo. 2003); *In re* New Valley Corp., 2000 U.S. Dist. LEXIS 12663 (D.N.J. Aug. 31, 2001); Constant L.P. v. Jamesway Corp. (*In re* Jamesway Corp.), 179 B.R. 33, 39 (S.D.N.Y. 1994); *In re* O'Neil Theatres, Inc., 257 B.R. 806 (Bankr.

and given the keys to the lessor. The equities, according to the court, would lead it to adopt the minority position "so as not to reward a lessor for the time it takes the debtor to get a court order."[206] The court wondered out loud why it should penalize the debtor when the debtor took unequivocal action to reject the lease, it was receiving no benefit from the premises and it had filed a motion to reject with the court. The court answered its own question. The Bankruptcy Code and Rules required it.[207] The court chose not to succumb to the minority rule despite its allure because that would mean no certainty for either party. Making rejection effective upon court order would allow the lessor to re-let without fear that it had "entered into two contracts for the same lease space with two different parties."[208] Still, a small voice cried out in the wilderness and the court responded to its call:

> [T]he rule stated above is the right one, but under the facts in this case, where the debtor vacated the premises and turned over the keys to the landlord over a month before the petition was filed, the debtor should not be permanently penalized by the time lag between filing a motion and the entry of an order by the court. In answer to this, the Court finds that nothing precludes a bankruptcy court, based on the equities of the case, from approving the trustee's rejection ... retroactively to an earlier date. [This approach] may help meld the reasoning in the two lines of cases that have developed in this area ....[209]

This approach has the drawback of creating uncertainty for commercial lessors.[210] For example, suppose a lessor receives notification that the debtor intends to reject and has vacated the premises. To mitigate its damages, the lessor wants to relet the premises as soon as possible. However, the lessor's ability to relet the premises depends on the debtor's rejection becoming effective, which itself depends on court approval. Theoretically anyway, the court could deny the debtor's motion to reject. Moreover, until rejection, the leasehold remains an asset of the bankruptcy estate. Thus, until the court approves rejection, the lessor relets the premises at its own risk—risk of exposure to its prospective tenant for failure to deliver the premises, and risk of liability for a willful violation of the automatic stay. If rejection is only effective upon entry of a court order, the lessor is at least compensated, via section 365(d)(3)'s "timely performance" requirement, for its inability to mitigate damages pending formal rejection. If the court backdates the effective date of rejection, the lessor is not compensated for the time the leased premises sat vacant pending court approval of the rejection. Equitable retroactivity is a fact-

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E.D. La. 2000); *In re* Amber's Stores, Inc., 193 B.R. 819 (Bankr. N.D. Tex. 1996); *In re* Garfinckels, 118 B.R. 154 (Bankr. D.D.C. 1990).

205 193 B.R. 819 (Bankr. N.D. Tex. 1996).

206 *Id.* at 826.

207 *Id.*

208 *Id.* at 827.

209 *Id.*

210 *See, e.g.,* Mary O. Guynn, *In re Thinking Machines: The Only Thought is in the Name*, 14 BANK. DEV. J. 227 (1997).

sensitive remedy. Courts apply it on a case-by-case basis.[211] How can lessors plan their future course of conduct?

Although no court has articulated a test for determining when equitable retroactivity is appropriate, the Ninth Circuit has identified three grounds that tend to support a bankruptcy court's use of its equitable powers.[212] As part of an aggressive growth strategy, in early 2000, the debtor in *At Home* had leased two buildings and escrowed nearly $20 million to fund renovation of the buildings to accommodate its business. When it petitioned for chapter 11 relief in September 2001, the renovations were nearly complete but the debtor had yet to occupy the premises. Prepetition, the debtor did not furnish its lessor with a formal surrender notice because it feared the lessor would convert into rent the more than $1 million remaining in the escrow account for remodeling. That conversion apparently took place on the same day that the debtor filed its bankruptcy petition. Along with its petition, the debtor had filed an emergency motion for an order authorizing rejection of the two leases. The debtor asked the court to make the rejection effective as of the petition/motion date. Retroactive rejection would preclude the lessor from receiving more than $1 million in administrative rent for unoccupied premises. The bankruptcy court granted the debtor's request.

The Ninth Circuit affirmed the bankruptcy court's retroactive order. First, the court noted the absence of any delay between the debtor's bankruptcy filing and its motion to reject. The debtor had attempted to set its motion for hearing as soon as possible. Second, The leased premises were vacant. Even though the automatic stay precluded the landlord from reletting the premises pending formal rejection, as a practical matter, the debtor's vacancy made it easier for the lessor to relet the buildings. Finally, the court considered the lessor's conduct and motives. The lessor opposed retroactive relief because it wanted to run up its administrative rent claim, not because it wanted to relet the premises as soon as possible. Accordingly, the bankruptcy court did not abuse its discretion when it made the rejection retroactively effective.

The Ninth Circuit stopped short of establishing any bright-line test:

> As did the First Circuit in *Thinking Machines*, "we eschew any attempt to spell out the range of circumstances that might justify the use of a bankruptcy court's equitable powers in this fashion." We likewise eschew any attempt to limit the factors that a bankruptcy court may consider when balancing the equities in a particular case. We need not and do not decide whether any one of the factors on which the bankruptcy court relied, standing alone, would justify an exercise of discretion. But in combination those factors supported the court's equitable decision.[213]

## VI. Debtor-tenant's Right to Assign a Lease of Real Property for a Use Other Than that Specified in the Lease

### A. The Issue

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211 *In re* Thinking Machs. Corp., 67 F.3d 1021, 1029 n. 9 (1st Cir. 1995).

212 Pacific Shores Dev., LLC v. At Home Corp. (*In re* At Home Corp.)392 F.3d 1064 (9th Cir. 2004).

213 *At Home Corp*., 392 F.3d at 1075 (internal citations omitted).

Section 365(f)(1) allows the trustee (or DIP) to assign an unexpired commercial lease notwithstanding any provision in the lease "or in applicable law, that prohibits, restricts, or conditions the assignment of such … lease …." To assign a lease, the trustee (or DIP) must assume it and provide "adequate assurance of future performance by the assignee…."

Congress did not define "adequate assurance of future performance" in the typical assignment context. However, in the legislative history for § 365(b) (requiring adequate assurance of a debtor's future performance to assume a lease in default), Congress indicated: "[i]f a trustee is to assume a contract or lease, the courts will have to insure [sic] that the trustee's performance under the contract or lease gives the other contracting party the full benefit of the bargain."[214]

Section 365(b)(3) defines "adequate assurance of future performance" in the context of "shopping center leases" as including "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 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.[215]

By negative implication, assignment of a non-shopping-center lease does *not* require each of these elements. But surely it must require *some* of them. It would seem strange, for example, if "adequate assurance of future performance under the lease" did not require demonstrating one's ability to pay the rent due under the lease for the foreseeable future as required by subparagraph (A). Surely rent is one of the key elements of the nondebtor lessor's bargain. But what of (C), requiring strict compliance with use clauses? Does that apply only to shopping center leases because such use clauses represent an essential and unique element of a shopping center lessor's "bargain"? Or must assignees of "ordinary" commercial leases comply with use clauses as well?

### B. Assignment of Non-Shopping-Center Leases Containing Use Clauses

If the lease is not a shopping center lease, courts have not required strict compliance with use

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214 H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 348 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6304-05.

215 11 U.S.C. § 365(b)(3) (emphasis added).

clauses unless the objecting lessor can prove substantial harm will result from noncompliance.[216] *In re U.L. Radio Corp.* is instructive.[217] The debtor (Debtor) operated a television sales and service store in a 170 unit apartment building which also contained a grocery store, a Chinese restaurant and a liquor store. Debtor's lease contained a clause restricting use of the premises to television service and sale of electrical appliances. As part of a liquidating chapter 11 plan, Debtor proposed to assign its lease to a restaurant company (Assignee) who wished to operate a small bistro on the premises. The assignment would generate enough money to provide a 100% payout to the estate's creditors over the life of the plan. Moreover, Assignee's president executed a personal guarantee in favor of the lessor (Lessor) for payment of the first two years' rent, as well as a statement that her net worth exceeded $50,000. To comply with a lease term that provided that "any noise emanating from said premises shall be deemed a breach of the terms and conditions of this Lease," Assignee allocated $20,000 for construction, including soundproofing. Assignee's vice president was a noted interior designer whose work included commercial restaurant design as well as soundproofing. Lessor nonetheless objected to the assignment, ostensibly because the restaurant would disrupt its desired commercial "tenant mix." (Lessor's building was residential, not a shopping center.)

The court noted that, beyond equating adequate assurance with the full benefit of the bargain, Congress offered no definition of the adequate assurance concept outside the context of shopping center leases. Thus,

> [a]part from shopping center leases, Congress entrusted the courts with the definition of adequate assurance of the performance of contracts and other leases. Adequate assurance of future performance are not words of art, but are to be given a practical, pragmatic construction. What constitutes "adequate assurance" is to be determined by factual conditions.[218]

The phrase "adequate assurance of future performance" was borrowed from the Uniform Commercial Code. According to UCC section 2-609, a party with reasonable grounds for believing itself insecure can demand "adequate assurance" from the other party. According to Official Comment 4, "adequate assurance" focuses on the *financial condition* of a contracting party and its ability to meet its *financial obligations*. Thus, the court concluded, "the *primary* focus of adequate assurance is the assignee's ability to satisfy financial obligations under the lease."[219] The court found that Assignee's president's guarantee, along with the money earmarked for soundproofing the premises, provided sufficient assurance of future performance of the lease's financial obligations.

But the inquiry did not end there. An assignee's financial capability may be sufficient for a finding of adequate assurance under an executory sales contract, but a landlord-tenant relationship may require more.

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216 *See, e.g., In re* Vista VI, Inc., 35 B.R. 564 (Bankr. D. Ohio 1990); *In re* Grudoski, 33 B.R. 154 (Bankr. D. Haw. 1983); *In re* Peterson's Ltd., 31 B.R. 524 (Bankr. S.D.N.Y. 1983).

217 19 B.R. 537 (Bankr. S.D.N.Y. 1982).

218 *Id.* at 542 (internal quotations and citations omitted).

219 *Id.* (emphasis added).

> Congress indicated that adequate assurance will give the landlord the full benefit of its bargain. In its case-by-case determination of those factors, beyond financial assurance, which constitute the landlord's bargain, the Court will generally consider the provisions of the lease to be assigned …. However, it is equally clear that by requiring provision of adequate assurance under section 365 … Congress did not require the Court to assure literal fulfillment of each and every term of the bargain. Section 365, by its own terms, empowers the court to render unenforceable [*ipso facto*] clauses and anti-assignment clauses which permit modification or termination of a lease for filing bankruptcy or assignment of the lease. Section 365(k) relieves the estate of liability for future breaches of a lease after assignment, notwithstanding lease provisions to the contrary.[220]

If the bankruptcy court's section 365(f)(1) power to invalidate *ipso facto* and anti-assignment clauses were interpreted narrowly, the court noted, "lessors could employ very specific use clauses to prevent assignment and thus circumvent the Code."[221] On the other hand, if all non-shopping-center use clauses were deemed *per se* unenforceable, potentially valuable elements of the lessor's bargain could go unprotected.

> [T]he Code provides no specific standard by which to measure permissible deviations in use. Whatever standard is applied must serve the policy aims of Congress. *** Section 365 expresses a clear Congressional policy favoring assumption and assignment. Such a policy will insure [sic] that potential valuable assets will not be lost by a debtor who is reorganizing his affairs or liquidating assets for distribution to creditors. … To prevent an assignment of an unexpired lease by demanding strict enforcement of a use clause, and thereby contradict clear Congressional policy, a landlord or lessor must show that *actual and substantial detriment* would be incurred by him if the deviation in use was [sic] permitted.[222]

Lessor failed to demonstrate any such harm. The use of the premises as a bistro, properly soundproofed, would have no adverse effect on the other tenants in the building. Accordingly, Lessor could not use the use clause to block the assignment.

### C. So You Want to Be a Shopping Center…

Section 365(b)(3) imposes significant restrictions on the assignment of a shopping center lease but does not define "shopping center." According to the legislative history, Congress recognized that assignment of a shopping center lease to an outside party could adversely affect other shopping center tenants.

> A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as

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220 *Id.* at 543 (internal quotations and citations omitted).

221 *Id.*

222 *Id.* at 544 (internal citations omitted, emphasis added).

> important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus, higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement.[223]

Taking their cue from this tidbit of legislative history, the courts have identified a number of factors that tend to indicate a relationship between retail tenants sufficient to invoke section 365's protections. *In re Joshua Slocum, Ltd.*,[224] the leading case, provides the following list of factors indicating the presence of a shopping center lease:

(a) A combination of leases;
(b) All leases held by a single landlord;
(c) All tenants engaged in the commercial retail distribution of goods;
(d) The presence of a common parking area;
(e) The purposeful development of the premises as a shopping center [does this beg the question?]
(f) The existence of a master lease;
(g) The existence of fixed hours during which all stores are open;
(h) The existence of joint advertising;
(j) [no (i) in original] Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;
(k) The existence of percentage rent provisions in the leases;
(l) The right of the tenants to terminate their leases if the anchor tenant terminates its lease;
(m) Joint participation by tenants in trash removal and other maintenance;
(n) The existence of a tenant mix; and
(o) The contiguity of the stores.[225]

In *Joshua Slocum*, the bankruptcy court had concluded the stores in question did not constitute a "shopping center," largely due to their physical location along "Main Street." The Third Circuit remanded for reconsideration in light of all of the above factors, emphasizing that physical resemblance to a shopping mall, though probative, was not determinative of "shopping center" status under the Code.

### D. Assignment of Shopping Center Leases Containing Use Clauses

Once it is established that a given lease is part of a shopping center, courts are more reluctant to question the validity of restrictive use clauses.[226] At least the Fourth Circuit was in its recent decision, *Congress Financial Corp. v. West Town Center, LLC (In re Trak Auto Corp.)*.[227]

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223 H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 348 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6305.

224 922 F.2d 1081 (3d Cir. 1990).

225 *Id.* at 1087-88.

226 *See, e.g., Joshua Slocum*, 922 F.2d at 1090; *In re* Heilig-Meyers Co., 294 B.R. 660 (Bankr. D. Va. 2001); *In re* Sun TV & Appliances, Inc., 234 B.R. 356, 370-71 (Bankr. D. Del. 1999); *In re* J. Peterman Co., 232 B.R. 366 (Bankr. D. Ky. 1999).

227 367 F.3d 237 (4th Cir. 2004).

In *Trak Auto*, the debtor (Debtor) operated an auto parts store in a shopping center. Debtor's lease limited permissible uses of the premises to "sale at retail of automobile parts and accessories and such other items as are customarily sold by Tenant at its other Trak Auto stores." After filing its chapter 11 petition, Debtor closed the store at issue, and sought to assign the lease to the highest bidder. Debtor solicited and received bids, but none from auto parts retailers. The high bidder was an apparel merchandiser who wished to open a "Pay Half" store on the premises to sell brand name family apparel at discount prices. Debtor moved to assume and assign. The lessor objected. It argued the proposed assignment would contravene the lease's restrictive use clause in violation of section 365(b)(3)(C). Moreover, it would disrupt the tenant mix in violation of section 365(b)(3)(D).

The bankruptcy court held an evidentiary hearing. It found the shopping center was located in urban Chicago, where only 59% of the population owned cars. The center was surrounded by competing shopping centers not owned by Lessor. The other 25 tenants of the center included clothing stores, food vendors, a K-Mart, a laundromat, a travel agency, a bank, a payday loan agency, an adult entertainment outlet, and a public library branch. Although Trak Auto was the center's only auto parts store, there were seven others within three miles of the center. Based upon these findings, the bankruptcy court concluded that the lease's use restrictions amounted to anti-assignment provisions that section 365(f)(1) prohibited. That no auto parts retailer had bid on the lease indicated the market in the area was saturated and could not bear the restriction limiting the use of the premises to the sale of auto parts. Accordingly, the court granted Debtor's motion to assume and assign. The district court affirmed.

The Fourth Circuit began by looking at the "interesting history of Congress's efforts to protect shopping center landlords." As enacted in 1978, section 365(b)(3)(C) required debtors to show only that assignment of the lease would not "breach *substantially* any provision, such as radius, location, use or exclusivity provision, *in any other* lease." This language enabled debtors to avoid section 365(b)(3)(C) by arguing the proposed assignment would only *insubstantially* breach a use clause, or it would not breach a use clause of any *other* lease as required by the statute. Commercial lessors lobbied Congress to change this practice of avoiding use restrictions, maintaining that it created problems with tenant mix in affected shopping centers. In 1984, Congress removed the word "substantially" from section 365(b)(3)(C), and provided that the assigned lease would remain subject to all of its own conditions as well as those of the other shopping center tenants.

Against this backdrop, the court "resolved" the conflict between section 365(f)(1)'s general rule invalidating anti-assignment clauses and section 365(b)(3)(C)'s specific rule effectively requiring the assignee to take the shopping center lease *cum onere*. Invoking the "specific controls the general" canon of statutory construction, the court concluded that assignment should be denied -- period, end of sentence -- if the assignee did not intend to observe the use restriction in the lease.

> According to the bankruptcy court, the market has turned the use restriction into an anti-assignment clause that is unenforceable under § 365(f)(1). This analysis overlooks that [Lessor] made the judgment that an auto parts retailer is important to a successful mix of stores in the center. And, in its lease with [Debtor], [Lessor] successfully negotiated to have the leased space dedicated to the sale of auto parts. [Lessor] insists that this use restriction be honored by any

assignee … and that is [Lessor's] right under § 365(b)(3)(C), regardless of market conditions.[228]

Finding this issue dispositive, the court did not pass on the bankruptcy court's factual finding that the proposed assignment would not disrupt the center's "tenant mix." Strangely, the court seemed to leave the door open for future application of section 365(f)(1)'s rule to shopping center leases.

> The special protection for shopping center landlords, as spelled out in § 365(b)(3)(C), dictates the result in today's case. But this does not mean that § 365(f)(1) can never be used to invalidate a clause prohibiting or restricting assignment in a shopping center lease. A shopping center lease provision designed to prevent any assignment whatsoever might be a candidate for the application of § 365(f)(1). For example, Senator Hatch, in explaining the 1984 amendment … said that the amendment is not intended to enforce requirements to operate under a specified trade name.[229]

We do not think *Trak Auto* will be the last word on this issue. First of all, if the impetus behind the 1984 amendments was to protect shopping center tenant mixes, shouldn't it matter (at least a little?) if the bankruptcy court finds, as a fact, that an assignment will not disrupt the tenant mix? Second, even the court noted section 365(f)(1) might be brought to bear when a lease provision prevented any assignment whatsoever.[230] But didn't the bankruptcy court conclude just that? According to the court, the absence of an auto parts retailer bidder meant the use clause barred *any* assignment whatsoever. It is not hard to imagine that carefully drafted use clauses will (have already?) become a popular method of avoiding bankruptcy entanglement.

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228 *Id.* at 244.

229 *Id.* at 245 (internal citations and quotations omitted).

230 In *In re* Rickel Home Ctrs., 240 B.R. 826 (Bankr. D. Del. 1998), *aff'd on other grounds*, 209 F.3d 291 (3d Cir. 2000), the court concluded the use restrictions in the shopping center leases were so restrictive as to constitute unenforceable restrictions on assignment. In reaching its conclusion, the court relied on the lower court's holding in *Auto Trak*. As noted, the Fourth Circuit reversed the lower courts in *Auto Trak.*