

# **Real Estate in Bankruptcy**

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Stinson LLP | Washington, D.C.

# Hon. Melanie L. Cyganowski (ret.)

Otterbourg P.C. | New York

# Hon. Heather Z. Cooper

U.S. Bankruptcy Court (D. Vt.) | Burlington

## Hon. Elizabeth L. Gunn

U.S. Bankruptcy Court (D. D.C.) | Washington

## Hon. Brendan Linehan Shannon

U.S. Bankruptcy Court (D. Del.) | Wilmington

# REAL ESTATE IN BANKRUPTCY MATERIALS September 27, 2024 | Washington, D.C.

Marc E. Albert, Moderator Stinson LLP   Washington, D.C.	Hon. Elizabeth L. Gunn U.S. Bankruptcy Court (D.D.C.)   Washington
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View from the Bench: Lease Acceptance / Rejection Deadline

## **Introduction**:

A debtor in bankruptcy may assume, reject, or assign an executory contract or lease pursuant to § 365.1 A debtor-in-possession ("DIP")2 may assume, reject, or assign a lease either by motion or by proposing the lease treatment in a plan. For leases of nonresidential real property, § 365(d)(4) gives a DIP 120 days from the petition date or until the date of plan confirmation to assume or reject its leases.3 If a lease is neither assumed nor rejected by the expiration of this period, the lease is deemed rejected.4 The bankruptcy court may extend this deadline by 90 days "for cause" and after the expiration of that period, the lessor must consent to any further extension of time.5 In considering whether to grant a 90-day extension, a DIP must receive a "reasonable time" in which to decide how to treat a lease.6 What constitutes a "reasonable time" depends on the facts and circumstances of each case.7 A party, usually a lessor, may also move the court to shorten a DIP's deadline.8 Such requests are rarely granted because the movant bears the burden of showing "cause" and the DIP still must have a "reasonable time" to determine whether to accept or reject a lease.9

<sup>&</sup>lt;sup>1</sup> Unless otherwise indicated, all statutory references are to Title 11 of the United States Code (the "Bankruptcy Code") and all references to "Rules" are to the Federal Rules of Bankruptcy Procedure. *See* Fed. R. Bankr. P. 9014, 6006(a).

<sup>&</sup>lt;sup>2</sup> This document mainly describes the timing of assumption and rejection of commercial leases in chapter 11 bankruptcy cases. The term "debtor" and "DIP" are used interchangeably to describe the entity or entities seeking to assume or reject a lease of nonresidential real property as that term is understood in the context of the Bankruptcy Code.

<sup>&</sup>lt;sup>3</sup> The Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, signed into law on December 27, 2020, briefly extended the initial § 365(d)(4) deadline to 210 days. This provision expired on December 27, 2022 and reverted to the 120-day period provided by BAPCPA. However, the 210-day period continues to apply in cases in subchapter V. At least one court which has considered the split has decided the 210-day period continues to apply in traditional chapter 11 cases filed before the sunset date, reasoning it would be absurd for Congress to provide such relief to the debtors who need it the least, while depriving it to those which need it most. *See In re Vital Pharmaceuticals, Inc.*, 651 B.R. 847, 854 (Bankr. S.D. Fla. 2023). In cases under chapter 7, the deadline for assumption or rejection is governed by § 365(d)(1) and is generally 60 days.

<sup>&</sup>lt;sup>4</sup> § 365(d)(4).

<sup>&</sup>lt;sup>5</sup> *Ibid*.

<sup>&</sup>lt;sup>6</sup> In re Theatre Holdings Corp. v. Mauro, 681 F.2d 102, 105 (2d Cir. 1982) (reaff'd by South St. Seaport Ltd. Pshp. v. Burger Boys (In re Burger Boys), 94 F.3d 755, 761 (2d Cir. 1996)).

<sup>&</sup>lt;sup>7</sup> In re Dunes Casino Hotel, 63 B.R. 939, 950 (D. N.J. 1986).

<sup>8 § 365(</sup>d)(2).

<sup>&</sup>lt;sup>9</sup> See In re Memory Lane of Bremen, LLC, 535 B.R. 901, 905-906 (Bankr. N. D. Ga. 2015) (denying lessor's motion to shorten deadlines on account of pending dispute as to whether properties subject to leases were "nonresidential leases of real property" within the meaning of § 365(d)).

The legislative history of § 365(d)(4) illustrates how Congress balanced the interest of the tenant-debtor in effective reorganization with the landlord's interest in speed and certainty. Under the former Bankruptcy Act, the trustee had a "reasonable time" within which to assume or reject a lease, determination of which was left to the discretion of the court. 10 Under the 1984 version of the Code, debtors had 60 days to decide whether to assume or reject nonresidential real property leases, but the bankruptcy court had discretion to extend the deadline for cause. 11 Congress intended these amendments to address two issues: "1) the long-term vacancy or partial operation of space by a bankrupt tenant and 2) the failure of the trustee or debtor in possession to pay rent after vacating the premises but prior to its decision to assume or reject."<sup>12</sup> In practice, bankruptcy courts often extended the deadline so that debtors had a "reasonable time" to decide whether to assume or reject a lease, especially in large chapter 11 with many leases. 13 In response to the interests of landlords, and perceiving that courts were extending this deadline too liberally, Congress lengthened the deadline in § 365(d)(4) from 60 to 120 days, but restricted courts' discretion to one 90-day extension. 14 Some commentators at the time praised the amendment because it protected landlords and incentivized DIP lenders to finance cure payments more quickly.<sup>15</sup> Others argued the revision made large debtors unable to make effective business judgments with respect to large numbers of leases, and discouraged DIP lenders from financing cases with many leases. 16 In late 2020, Congress extended the § 365(d)(4) deadline to 210 days for two years in response to the COVID-19 pandemic, but these changes have expired, reverting the deadline back to 120 days.<sup>17</sup>

<sup>&</sup>lt;sup>10</sup> Theatre Holdings, 681 F.2d at 105.

<sup>&</sup>lt;sup>11</sup> 3 Collier on Bankruptcy ¶ 365.05; see also Wendy Tien, Treatment of Unexpired Leases: Post-Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 54 U.S. ATT'YS BULL. 35 (2006).

<sup>&</sup>lt;sup>12</sup> In re Player's Poker Club, Inc., 636 B.R. 811, 822 (Bankr. C.D. Cal. 2022) (quoting In re At Home Corp., 392 F.3d 1064, 1068 (9th Cir. 2004)).

<sup>&</sup>lt;sup>13</sup> Tien, 54 U.S. ATTY'S BULL. at 35.

<sup>&</sup>lt;sup>14</sup> Steven E. Ostrow, What You Need to Know about the Treatment of Commercial Leases under the Bankruptcy Reform Act, 22 Prac. Real Est. Law. 27, 28-29 (2006).

<sup>&</sup>lt;sup>15</sup> Jordan M. Kirby, *Unexpired Leases under the New Bankruptcy Act: A Win-Win for Landlords and Lenders*, 10 N.C. BANKING INST. 379, 381 (2006); *but see* Margaret Howard and Lois R. Lupica, *Bankruptcy: Cases and Materials* 607-609 (6th ed. 2015) (excerpting Kara R. Bruce, *Rehabilitating Bankruptcy Reform*, 13 Nev. L. J. 174, 202-207 (2012)) (arguing revised § 365(d)(4) makes DIP lending a less profitable prospect by restricting a DIP's ability to market its leases, especially in large retail cases).

<sup>&</sup>lt;sup>16</sup> Bruce, 13 Nev. L. J. at 202-207.

<sup>&</sup>lt;sup>17</sup> See n. 2.

Other provisions of the Bankruptcy Code interact with § 365(d)(4). Most significantly, debtors must continue to "timely perform all the obligations of the debtor." Depending upon the circumstances and specifically whether debtors can meet lease obligations, § 365(d)(3) may prevent lease assumption. The 120-day exclusivity period imposed by § 1121(c)(1) for a debtor to propose a plan and the 180-day timeline for that plan to be accepted imposed by § 1121(c)(2) may also impact lease decisions. When formulating a plan, a debtor must take lease treatment into account, so even if a debtor can demonstrate "cause" for extending the § 365(d)(4) deadline by 90 days, it may need to seek separate relief to extend the exclusivity period for filing a plan. Under § 503(b)(7), Lessor damages as post-petition administrative expenses are capped at two years' rent with any amount more than the cap subject to limitation under § 502(b)(6). This provision may allow debtors greater flexibility either in negotiations or plan treatment to effectuate a more predictable outcome if the debtor rejects the lease. Finally, § 365(b)(1)(A) allows debtors to request up to 60 days to perform post-petition lease obligations. This provision allows debtors limited additional time to consider whether to assume or reject a lease even if they are not able to meet their lease obligations as of the petition date.

## The "For Cause" Extension Standard of § 365(d)(4)(B)(i):

A bankruptcy court has discretion to grant or deny a motion for a 90-day extension of time under § 365(d)(4) even if the debtor is not current on post-petition lease obligations. <sup>19</sup> In exercising its discretion, the court considers a number of factors, including: "(1) whether the debtor was paying for the use of the property; (2) whether the debtor's continued occupation ... could damage the lessor beyond the compensation available under the Bankruptcy Code; (3) whether the lease is the debtor's primary asset; and (4) whether the debtor has had sufficient time to formulate a plan of reorganization."<sup>20</sup> In addition to these factors, some cases may be suitable for the court to consider "the complexity of the case facing the debtor, the number of leases that the debtor must evaluate, and "the need for judicial determination of whether a lease exists."<sup>21</sup>

<sup>&</sup>lt;sup>18</sup> § 365(d)(3). This provision applies regardless of the rent cap imposed by § 503(b)(1), but does not require the DIP to meet the types of obligations described in § 365(b)(2).

<sup>&</sup>lt;sup>19</sup> This rule applies in the Second Circuit. *See Burger Boys*, 94 F.3d at 761. At least one other circuit has followed similar reasoning, *see In re Channel Home Centers, Inc.*, 989 F.2d 682 (3rd Cir. 1993) (following *In re Wedtech Corp.*, 72 B.R. 464, 471 (Bankr. S.D.N.Y. 1987)).

<sup>&</sup>lt;sup>20</sup> *Ibid.*; see also Theatre Holding 681 F.2d at 102 (internal quotation marks omitted).

<sup>&</sup>lt;sup>21</sup> *Ibid.*; see also Wedtech Corp., 72 B.R. at 471.

Burger Boys, the case setting out this standard in the Second Circuit, involved a dispute between one debtor and one landlord. Burger Boys, the tenant-debtor, refused an offer from its landlord to leave the premises while the building underwent renovations.<sup>22</sup> The tenant-debtor stopped paying rent and the landlord started an eviction proceeding in state court; the tenant-debtor asserted counterclaims. 23 Just before trial in state court, the tenant-debtor filed chapter 11.24 Several months later, the tenant-debtor filed an adversary proceeding against the landlord, asserting substantially the same counterclaims as in the state court case. 25 The parties engaged in protracted litigation over the correct forum for the dispute.<sup>26</sup> During this time, the tenant-debtor received extensions of the § 365(d)(4) deadline.<sup>27</sup> After the district court affirmed the bankruptcy court's decision to abstain from hearing the adversary proceeding, the bankruptcy court entered an order requiring the tenant-debtor to become current on post-petition rent within a few weeks or risk having its lease deemed rejected.<sup>28</sup> When the tenant-debtor failed to pay this rent, the bankruptcy court deemed its lease rejected and the tenant-debtor appealed.<sup>29</sup> The district court reversed the bankruptcy court and allowed the tenant-debtor a period of time to accept or reject the lease, and the landlord appealed.<sup>30</sup> In affirming the district court, the Second Circuit's central holding was that the bankruptcy court had erred as a matter of law in deciding that the tenant-debtor had rejected the lease because it had not made post-petition rent payments.<sup>31</sup> It remanded the case to the district court to determine the debtor's capacity to make cure payments under § 365(b) before allowing it to assume the lease.<sup>32</sup>

In *Burger Boys*, the Second Circuit relied upon and reaffirmed its pre-1984 amendment decision in *Theatre Holding Corp. v. Mauro*, 681 F.2d 102 (2d Cir. 1982). In that case, the DIP was a holding company for land and its main asset was a ground lease.<sup>33</sup> In giving the DIP only 30 days to decide whether to assume or reject this lease, the bankruptcy court may have erred because

<sup>&</sup>lt;sup>22</sup> Michael N. Gottfried & Andrew N. Goldman, In Re Burger Boys: *Are Landlords Being Grilled in the Second Circuit*, 63 BROOK. L. REV. 437, 442 (1997).

<sup>&</sup>lt;sup>23</sup> *Ibid*.

 $<sup>^{24}</sup>$  Ibid.

<sup>&</sup>lt;sup>25</sup> *Ibid*.

<sup>&</sup>lt;sup>26</sup> Ibid.

<sup>&</sup>lt;sup>27</sup> *Id* at 443.

<sup>&</sup>lt;sup>28</sup> *Id.* at 443-444.

<sup>&</sup>lt;sup>29</sup> *Ibid*.

<sup>&</sup>lt;sup>30</sup> Ibid.

<sup>&</sup>lt;sup>31</sup> *Ibid*.

<sup>&</sup>lt;sup>32</sup> Burger Boys, 94 F.3d at 764.

<sup>&</sup>lt;sup>33</sup> Theatre Holdings, 681 F.2d at 106.

it did not give the DIP a reasonable time to make this decision.<sup>34</sup> However, the appeals court did not explicitly decide this issue because the pendency of the appeal had been over a year; the court reasoned that was enough time for a DIP to formulate a plan, and that remanding with instructions to provide the DIP with more time would be inappropriate.<sup>35</sup> This case also held that cases under the former Bankruptcy Act delineating what constitutes a "reasonable time" in the context of lease treatment remained good law under the Bankruptcy Code.<sup>36</sup>

## **Recent Cases**

Bankruptcy courts use different approaches to tailor the § 365(d)(4) deadline to specific cases, especially those with large numbers of leases to assess.<sup>37</sup> In emergency situations, such as the COVID-19 pandemic, some courts have allowed debtors to make catchup payments on their lease obligations or suspend their cases by using their equitable power under § 105(a). Other courts have found § 105(a) does not allow the bankruptcy court to alter state law lease obligations, even in emergency situations. Outside of the emergency context, courts have deferred to the DIP's business judgment in approving DIP motions to assume leases.

*In re Pier 1 Imports, Inc.*, Case No. 20-30805, 615 B.R. 196 (Bankr. E.D. Va. Mar. 31, 2020):

This retail debtor entered bankruptcy on February 17, 2020, expecting to exit within a few months after an asset sale or equitizing its lenders.<sup>38</sup> However, this strategy fell apart when COVID-19 forced many retail businesses to shut down almost completely and overnight.<sup>39</sup> The DIP in this and other cases struggled merely to keep the estate's *status quo* during the steep decline in sales.<sup>40</sup> In an attempt to keep the case on track, the DIP proposed drastically reducing its expenses. This plan included paying certain landlords less than the amounts required under their lease obligations, furloughing many employees, and paying only "critical expenses" as laid out in a limited-scope operating budget.<sup>41</sup> Under this order, the DIP incurred the obligation to pay rent

<sup>&</sup>lt;sup>34</sup> *Ibid*.

<sup>&</sup>lt;sup>35</sup> *Ibid*.

<sup>&</sup>lt;sup>36</sup> *Id.* at 106.

<sup>&</sup>lt;sup>37</sup> Luke G. M. Johnson, *Covid-19 Highlighted Fundamental Failures in Sec. 365 of the Bankruptcy Code: Utilizing Option-Value Theory to Assume or Reject Executory Contracts in Bankruptcy*, 2022 U. ILL. L. REV. 897 (2022). <sup>38</sup> *In re Pier 1 Imports, Inc.*, 615 B.R. 196, 198 (Bankr. E.D. Va. 2020).

<sup>39</sup> Ihid

<sup>&</sup>lt;sup>40</sup> Id.; see also In re CraftWorks Parent, LLC, Case No. 20-10475 (BLS) (Bankr. D. Del. Mar. 20, 2020), ECF No. 174.

<sup>&</sup>lt;sup>41</sup> *Id.* at 199.

pursuant to its leases; the court's order merely allowed the DIP to defer paying certain lease obligations during the crisis.<sup>42</sup> The DIP credibly represented to the court that it would have the ability to make catchup payments within a month after the limited operations period ended in June, 2020. The court entered the order after finding the plan complied with § 365(d)(3) because that section does not compel debtors to pay rent in accordance with their lease agreements.<sup>43</sup> it merely gives lessors an administrative expense claim subject to limitation by § 502(b)(6).<sup>44</sup>

## In re Modell's Sporting Goods, Inc., Case No. 20-14179 (Bankr. D. N.J. Mar. 23, 2020):

This retail debtor petitioned for bankruptcy relief, intending to liquidate in chapter 11, on March 11, 2020, at the outset of the COVID-19 pandemic. Within a matter of days, it moved to suspend its bankruptcy case because of the emergency response to the pandemic. <sup>45</sup> Debtor's motion sought to suspend all deadlines, including the lease assumption/rejection deadline, for up to 60 days in accordance with §§ 105(a) and 305. In moving for this relief, the debtor considered a drastic step – conversion to chapter 7 – but opted against it because a chapter 7 Trustee would face the same difficulties in liquidating the debtor's estate as a DIP. <sup>46</sup> The debtor also emphasized suspension did not equate to voluntary dismissal because all statutory and contractual obligations would remain in place during the suspension period. <sup>47</sup> The court found suspension a reasonable remedy in the face of an unprecedented situation because it would give all creditors room to negotiate. <sup>48</sup> The suspension of this case allowed the debtor to negotiate with its landlords and other creditors and reach a confirmed plan within 9 months of the suspension. <sup>49</sup>

### In re CEC Ent., Inc., Case No. 20-33163, 625 B.R. 344 (Bankr. S.D. Tex. Dec. 14, 2020):

The DIP, operator of a nationwide chain of Chuck E. Cheese locations, filed for chapter 11 in 2020 and sought an order "abating rent payments for stores closed or otherwise limited in operations" because of the emergency response to the COVID-19 pandemic.<sup>50</sup> Like Pier 1 Imports,

<sup>&</sup>lt;sup>42</sup> Ibid.

<sup>&</sup>lt;sup>43</sup> *Ibid*.

<sup>&</sup>lt;sup>44</sup> *Ibid*.

<sup>&</sup>lt;sup>45</sup> In re Modell's Sporting Goods, Inc., Case No. 20-14179 doc. # 115 (Bankr. D. N.J. 2020).

<sup>&</sup>lt;sup>46</sup> *Id.*, doc. # 187 at 9.

<sup>&</sup>lt;sup>47</sup> *Id.*, doc. # 187 at 20.

<sup>&</sup>lt;sup>48</sup> *Id.*, doc. # 187 at 51.

<sup>&</sup>lt;sup>49</sup> *Id.*, doc. # 827.

<sup>&</sup>lt;sup>50</sup> In re CEC Ent., 625 B.R. 348, 349 (Bankr. S.D. Tex. 2020).

this DIP faced significant restrictions on its business operations as a result of the pandemic.<sup>51</sup> However, unlike in *Pier 1*, the court found its equitable powers did not extend to any alteration of the DIP's state law obligations under its leases.<sup>52</sup> It found "the text and the intent of § 365(d)(3) are clear: commercial real property lessees must continue to perform after filing for bankruptcy. Section 365(d)(3) requires that the debtor timely perform its lease obligations."<sup>53</sup> The court also declined to alter the DIP's lease obligations under the state law *force majeure* clauses in the leases or the doctrine of frustration of purpose.<sup>54</sup>

## In re Vital Pharmaceuticals, Inc., 651 B.R. 847, 854 (Bankr. S.D. Fla. 2023):

At the outset of its bankruptcy case, this debtor had 50 leases spread across five different types of properties related to its energy drinks business.<sup>55</sup> As part of negotiating its asset sale plan, the debtor needed flexibility with regard to its leases because it did not know which potential buyers would want which of its leases.<sup>56</sup> The debtor moved for the entry of an order declaring the 210-day deadline applied, not the 120-day deadline, since the debtor had filed its case on December 10, 2022, just before the expiration of the legislation authorizing the 210-day deadline.<sup>57</sup> In declaring the 210-day period applied, the court reasoned that Congress could not have intended to extend the § 365(d)(4) deadline to 210 days only for subchapter V debtors in perpetuity, while denying this relief to traditional chapter 11 debtors, since subchapter V debtors must file a plan within 90 days, but traditional chapter 11 debtors have 120 days to file a plan.<sup>58</sup> The court also ordered the debtor had shown "cause" for a further 90-day extension of the deadline.<sup>59</sup>

## *In re Yellow Corp.*, Case No. 23-11069 (slip. op. April 19, 2024):

Judge Craig T. Goldblatt of Delaware recently allowed a DIP in a liquidating chapter 11 case to assume leases over landlord objections. The DIP is one of the largest trucking companies in the country and its assets included substantial real estate. The DIP successfully marketed and

<sup>&</sup>lt;sup>51</sup> Ibid.

<sup>&</sup>lt;sup>52</sup> Id. at 352-353.

<sup>&</sup>lt;sup>53</sup> *Id.* at 352.

<sup>&</sup>lt;sup>54</sup> *Id.* at 353-365.

<sup>&</sup>lt;sup>55</sup> Vital Pharmaceuticals, 651 B.R. at 850-851.

<sup>&</sup>lt;sup>56</sup> *Id.* at 851.

<sup>&</sup>lt;sup>57</sup> In re Vital Pharmaceuticals, Case No. 22-17842 (S.D. Fla. 2022).

<sup>&</sup>lt;sup>58</sup> Id. at 853-854.

<sup>&</sup>lt;sup>59</sup> *Id.* at 855.

sold many of these assets, many of which were leases on trucking terminals. These sales left the DIP with a significant positive cash balance. The DIP moved the court to approve the assumption of 75 leases which it planned to sell after the passing of the statutory deadline for assumption of nonresidential leases of real property. In its business judgment, the DIP felt it could get a better recovery for the estate by paying rent and meeting its other lease obligations while it allowed the market to digest the assets it had recently sold. If it could not find a buyer for the lease, the DIP reasoned it could find a suitable subtenant. After a period of time, the DIP proposed to sell the remaining leases.

In finding the DIP made a reasonable business judgment in moving to assume the leases, Judge Goldblatt distinguished § 365(d)(4) from § 365(f)(2). The former statutory deadline regards assumption; the latter governs assignment. The landlords argued the § 365(d)(4) deadline should give them certainty as to the treatment of their leases by the end of the statutory period absent their consent. The opinion, citing *In re Eastman Kodak*, 495 B.R. 618 (Bankr. S.D.N.Y. 2013), clarifies the type of certainty to which landlords are entitled under 365(d)(4) is certainty as to whether the DIP will assume or reject their lease, not total certainty.

As Judge Goldblatt noted, this case presented some unique facts: 1) the DIP entered bankruptcy intending to liquidate real estate assets in a narrow category, 2) the sale of those assets provided the DIP an argument that selling more of the same type of property too soon would decrease the recovery to the estate, and 3) the initial asset sales were successful enough to allow the DIP to continue to meet its obligations under the existing leases. Under these circumstances, the § 365(d)(4) deadline operated to force the DIP to choose how much risk it wanted to take on – how many leases it could reasonably assume. As of August, 2024, the DIP continues to attempt to market its remaining leases and settle various liability claims.<sup>60</sup>

<sup>&</sup>lt;sup>60</sup> Todd Maiden, *Yellow's Unsecured Creditors Frustrated as Professional Fees Mount*, FreightWaves (Aug. 9, 2024) <a href="https://www.freightwaves.com/news/yellows-unsecured-creditors-frustrated-as-professional-fees-mount">https://www.freightwaves.com/news/yellows-unsecured-creditors-frustrated-as-professional-fees-mount</a>.

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1	DISTRICT	BANKRUPTCY COURT OF DELAWARE
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3		Chapter 11 Case No. 23-11069 (CTG)
4		(Jointly Administered)
5		
6		Courtroom No. 7 824 North Market Street
7		Wilmington, Delaware 19801
8	Debtors	Friday, April 19, 2024 4:00 p.m.
9	II .	T OF HEARING
10		LE CRAIG T. GOLDBLATT BANKRUPTCY JUDGE
11	APPEARANCES:	
12	III	son Smith, Esquire
13	II .	LAND & ELLIS LLP LAND & ELLIS INTERNATIONAL LLP
14		Lexington Avenue York, New York 10022
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16		ley Foxman, Esquire ON & ELKINS LLP
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1	APPEARANCES (CONTINUED):		
2	For the Terreno	Common MaDamial Barrier	
3	Landlords:	Garvan McDaniel, Esquire HOGAN MCDANIEL	
4		1311 Delaware Avenue Wilmington, Delaware 19806	
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	4
1	(Proceedings commenced at 4:18 p.m.)
2	THE COURT: Good afternoon, all. This is Judge
3	Goldblatt. We are on the record.
4	So, my apologies to everyone for the technical
5	difficulties. We had just a host of technical issues here
6	with the Zoom at the Court. So my apologies for that.
7	Let me ask, is there a critical mass of folks who
8	have gotten the message and gotten back on or should we give
9	folks an additional minute or two?
LO	MR. FOXMAN: Your Honor, counsel to the Realterm
L1	Landlords. It looks like we have all of our folks on the
L2	line.
L3	THE COURT: For the debtor, I see Ms. Smith.
L4	MS. SMITH: Yes. We're good to go, Your Honor.
L 5	THE COURT: Terrific. So, I think that is
L 6	probably the most centrally involved parties. So, I am happy
L7	to proceed.
L 8	Thank you all again for your patience. Again, my
L 9	apologies for the delay on our end.
20	So, as promised or perhaps threatened, I have
21	written a decision consistent with what I said yesterday.
22	So, there should be no surprises here. And I have seen the
23	proposed form of order.
24	Before I start, is there anything about the
25	proposed form of order that I should know? Is that, you
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1	know, reserving everyone's right among the parties or are
2	there issues that we should discuss?
3	MS. SMITH: So, Your Honor, maybe I can just kind
4	of level set there. Allyson Smith, Kirkland & Ellis, for the
5	debtors.
6	The form of order that we sent to Chambers this
7	afternoon is the latest form of order that was circulated to
8	all the parties just so everybody is aware that we are
9	talking about the same document.
LO	THE COURT: Okay. And have the parties well,
ll	why don't I give you my ruling and then at the end if there
12	are issues with the proposed form of order we can address it
L3	at that time.
L4	Anything else as a housekeeping matter we should
L5	address before we launch?
16	MS. SMITH: Not from the debtors, Your Honor.
L7	MR. FOXMAN: No, Your Honor. Thank you.
18	THE COURT: So, I should say that one reason I
L 9	write probably more then my fair share of opinions is because
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20 | there is nothing that I hate more then making everyone get on a Zoom call and listen to me read. So, one of my law clerks described what we were about to get is a recording of the audio book of the opinion. So, apologies for making you all listen to this. There is a fair amount of it, but here it goes.

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So, I would like to begin by thanking counsel on all sides. The circumstances of this bankruptcy case are highly unusual. The motion before me today is one that I acknowledge I have never seen before in the more then 25 years that I have been involved in restructuring matters. We have debtors that came into Chapter 11 neither seeking to reorganize, nor seeking a going concern sale, but are instead liquidating through a series of asset sales, and we are here on a motion in which the debtors seek to assume but not yet assign approximately 75 real property leases.

While that is unusual, I am satisfied, based on the factual record before me, that the relief the debtors seek complies with the text of the bankruptcy code, applicable case law, and is a prudent exercise of the debtors' business judgment notwithstanding or even it might be argued because of its novelty. I will set out below my findings of fact and conclusions of law as the bankruptcy rules require.

So, the factual background is that the debtors here are once among the oldest and largest freight trucking companies in the nation. They sought bankruptcy protection August of 2023. When the debtors filed for bankruptcy, they had a very substantial portfolio of real estate assets.

Advised by Ducera Partners as their investment banker, the debtors broadly marketed this portfolio of assets. At the

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debtors request and without objection from any party I entered a bid procedures order that gave the debtors substantial flexibility in how they chose to market and sell their assets.

They engaged in extensive outreach to approximately 650 parties. All of the assets were taken to market in mass as the debtors wanted to see what the market would bear. These assets had been appraised at \$1.1 billion and the debtors had received a stalking horse bid of \$1.5 billion. That stalking horse bid, which was in an amount that would have covered substantially all of the debtors funded debt, was at the time a substantial accomplishment.

After receiving bids, the debtors determined to sell 118 owned properties and 35 leased properties for an amount that approached \$2 billion. That was sufficient to permit the debtors to pay off of their prepetition funded debt as well as their DIP loan and leave them now sitting with more then \$350 million in cash. Significantly, for today's purposes, it also left them with some portion of their real estate portfolio that they had elected not to sell at the best prices that they had as of then received.

With respect to the leased properties, Section 365(d)(4) of the Bankruptcy Code sets an outside limit on the time the debtors have to make a decision whether to assume or reject. For non-residential real property the code says that

a lease is deemed rejected and the Trustee shall immediately surrender that non-residential real property to the lessor if the Trustee does not assume or reject the lease by 120 days following the entry of the order for relief which period of time the Court may extent for 90 days.

While the parties have in some cases consensually extended the time beyond those deadlines, the debtors filed the motion that is now before the Court because they were bumping up against that statutory deadline. And the decision they made was to assume approximately 75 of the remaining leases. That motion is docketed at D.I. 2157.

The underlying premise is that the debtors will at some point find a buyer for these leases at which time they will seek to assign them. By assuming the leases, the debtors are taking on the obligation to continue paying rent and otherwise meeting their lease obligations while they continue to market the leases. If the debtors fail to find a buyer, they remain on the hook for the rent subject only to their ability to reject after assumption in which case Section 503(b)(7) of the Bankruptcy Code would grant the landlord an administrative claim for two years rent subject only to the landlords duty to mitigate.

The implicit business judgment in the debtors decision is that there either is or will be sufficient value in these leases that taking on all of that liability to the

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landlords is a prudent business decision notwithstanding the substantial cost and risk associated with doing so. That option is not typically available to a liquidating debtor. Indeed, I am not aware of any case in which it has even been attempted. The reason for that is that in order to assume a lease a debtor needs to provide its counterparty with adequate assurance of future performance.

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Most liquidating debtors, unsurprisingly, are unable to do that, but this is an unusual case. The liquidating debtors have satisfied their funded debt and find themselves with about \$365 million in cash plus other assets both rolling stock and owned real estate that they have not yet sold that they expect to bring in hundreds of millions of dollars in additional revenues. The practical reality is that with all of those resources at their disposal these debtors have options for maximizing value that are not typically available in liquidating cases.

A number of landlords objected to the debtors' motion to assume. The debtors were able to resolve certain of those objections. The objections that remained and that were the subject of yesterday's hearing were those filed by the Realterm Landlords at D.I. 2515, Finlayson Logistics

Assets LLC at D.I. 2243, and Terreno Realty Corporation at D.I. 2242. I will at times refer to those entities collectively as the "Objecting Landlords."

The Court yesterday held an evidentiary hearing on the motion. The Court heard testimony from a total of four live witnesses and a large stack of documents were admitted into evidence. The parties did a terrific job of resolving the evidentiary issues such that the Court was required to address only a handful of disputes with respect to evidence.

I do want to express my appreciation for the professionalism that has been demonstrated by all of the parties. I will briefly review the relevant facts based on the evidence that was presented.

One of the individuals, who played an instrumental role in the decision to assume, was Kody Kaldenberg who is a founding member of Ducera Partners, the debtors investment banker. Ms. Kaldenberg has impeccable credentials based on her work at Ducera and at Perella Weinberg before that. She has extensive experience in advising and is highly qualified to advise companies in financial distress. Her testimony, including on cross-examination, was forthright and direct.

I do not myself have the knowledge, skills or experience to form a judgment about whether Ms. Kaldenberg's predictions about what will happen in the future will turn out to be right or wrong. But I will say that as a lay person hearing the testimony without the background, training or experience of investment banker the testimony aligned with what I believe to be ordinary commonsense. It was both

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credible and persuasive.

The substance of the analysis leading to the decision to assume the leases was that the Ducera team looked on a property by property basis at the terms of all of the leases, including the duration of the lease and the economic terms, and they compared those terms to what they considered to be the prevailing market rent in each of the localities. They took account of the level of interest they had received for the property, the strategic nature of the assets fitting into potential buyers networks, the conditions of the properties and the anticipated cure costs which of course included that assessment of the properties condition.

Am important backdrop to this analysis was their judgment that the nearly \$2 billion in trucking real estate assets that Yellow had just sold may have had an impact on the market for the rest of the portfolio. It is elementary economics that a large influx in supply of an asset has the effect of driving down the market clearing price of similar assets.

As Ms. Kaldenberg put the point, they concluded that it would make sense to give the market some time to digest the assets that had just been sold before seeking to sell the rest. Their judgment was that for the leases in question giving the market this time would likely to prices that will generate greater value for the estate then their

next best alternative. And to be clear, Ms. Kaldenberg testified that their next best alternative was that the highest bids that the debtors had received for the properties in question was approximately \$100 million.

Another factor that the debtors considered was the possibility that if there were properties for which the debtors were unable to find a counterparty that would purchase the entire lease by taking an assignment they may well be able to find a tenant who would be able to sublease from the debtor which could turn out to be profitable if the leases are sufficiently below market that the difference in the rental rates would cover the costs of curing defaults and carrying the property until a subtenant is found.

Ms. Kaldenberg's testimony was that the debtors expected to be able to complete this process with respect to the 75 leases in question over a two-year period.

Unsurprisingly, her testimony was just that this was the debtors expectation. As a prediction about the future, this is subject to risk and successes not guaranteed.

In reaching these judgments with respect to individual leases, there was no single piece of information that was controlling. Ducera looked at a number of different potential sources of information. On cross-examination the landlords did an effective job of pointing out that some of the information that was available to Ducera contained

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mistakes. In light of ordinary human error some of that is to be expected, but the evidence is that the debtors consulted multiple sources of information in making a lease-by-lease determination with respect to the 75 leases at issue.

at least, some of the leases the rent that the debtors will owe over the next two years is substantially more then the highest bid the debtors received for those leases when they originally marketed the full array of real estate assets.

Indeed, for some of the leases they had received no bids at all, but the punchline here is that if the debtors are wrong in their judgment that they will seek bids for these assets when they are remarketed that exceed what they saw in their original effort then they are making a big mistake the estate will lose a great deal of money.

For reasons I will describe in further detail below, however, I am not persuaded by the contention that the debtors are making such a mistake. Rather, I believe that the record supports creating the debtors' business judgment.

The further point in terms of the process for making the business decision is that while Ducera reviewed the leases on a lease by lease basis the recommendation made to the board to assume these 75 leases was made in the aggregate. The board did not separately consider each

individual lease. The record further indicates, based on the testimony of the witnesses, that the members of the Yellow board have expertise in the trucking industry and have, at least, a working familiarity with the real estate issues involved in running a trucking business.

There is no reason to believe, however, that the trucking board -- I'm sorry, that Yellow's board has particular expertise in deciding whether a particular lease might be assumed and assigned in bankruptcy in a way that will maximize the value of the bankruptcy estate for the benefit of creditors and other stakeholders. That is the expertise that Ducera brings to the table.

In addition to the testimony of Ms. Kaldenberg the debtors also presented the testimony of Brian Whittman of Alvarez & Marsal, which is the debtors financial advisor.

Alvarez & Marsal has been responsible for assisting the debtors cash flow projections, liquidity management, reporting requirements and claims reconciliation. Mr.

Whittman leads the team and has 25 years' experience in providing such services to companies in financial distress including having served in other high profile and high stakes bankruptcy cases as chief restructuring officer or chief financial officer of various debtors.

Mr. Whittman walked through the debtors financial projections which were admitted as Debtors Exhibit 3. It

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appears that these projections were prepared in February of 2024 and based on these projections the debtors were expected to have approximately \$350 million in cash as of now. Mr. Whittman testified, however, that the projections proved to be somewhat conservative and that the debtors are, in fact, holding approximately \$365 million in cash.

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In substance these projections show from April 2024 through February of 2025 that the debtors anticipate cash outflows on account of administrative obligations including restructuring costs of something in the range of \$20 million a month on average over the length of that 11-month period. They also project, however, to bring in substantially more then that on account of the sale of rolling stock as well as interest income on the cash they are holding.

The net result then is that the debtors cash on hand is expected to grow materially over those 11 months. Specifically, the debtors project to have more then \$36 million in cash by the end of February 2025. With two exceptions the amount of the debtors cure costs and the cost of carrying insurance on the leased properties, both of which points I will discuss in greater detail below, no party challenged the projections that the debtors presented. The Court will, accordingly, proceed on the assumption that subject to those exceptions that those figures are accurate.

There are two additional projections that I want to note. In March of 2025, which is the final month of the projections, the debtors show proceeds of more then \$275 million from the sale of the owned properties that were not included in the original sale and of more then \$530 million from the sale of the leased properties including those that are the subject of the motion that is before us today.

As I understand these projections, these are listed in March of 2025 because that is the end of the projection period and the debtors wanted to capture what is, essentially, the terminal value of these assets. The record does not suggest, however, that all of these sales will be completed by that time. I am not, for the purposes of this dispute, crediting the accuracy of those estimates at all. The objecting landlords hotly dispute the suggestion that the debtors can capture more than \$500 million for the leases in question. Indeed, they argue that the debtors are likely to lose money as a result of this decision.

For the reasons I have described below, if I had to make my own prediction about the future I think the debtors are more likely to be correct about this then the are the objecting landlords, but for purposes of today's analysis and particularly for the purpose of assessing adequate assurance of future performance, which is the question to which it is relevant, I am going to proceed on the assumption

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that the leased properties will prove to be a net wash and that the debtors will receive some positive number from the sale of the owned properties. As I will explain, however, there is no need to form a judgment about whether that is likely to be one dollar or \$275 million as the debtors project or some other number.

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The other topic on which Mr. Whittman testified were the costs associated with the assumed leases. Those costs were set out on Exhibit 3 which was admitted into evidence. The spreadsheet shows that for all of the leases that the debtors proposed to assume the total cost of the lease are likely to be approximately \$79 million in the first year and \$81 million in the second.

Here, its worth noting that the \$79 million in first year expenses are already included in the debtors cash flow projections that I described above. So, the \$35 million that I mentioned earlier is what the debtors project to have on hand after paying that \$79 million. And I will add that since the time that this exhibit was prepared the debtor determined to reject some number of the real property leases. From a cash perspective that is favorable to the estate since the rejection of the lease reduces the estate's administrative obligations. For the sake of simplicity, however, in the analysis below I will use the numbers included in the exhibit which again is a conservative

assumption that understates the debtors' projected cash resources.

In addition, the spreadsheet shows substantial additional costs, I am not talking about the exhibit that listed the cost associated with the leases, that total more then \$331 million that the debtors would be required to meet if the lease obligations ran until the termination date of the leases. Here, I want to touch on two additional disputed issues.

Mr. Whittman's projections are based on the debtors assumptions about the likely cure costs. The objecting landlords argue strenuously that the properties are in much worse condition then the debtors believe and that the cure costs will be substantially greater than the debtors' project. Mr. Whittman, however, calculated that the difference between the cure costs that were built into the debtors' estimates and those asserted by the landlords comes to approximately \$50 million.

As I will describe below, in addressing the issue of adequate assurance of future performance, I will assume, without necessarily deciding, that the objecting landlords are correct about this and that the debtors will be required to pay that \$50 million in additional cure costs. That leaves only the question of insurance and, as I will describe later, that is really the only loose end that is not fully

captured by Mr. Whittman's testimony. I will discuss that issue in further detail when we address the question of adequate assurance.

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The objecting landlords also called witnesses of their own. Finlayson put on Brian Roach, who is the portfolio manager with responsibly for the Finlayson property at issue. Mr. Roach testified that the property at issue is a very large one covering 33 acres. He explained that when he has visited the property there was only one Yellow employee on the premises. He indicated that he had concerns that the property could be subject to vandalism if it is not in more active use. He added that he believed there might also be environmental liabilities associated with the property and he added that he believed that the market for similar properties was softening.

The Realterm Landlords also called a witness,
Victor Cirrincioni, who is a senior regional property manager
who has responsibility for many of the Realterm properties at
issue. He testified that certain of the properties were
generally in a state of serious disrepair and that curing the
default in terms of ongoing maintenance would involve very
substantial expense which were set forth in detail in an
exhibit that came into evidence. So, that is, at least, the
first pass at the facts.

With respect to jurisdiction the debtors motion

arises under Section 365 of the Bankruptcy Code. As such, this Court has subject matter jurisdiction under 28 U.S.C. Section 1334(b). This is a core matter under 28 U.S.C. Section 157(b). As such, in light of the standing order of reference issued by the United States District Court for the District of Delaware on February 29th, 2012 and the provisions of 28 U.S.C. Section 157 this Court has the authority to enter final judgment.

Turning to the analysis, as I said, I am going to grant the motion. I will endeavor here to walk through each of the objections that the objecting landlords have asserted as well as to explain why I have concluded that the debtors have met their burden of demonstrating that they are entitled to the relief they seek which is an order authorizing them to assume the leases.

There are, broadly speaking, two principal issues. The first is whether the debtors have properly exercised their business judgment, the second is whether the debtors have provided adequate assurance of their go-forward ability to perform under the leases. Each question involves a handful of, sort of, subsidiary legal issues. I will address those two issues in turn.

So, first, the objecting landlords offer no persuasive reason to doubt the exercise of the debtors' business judgment. Section 365(a) of the Bankruptcy Code

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authorized the Trustee, here that is the debtor-inpossession, to assume or reject the lease. The law is clear
that this decision is committed to the debtors' business
judgment which a Court should not likely second guess. As

Judge Walsh put it in <a href="Trans World Airways">Trans World Airways</a>, 261 B.R. 103, 121

Bankruptcy District of Delaware (2001): "The debtors business
judgment on decisions whether to assume or reject should be
affirmed unless it is the product of bad faith, whim or
caprese."

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Before getting into the specifics of this issue I wanted to step back and offer my big picture take on the business judgement question. I begin with the premise that most parties make basic business and litigation decisions with an eye towards maximizing their own economic self-interest. This commonsense point tells us most of what we need to know. The debtors passed up \$100 million in cash for these leases deciding that it would be better for the estate if they assumed the leases and took on all of the liability to the landlords associated with doing so because they believe that following this path is in the interest of the bankruptcy estate.

If the debtors are right about this they will capture substantial value for the benefit of the bankruptcy estate that were they to reject the leases would, otherwise, go to the landlords who upon rejection would get possession

of the properties and be able to capture whatever the market will bear for the properties. None of the parties who will suffer if the debtors are wrong about this, if they are incorrect in assuming that the leases have objected to what the debtors propose to do.

At this point in the bankruptcy case we don't know who holds the fulcrum security, but we do know that the most likely candidates, the pension funds, the UCC and the equity holders are all sophisticated entities represented by very capable professionals and all know that they are free to speak up in Court if there is an issue on which they want to be heard.

The Court can only infer from those parties silence that they either agree with or at the very least are inclined to defer to the business judgment of the debtors and their professionals about how to maximize value. It is the landlords who are objecting arguing that the debtors are making a big mistake. The problem that I have just been unable to get past is that if the landlords are correct about that then it is the landlords who would turn out to be the beneficiaries of that mistake and that cannot help but inform the way I view the landlords objection that the debtors are imprudently risking their creditors money.

Its simply strange credulity to believe that the landlords are going to the trouble of objecting to the

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debtors motion to assume because they truly believe that the debtors have made a mistake in judgment that will turn out to benefit the landlords. I should say that when I asked this question yesterday to various of the lawyers for the objecting landlords, I don't believe I received a satisfactory answer. Now, in retrospect I was probably less patient about that then I ought to have been. I do want to be very clear that all of the lawyers involved in this dispute have demonstrated the highest level of professionalism and all have done truly terrific work in representing the interest of their clients.

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The problem with the landlords challenge to the debtors' business judgment however is what it is. If the landlords actually believe that the debtors were making a mistake it would be in their own economic interest to say thank you very much and otherwise stay quiet. The fact that they are objecting as strenuously as they are necessarily supports the commonsense inference that the debtors are probably right about the judgment they are making.

That said, it is still the debtors burden to present evidence to demonstrate that they exercised sound business judgment. I find that they have met that burden. I credit Ms. Kaldenberg's testimony about how the debtors reached that judgment. While the objecting landlords raised various procedural objections to how the decision was made, I

do not find anything irregular or improper in how the debtors, working with their advisors, reached this decision. There is no suggestion in the record that the decision was the result of, in Judge Walsh's words, "bad faith, whim or caprese."

As I noted, when I walked through Ms. Kaldenberg's testimony, the strategy of waiting till the market has digested the results of the initial sale accords with ordinary commonsense. The objecting landlords are, of course, correct that there is a great deal of law suggesting that ordinarily the best measure of an assets value is the price it will obtain at an auction. Here, the debtors did put all of these assets out to bid after an extensive and thorough marketing process. That does not contradict the proposition that a seller may command a higher price when inventory is in shorter supply then it would if it sold the asset at a time when many similar assets were on the market.

The objecting landlords make a few legal points in response, none of which I ultimately find persuasive. First, they contend that because the debtors are liquidating, they should not get the same business judgment deference that an operating company would receive in the field in which it is operated. That argument, however, blinks the reality of modern Chapter 11 practice. This particular business judgment is one that draws upon the expertise in navigating

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financial distress.

In Ducera and Alvarez & Marsal, the debtors have retained leading experts in that area and the record before me indicates that the debtors relied on these advisors expertise in making the decision they did. There is no reason to second guess that judgment.

Second, the objecting landlords also contend that the debtors have relied on the wrong legal premise in assuming the leases. They suggest that once the decision to assume is made if the market were to take a turn for the worse the debtors will thereafter be unable to reject. The text of the bankruptcy code, however, is to the contrary. Section 503(b)(7) deals expressly with that question and provides that a Trustee can reject an executory contract after it has been assumed to be sure it creates the possibility of an administrative claim of up to two years which could be substantial liability.

I conclude that the objecting landlords are incorrect in suggesting that assumption entirely precludes the possibility of subsequent rejection. Relatedly, the objecting landlords also argue that the debtors are wrong about their ability to assign the leases to third party buyers at some point that may be up to two years after the date in which they assume the contract. Again, I find this argument to be precluded from the language of the bankruptcy

1 | code.

The objecting landlords argument in a nutshell is that the deadline for an assumption rejection decision set out in 365(d)(4) was intended to set an outside deadline by which a commercial real estate landlord will get peace of mind knowing that as of that time how their leases will be treated in the bankruptcy case but that is just now how the bankruptcy code is written.

Judge Gropper explained this point persuasively in his decision in <a href="Eastman Kodak Co.">Eastman Kodak Co.</a>, 495 B.R. 618, Bankruptcy Southern District of New York (2013). The deadline for an assumption rejection decision for a non-residual real property set out in 365(d)(4) the authority to assign, however, it set out in 365(f)(2). Now that provision does condition the ability to assign the assignees ability to provide adequate assurance of future performance. As Judge Gropper explained, assumption must happen before assignment in order to assign. A debtor must therefore satisfy the requirements governing assumption, but the deadline in Section 365(d)(4), by its terms, applies to assumption and not assignment.

So, what Section 365(d)(4) gives the landlords is certainty by that deadline about whether the property will be assumed or whether they will be rejected and that provides a great deal of certainty, but it doesn't provide all of the

certainty. In the world it doesn't preclude the possibility that they will thereafter be assigned -- if they are assumed that they will there -- doesn't preclude the possibility that they will thereafter be assigned to another party. So, the attack on the debtors' business judgment on the ground that the law will preclude the debtors from later assigning the contracts they are today seeking to assume is unsuccessful.

Point two, the debtors have provided adequate assurance of their ability to perform their obligations under the leases. The bankruptcy code is also clear that in order to assume a lease the Trustee must cure past defaults and provide adequate assurance of its ability to perform on the lease in the future. Here, the relevant statutory provision is 365(b)(1). In broad strokes, it says that when there is a default a Trustee can only assume if it either cures the default or provides adequate assurance that it will promptly cure as well as providing adequate assurance of future performance under the lease.

There are special provisions addressing nonmonetary defaults that I will touch on in a moment. The code
also operates to prevent the enforcement of ipso facto
clauses and anti-assignment provisions. But I will begin
with the question where the debtors have shown that they have
the financial wherewithal to perform their obligations under
the leases. The leading case on the meeting of adequate

assurance in this jurisdiction is the Third Circuit's decision in In Re Fleming Companies, 499 F.3d 300, 307, Third Circuit (2007). That opinion makes clear that the judgment is a pragmatic one. It does not require a hundred percent confirmation of future payment with every detail confirmed upon assumption but rather requires a measure of protection that the debtors should have the means to fulfill their contractual obligations.

Applying that standard here is what I find: the record suggests that at the end of the first year of the assumed leases, and, again, I credit the testimony that the leases will be further assigned by the end of two years, so by the end of the first year the debtors will be holding more then \$400 million in cash. As of then they will then owe an additional \$81 million for the second year of the leases making the conservative assumption that the debtors will also be obligated to pay the incremental \$50 million sought by the landlords in cure amounts, the debtors will then be left with a cushion of more than \$270 million.

Now the assumptions that support that conclusion are all conservative ones. It assumes that the value obtained for the leased properties will be a net wash when my actual judgment, based on the record before me, is that it is more likely that the assumption will be the source of material income. It assumes that the debtors will take the full two

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years to market the leases when Ms. Kaldenberg testified that she expected that -- I'm sorry, when Ms. Kaldenberg testified that she expected that would be the date for completing the process.

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To be clear, in crediting Ms. Kaldenberg's testimony that the sale process will be complete within two years that does not necessarily mean that every property will, in fact, successfully be sold in that timeframe. It assumes only that the to extent some are sold more quickly that that will offset any additional expense associated with those that may take longer.

This analysis ascribes no value at all to the owned properties to which the debtors ascribe more then \$275 million of value. So, even with all of those assumptions one is left with a cushion of more than \$270 million subject only to the insurance issue that I will describe below. And on this record in making the pragmatic judgment that <a href="#Fleming">Fleming</a> directs, I am satisfied that the debtors have provided adequate assurance of their ability to cure past defaults and perform on the leases in the future.

For that reason, I do not believe the records suggest there is any reason why funds need to be segregated for this purpose. The landlords will hold administrative claims and will have the full panoply of remedies provided by the bankruptcy code if their claims are not timely paid.

The objecting landlords make a handful of additional points regarding the debtors ability to cure and provide adequate assurance. First, they say that the leases contain -- certain of the leases contain restrictions that require the properties to be used only as a trucking terminal. They contend it has not been used as such since the debtors discontinued operations and would not be so used in the period before they are assigned to a third party. As a result, they say the debtors are unable to provide adequate assurance that they will, in fact, perform under the leases.

Section 365(b)(1)(a), however, makes clear that the in the property of real property leases prior non-monetary defaults need not be cured. This point is set forth in detail in Colliers on Bankruptcy, Volume III, Paragraph 365.063(c). That section of Colliers explains how the 2005 amendments were intended to overrule the Ninth Circuit's decision in Claremont Acquisition and makes clear that in the context of real property leases past non-monetary defaults need not be cured.

There are further reasons why the use restriction cannot prohibit the proposed assumption. Judge Farnan held in <u>Rickel Home Centers</u>, 240 B.R. 826, District of Delaware (1998), that a use restriction operated as, in effect, an anti-assignment provision that was invalidated by Section 365(f)(1). The same conclusion was reached in a case from

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the Eastern District of Virginia called <u>LaSalle National</u>

<u>Trust v. Trak Auto Corp.</u>, 288 B.R. 114, Eastern District of

Virginia (2003). An exception to this principal, however, is

reflected in 365(b)(3). That provision does require that

adequate assurance include the satisfaction of use

restrictions, but by its terms that provision is expressly

limited to shopping centers. The trucking terminal at issue

here, obviously, do not qualify as shopping centers.

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The net result of these cases as against the backdrop of Section 365(b)(3) is that outside the context of shopping centers the restrictions in a lease may be invalidated -- use restrictions in a lease may be invalidated on the ground that they operate as anti-assignment provisions.

There is also perhaps a more fundamental supporting the conclusion that the use restrictions do not prevent the debtors proposed assignment which is the language of the provisions themselves. One example of this is in the document that is Realtern Exhibit 8, Section (7). The language of this provision says that the property at issue shall be used solely as a freight terminal and not for any other purpose. The parties have agreed that the language of the other provisions in the other leases, at least to the extent that they contain use restriction, not materially different from the provision at issue here.

No one is suggesting that the debtors will convert these freight terminals into amusement parks or condominiums. The debtors are for now proposing not to use the terminal at all while they look for a buyer for the property. That conclusion is far more natural then the one proposed by the objecting landlords that the debtors will use the properties for a new storage business that they are getting into.

So, my own conclusion is that I do not read the debtors motion to assume to create a circumstance in which the debtor is seeking to use the property for some other purpose other than to operate as a trucking terminal. They propose to use it not at all. Therefore, there is no reason to believe that the debtors proposed use, which as I said is not to use it until they find a buyer for the lease, would amount to a default under the lease.

Second, the objecting landlords point to the requirement that the debtors maintain specified insurance coverage. An example of this provision in the same lease, which is the document that is Realtern Exhibit 8, this is set forth in Section 14 of that document and, again, the parties essentially agree that the insurance clauses of any of the other leases that contain such insurance clause are materially the same. That provision requires, among other things, that the debtors carry comprehensive general liability policy with a \$6 million per occurrence limit and a

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\$6 million aggregate limit. But it goes onto say that if the tenant fails to carry such insurance that the landlord can acquire that insurance and charge it through to the tenant as additional rent. That language is in the same section of the lease, its on page 8 of Exhibit 8, real term Exhibit 8.

The record before me suggests that since the winddown of the debtors business operations the debtor has not been able to obtain insurance that meets these requirements. Instead, the insurance it has purchased has lower per occurrence and aggregate limits. That said, thoroughly read the lease provision does not affirmatively require the tenant to obtain insurance in the specified amount in the sense that the tenants failure to do so would be an event of default under the lease; rather, the substance of the provision is that the tenant has the choice either to buy the insurance or to pay the landlord for that insurance if the landlord chooses to acquire it.

I will require that any order authorizing the assumption of the leases provide that the debtors will be bound post-assumption by the terms of the leases. I have seen that the parties have included such language, at least in the most recent form of order that has been circulated. So what that means is that to the extent the debtors do not know have sufficient insurance that after the assignment the landlords would be entitled to enforce the provision that

permits the landlord to obtain insurance and pass the cost of that insurance through to the debtor. That is, of course, relevant to the adequate assurance inquiry since those costs are not included in any of the projections that were admitted into evidence or in the description of the analysis that I described that would have left a \$270 million cushion.

That said, in light of the pragmatic inquiry required by <u>Fleming</u> and the fact that we're talking about a cushion conservatively of \$270 million in this adequate assurance analysis, I have no trouble finding that even with the incremental costs of compliant insurance that the debtors may need to bear on a go forward basis, the debtors will nevertheless have the financial wherewithal to perform their obligations under the leases.

Finally, the landlords expressed concern that the debtors will not maintain the properties — they expressed the concern that the debtors will not maintain the properties. That concern is fully addressed by the very same language in the order making clear that the leases are enforceable against the debtors after assumption. The landlords are entitled to the benefit of their bargain. If the debtors fail to live up to their lease obligations to maintain the properties appropriately the landlords will have recourse under the terms of their lease to enforce those obligations.

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So, for that reason I find that both that the debtors have appropriately exercised their business judgment as well as carried their burden of demonstrating adequate assurance of future performance under the leases. I would like to thank counsel for all of the parties for the truly excellent presentation of these novel issues.

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I guess I would like to hear where we are in terms of the status of an order reflecting that ruling. So, let me turn it over to the parties.

MS. SMITH: I apologize, Your Honor. Allyson Smith, Kirkland & Ellis, for the debtors.

From our perspective, and I hope I am not speaking out of turn, but I do believe we are agreed on the order. We are certainly happy to recirculate, to reconfirm with all parties prior to submitting under certification of counsel, but unless Your Honor had any specific issues or concerns, I think we are largely agreed.

THE COURT: So, I did review the order. It looked to me like it addressed the concerns that I expressed yesterday, the provisions, the cherry-picking provisions, the requirement that the debtor comply. It looked to me like the language addressed the concerns that I had, but let me just ask this question: Is there any objecting landlord that has remaining concerns with the form of order? Either Mr. Foxman or Mr. McDaniel, either of you have concerns?

# **BANKRUPTCY 2024: VIEWS FROM THE BENCH**

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1	MR. MCDANIEL: Your Honor, Garvan McDaniel, Hogan
2	McDaniel, for the Terreno landlords.
3	Your Honor, the last version I saw that was
4	circulated was at 10:51. I know my co-counsel is about to
5	hop on a plane to California. So, I don't know where that
6	stands. I haven't heard from him if he was finally signed
7	off on that. I don't know if there has been any changes
8	since the version that I saw by other landlords.
9	MS. SMITH: There has been no changes since what
10	we circulated this morning at what you noted, Mr. McDaniel. I
11	do believe Mr. St. James was signed off on that version, but
12	I am happy to wait for him to land and confirm. I don't
13	obviously, you know, we would like to have an order entered
14	soon, but I don't think an extra hour or two will really
15	affect anything.
16	MR. MCDANIEL: I appreciate that courtesy, Ms.
17	Smith. If that is acceptable to Ms. Smith and the Court, is
18	would just like to confirm that, you know, Mr. St. James has
19	talked to the client and signed off on it.
20	MS. SMITH: No objection from the debtors, Your
21	Honor.
22	THE COURT: Okay. We can as usual, I'm leaning
23	on the terrific team here that does all of the actual work
24	which I routinely take credit. I think we can do that.
25	Is there Mr. Foxman, anything from your

perspective?

MR. FOXMAN: Thank you, Your Honor. We appreciate the time that the Court spent in coming up with such a comprehensive ruling and while we understand that we are being overruled on a number of points we appreciate the time and consideration into the matter. The order that was provided, if it was the version as of 10:50 does reflect a number of comments made in anticipation of such ruling. So, I think for the most part it is reflective of the ruling that the Court gave.

I would note that we didn't anticipate Your Honor making a formal opinion and so we would ask for a clean record to add to the order an incorporation of those findings of facts and conclusions of law and any written opinion that is made just so that we have a clean record here.

One additional comment, and this is not meant in a way to comment upon or reargue any aspect of the ruling, but there is significant concern on our side about the insurance and the ability to get insurance and enforce insurance and so on, so we may have a need to come back in front of Your Honor on those points as that is a very significant economic issue to the client and to the estate.

THE COURT: So, let me, just by way of clarity, I do think having the form of order, say for the reasons set forth on the record today, if it doesn't say that already,

would be a good idea. I am not contemplating issuing any of what I just said as a written decision. I put out enough of those. You know, in the event there were an appeal I might want to, you know, in light of the usually rambling nature of what I read, then try to do this in a way that is more digestible for a reviewing court, but in the absence of that I don't propose to cause more trees to fall in the service of this question.

With respect to the point you raised with respect to the insurance issue, obviously the order gives you the rights it gives you and to the extent an issue would arise you all know how to find us.

MR. FOXMAN: Thank you, Your Honor. That is certainly fine. I misunderstood the Court at the beginning about the written opinion, but if we could incorporate the oral opinion that would be great.

THE COURT: Okay. Looks like Ms. Smith is nodding. So, will assume she agrees unless she says otherwise.

Is there any other party in interest that would like to be heard on any other matter or on this matter or any other while we are here?

(No verbal response)

THE COURT: Again, apologies for the delay in getting started. We appreciate everyone's patience while we

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	39
1	work through the technology glitches. Thanks again for the
2	parties for their truly terrific presentation of these novel
3	and complicated issues. We will look for the order to come
4	across on certification and enter it this evening.
5	With that and with my thanks we are adjourned.
6	(Proceedings concluded at 5:13 p.m.)
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# **BANKRUPTCY 2024: VIEWS FROM THE BENCH**

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1	<u>CERTIFICATION</u>
2	We certify that the foregoing is a correct
3	transcript from the electronic sound recording of the
4	proceedings in the above-entitled matter to the best of our
5	knowledge and ability.
6	
7	/s/ William J. Garling April 20, 2024
8	William J. Garling, CET-543
9	Certified Court Transcriptionist
10	For Reliable
11	
12	/s/ Tracey J. Williams April 20, 2024
13	Tracey J. Williams, CET-914
14	Certified Court Transcriptionist
15	For Reliable
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# **Great Big Commercial Ground Lease Issues in Bankruptcy**

Hon. Elizabeth L. Gunn<sup>1</sup>
United States Bankruptcy Court
District of Columbia

Businesses are continuing to feel the aftershocks of the COVID-19 pandemic and shifting employment norms. As more employees and businesses switch to hybrid or fully-remote workplaces, office buildings that were once stable sources of income for their owners are becoming redundant overhead.<sup>2</sup> Commercial building owners in large metropolitan areas such as New York City are eager to sell the buildings, sometimes at steep discounts, as the buildings continue to lose tenants and revenue.<sup>3</sup> Yet there are numerous challenges to selling the buildings, including the higher costs associated with shifting to a more profitable business model such as apartments or condos, and a dearth of potential buyers.<sup>4</sup> An additional challenge is that many of these commercial building owners only own the building itself—they do not own the land beneath the building.<sup>5</sup> Instead, they lease the land on which the building sits from a third-party ground lessor. As commercial building owners and their landlords file for bankruptcy, ground leases will come to the forefront of the bankruptcy process.<sup>6</sup>

Simply defined, a ground lease is an agreement whereby the landlord leases a parcel of property to a tenant to develop (frequently with the financial assistance of a mortgage) and, after

<sup>&</sup>lt;sup>1</sup> Judge Gunn thanks her 2024–25 term clerk Evanthea Hammer for her assistance in preparation of these materials. These materials focus on urban, commercial ground leases with substantial buildings on them, different and equally interesting issues relate to undeveloped parcels or more rural parcels, but are outside the scope herein.

<sup>&</sup>lt;sup>2</sup> See Matthew Haag, This 23-Floor Manhattan Office Building Just Sold at a 97.5% Discount, N.Y. TIMES, Aug. 1, 2024.

<sup>&</sup>lt;sup>3</sup> See id.

<sup>&</sup>lt;sup>4</sup> See id.

<sup>&</sup>lt;sup>5</sup> See id.

<sup>&</sup>lt;sup>6</sup> See David R. Kuney, Will Mission Product Control Ground Tenant Lease Rejection and Survival of Subordinate Interests?, 39-AUG Am. BANKR. INST. J. 24 (2020).

# **BANKRUPTCY 2024: VIEWS FROM THE BENCH**

the leasehold ends, the property and its developments revert to the landlord.<sup>7</sup> Additional, non-exhaustive terms frequently found in a ground lease include:

- subordination of the landlord's fee interest to a mortgage lender;
- notice requirements to the mortgage lender, landlord, and tenant;
- cure, lease reinstatement, and lease amendment protections for the mortgage lender;
- landlord recognition of subleases such as for offices and retail spaces, regardless of whether the ground lease is terminated;
- right of first refusal for the tenant if the landlord opts to sell its fee interest in the land;
- protections during the construction phase such as a construction loan mortgage and due diligence regarding the contractor, subcontractor, and construction lender; and
- ground lease rental reserves held by the mortgage lender as a first lien security interest to cover crucial expenses such as taxes and insurance costs.<sup>8</sup>

If a ground lease landlord or tenant declares bankruptcy, possible issues in the bankruptcy case include the assumption, rejection, or assignment of the ground lease itself, termination of any mortgages or subleases, and the sale of the property or building. The common root of these issues

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<sup>&</sup>lt;sup>7</sup> James Chen, *What is a Ground Lease? How it Works, Advantages, and Example*, INVESTOPEDIA (Jul. 24, 2023) https://www.investopedia.com/terms/g/ground-

 $lease.asp\#: \sim : text = A\%20 ground\%20 lease\%20 is\%20 an\%20 agreement\%20 in\%20 which, improvements\%20 are\%20 turned\%20 over\%20 to \%20 the\%20 property\%20 owner.$ 

<sup>&</sup>lt;sup>8</sup> See Jerome D. Whalen, On Financing an Unsubordinated Ground Lease in the Twenty-First Century, 33-APR PROB. & PROP. 26, 28–33 (2019).

<sup>&</sup>lt;sup>9</sup> See id. at 34; see Kuney, supra note 6, at 25.

is that if a ground lease can be rejected under § 365(d) of the Bankruptcy Code<sup>10</sup>, does that rejection terminate the subordinated mortgage or sublease?<sup>11</sup>

On the one hand, it is possible that a rejected ground lease could implicate § 365(d)(4) of the Bankruptcy Code, which requires that the tenant debtor "immediately surrender that nonresidential real property" to the landlord.<sup>12</sup> In that case, there would likely be litigation over whether the subordinated interests are automatically terminated upon surrender of the property, and who is left holding the bag on the terminated interests.<sup>13</sup>

On the other hand, it is possible that a rejection would only impact the ground lease itself, and that the subordinated interests would ride through and be entitled to state law rights and remedies. <sup>14</sup> A further complication in either situation could arise in the case of a ground lease that involves residential property or residential subleases. <sup>15</sup>

The question of termination will take on new dimensions as the case law surrounding ground leases develops, particularly as commercial building owners continue to feel the strain of the post-COVID 19 pandemic era and accompanying cultural shifts in residential preferences and employment. It is likely that the most financially dire impacts of this change will be felt in more expensive and aggressive commercial real estate markets. Practitioners should be aware of the potential increase of single asset real estate and other real estate bankruptcy filings in those jurisdictions. Further, practitioners should also keep in mind that the standard protections of § 365 of the Bankruptcy Code may be interpretated differently by courts in the context of ground leases that are accompanied by subordinated mortgages and subleases.

<sup>&</sup>lt;sup>10</sup> 11 U.S.C. §§ 101–1532.

<sup>&</sup>lt;sup>11</sup> See Kuney, supra note 6, at 25.

<sup>&</sup>lt;sup>12</sup> 11 U.S.C. 365(d)(4); see Kuney, supra note 6, at 25.

<sup>&</sup>lt;sup>13</sup> See Kuney, supra note 6, at 25.

<sup>&</sup>lt;sup>14</sup> See id.

<sup>&</sup>lt;sup>15</sup> See 11 U.S.C. 365(d)(1–2).

# Feature

By David R. Kuney<sup>1</sup>

# Will Mission Product Control **Ground Tenant Lease Rejection and** Survival of Subordinate Interests?

n April 26, 2020, Surrey NY LLC, the holder of a leasehold mortgage on the Surrey Hotel, an upscale hotel in the heart of Manhattan, filed an involuntary bankruptcy petition against 20 East 76th Street Co. LLC, the operator of the Surrey Hotel.<sup>2</sup> The Surrey was yet another victim of the COVID-19 crisis and found itself unable to pay its ground lease rent.

The filing of this involuntary petition raises important questions for commercial real estate owners and lenders, as well as hotel operators. This case could address potentially unresolved issues in the recent decision of the U.S. Supreme Court in Mission Product Holdings Inc. v. Tempnology LLC.3 The issue, simply stated, is the consequence of a debtor/ground lessee's rejection of a ground lease and the consequence to the ground lessee's mortgage lender. More broadly, it again raises the meaning of rejection of an executory contract under bankruptcy law and the longstanding judicial split on the meaning of lease rejection.



David R. Kunev Potomac, Md.

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# **Ground Lease Financing: Possible Risk of Leasehold Termination**

The operator of the Surrey Hotel - 20 East 76th Street Co. LLC — is the ground tenant under the terms of a long-term ground lease with Surrey Realty Associates LCC (the "ground lessor"). The Surrey had also obtained a mortgage from Surrey NY LLC (the "petitioner") in the amount of \$45 million, which was secured by the Surrey's interest as tenant under the ground lease.

According to the pleadings filed in the case, the Surrey "suspended" operations at the hotel on March 23, 2020, due to the COVID-19 pandemic.4 According to the ground lessor, the Surrey had not paid rent for April, May and June, which totaled \$1,575,000.5

Given the alleged failure to pay ground rent, the petitioner may have been concerned that the ground lessor might seek to declare a default, then terminate the ground lease, thus possibly impairing the mortgage lender's interest. From the court pleadings, it

does not appear that the ground lease was subordinated to the mortgage, meaning in effect that if the ground lessor terminated the lease, then, absent a contractual provision protecting the mortgage lender, the mortgage would be extinguished.

However, the ground lease in this case did contain contractual rights for the mortgage lender that protected it from a termination of the leasehold without the ground lessor having first provided it with certain protections. For example, the ground lessor could not have terminated the ground lease without giving notice to the mortgage lender and providing an opportunity to cure the defaults.6 According to the ground lessor, the mortgage lender refused to exercise its cure rights, but the pleadings do not disclose whether the petitioner had the additional right to become a substitute or new ground lessee as a result of the alleged default.

# **The Involuntary Petition**

The Surrey answered the involuntary petition by stating that the petition was defective because the petitioner had failed to join the required three creditors. The answer also contended that the Surrey could not fund nor maintain a chapter 11 case, and did not have the resources to contest the petition beyond the filing of an answer. According to the Surrey, the petitioner filed the involuntary petition because of the "ground lessor's wrongful and bad-faith attempt to terminate the Ground Lease based on the alleged failure of the [operator] to pay April rent in the midst of the worldwide COVID-19 pandemic.

The ground lessor filed a response, contending that (1) the involuntary was wrongful; (2) the petitioner failed to have three petitioning creditors;9 (3) the alleged debtor could not pay the costs of operating the hotel (including its union employees and the payment of the ground rent); and (4) the petitioner, as mortgage lender, could simply cure the defaults and/or step into the shoes of the ground lessee. The ground lessor also denied that it had terminated the ground lease as of April 27, 2020.10

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24 August 2020

The author's blog website is bankruptcyadvocacy.net. In re 20 E. 76th St. Co. LLC, Case No. 20-11007 (Bankr. S.D.N.Y.).

<sup>139</sup> S. Ct. 1652 (2019)

Answer of 20 E. 76th St. Co. LLC to the Involuntary Chapter 11 Petition, Dkt. ¶ 7, p. 1. Response of Ground Lessor to the Involuntary Chapter 11 Petition, Dkt. 10, ¶ 1, p. 2.

<sup>6</sup> Response of Ground Lessor, ¶ 7, p. 3.

<sup>7</sup> *Id.* 8 Answer, ¶ 3.

<sup>9</sup> Answer, ¶ 7. 10 Response of Ground Lessor, ¶ 7.

# **The Deemed Rejection Risk Yet Again**

The real question with the Surrey bankruptcy is the effect of the possible rejection of the ground lease, and the effect of such rejection on the subordinated interest of the mortgage. If the petition was granted and the court entered an "order for relief," the Surrey should have had to pay the rent on a current basis until it either assumed or rejected the ground lease.11 It only has 210 days at most to assume or reject the lease, but if it wants to assume the lease, it will have to cure all defaults.<sup>12</sup> If it does not meet these time periods, the lease will be deemed rejected, and the debtor will be obligated to immediately surrender "that nonresidential real property to the lessor."13

Given the various statements made by the Surrey in its pleadings, it appears that it lacked the resources to pay the rent timely and to cure any prebankruptcy defaults. If the petitioner is not willing to cure the defaults, a deemed rejection also seems very possible. If so, what happens to the mortgage if the ground lease is rejected?

# The Meaning of "Rejection" in the **Ground Lease/Mortgagee Context**

There has been a longstanding divide among the courts on whether the rejection of a lease by a bankrupt tenant terminates the interest of subordinate interests, including both subtenants and leasehold mortgagees.14 The In re Park case stated, "With respect to non-residential real estate, however, a majority of courts have concluded that the express requirement for surrender upon failure to assume within the statutory period necessarily implies a termination of the leasehold estate."15 Another court added this: "Under this view ... [a] deemed rejection terminates the master lease and all derivative interests in the property."16 A California court applied the same logic to hold that a lease rejection terminates the rights of a mortgagee on the leasehold.<sup>17</sup>

However, there remains a divergence of views. For example, the Second Circuit in *In re Lavigne*<sup>18</sup> stated that rejection does not "completely" terminate the contract (albeit in a case that did not address either ground leases or § 365(d)(4)):

While rejection is treated as a breach, it does not completely terminate the contract. See also 3 Collier on Bankruptcy (Lawrence P. King, et al. eds., 15th ed. 1996) (Collier) § 365.09[3] (breach is not termination of contract because, among other reasons, "[i]f rejection terminates the contract ... such termination may have consequences that affect parties other than [the parties] to the contract." Thus, "[r]ejection merely frees the estate from the obligation to perform; it does not make the contract disappear."19

The Fifth Circuit addressed the specific issue of the effect of rejection of a ground lease on a ground lease mortgage in the Matter of Austin Development Co.20 Hon. Edith Jones held

that rejection of a ground lease does not cause a rescission of the lease nor cause the mortgageholder to lose whatever rights it had under the terms of the ground lease. Judge Jones said that despite the rejection, the subordinate interests were not extinguished; whatever state law contractual rights they had vis-à-vis the ground lessor remained intact.

The rights flowing to the mortgagee in Austin were not found in a separate nondisturbance agreement, but rather were embedded in the ground lease itself and provided rights that were "similar to those found in nondisturbance agreements." This made the mortgagee a third-party beneficiary of the ground lease.<sup>21</sup> Because of the lack of privity, Judge Jones had to decide whether the rejection extinguished those rights found in the lease itself.

Judge Jones examined the body of case law that had equated rejection with termination, and found it wanting. She rejected the argument that the obligation of a tenant to "surrender" the premises after a deemed rejection meant that the lease was terminated. The rejection as termination view would make rejection of a lease an "avoidance" power, not merely a breach of contract. She found no legislative or policy basis for such a view, which she saw as working a forfeiture on the rights of subordinate holders, among other issues.

She also held that the notion that the tenant's rejection of a lease could extinguish the rights of a secured party in that the lease was arguably "unconstitutional" - a point that should not be ignored.<sup>22</sup> Given that the mortgagee had agreed to a subordinate position, and that under state law a foreclosure by a senior encumbrance extinguishes a junior encumbrance, this constitutional concern seems unfounded.

Judge Jones held that whatever rights the mortgage lender had would have to be resolved in state court, and that her ruling meant only that such rights were preserved — whatever they may be.23 This view is not accepted by all courts and seems to overlook the requirement to "surrender" the real property.24

# **Does Mission Product Control in the Context of Leasehold Rejection? If So. Don't** the Parties Just Return to State Court?

The Supreme Court's decision in Mission Product Holdings Inc. v. Tempnology LLC<sup>25</sup> seems, at first, to be more in keeping with Austin Development. The Court confirmed that rejection is not an avoidance power, but simply a decision not to assume, simply a breach of contract that gives rise to a damage claim: "For the reasons stated above, we hold that under Section 365, a debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction

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<sup>11 11</sup> U.S.C. § 365(d)(3).

<sup>12 11</sup> U.S.C. § 365(b)(1)

<sup>13 11</sup> U.S.C. § 365(d)(4)(A).

<sup>14</sup> David R. Kuney, Retail and Office Bankruptcy: Landlord/Tenant Rights, pp. 84, et. seq. (ABI 2018). This publication is available for purchase at store.abi.org.

<sup>15 275</sup> B.R. 253, 257 (Bankr. E.D. Va. 2002).

<sup>16</sup> Svufy Enters TP v. City of Oakland, 104 Cal. Ann. 4th 869 (Cal. Ann. 2002)

<sup>17 366-386</sup> Geary St. LP v. Superior Court, 219 Cal. App. 3d 1186, 1197-98, (Ct. App. 1990).

<sup>18 114</sup> F.3d 379, 386-87 (2d Cir. 1997).

<sup>19</sup> Citations omitted

<sup>20 19</sup> F.3d 1077 (5th Cir. 1994), cert denied, 513 U.S. 874 (1994).

<sup>21</sup> Austin. 19 F.3d 1080.

<sup>22</sup> Id. at 1081 23 Id. at 1084

<sup>24</sup> In re Collins, 2019 WL 103774 at \*3 (Bankr. E.D.N.C. 2019) ("With the deemed rejection of the Lease, § 365(d)(4) requires that the Debtors immediately surrender the Property ... without the need for relief from the automatic stay and eviction proceedings under state law [because] pursuant to the Constitution's Bankruptcy Clause, the Bankruptcy's Code requirement for immediate turnover of nonresidential real property following rejection of lease pre-empts state law regarding landlord-tenant relations.").

<sup>25 139</sup> S. Ct. 1652 (2019).

# Ground Tenant Lease Rejection and Survival of Subordinate Interests

from page 25

of Section 365 means that the debtor/licensor's rejection cannot revoke the trademark license."<sup>26</sup>

Does *Mission Product* now pertain to and govern what happens when a ground tenant rejects the ground lease and has granted a mortgage on its ground lease interest? It is certainly possible that the modern view of *Mission Product* will prevail if the issue is litigated in the *Surrey* bankruptcy. At least twice, the Court noted that its view that rejection is a breach and not a termination or rescission applies to "any contract."<sup>27</sup>

However, the question presented in the petition for *certiorari* in *Mission Product* did *not* address "any contract" but instead sought a narrow ruling on the effect of rejection by a licensor on its licensee. There are important differences between what the Court was asked to rule upon, what it did rule upon, and the factual and legal context of a ground-lease termination. The issue in *Mission Product* was a statutory question brought about because the Bankruptcy Code's protections for licensees seemed to omit any reference to trademark licensees. The Court did not consider the distinctive congressional scheme for real estate leases, nor the requirement and meaning of the duty to "surrender" the property *to the lessor* upon the breach.

The Supreme Court in *Mission Product* answered the question posed in the *cert* petition by stating that rejection has the same effect as a breach would outside of bankruptcy. This was precisely what the *cert* petition sought: for application of an outcome that mirrors "applicable nonbankruptcy law."<sup>29</sup>

The *amici* in *Mission Product* said that the *only* effect of rejection is to create a pre-petition breach: "Section 365 does nothing more than that." But § 365 does do more. In

the context of a real estate lease, it mandates the surrender of possession — a transfer of the real estate interest back to the lessor. In this sense, it is an avoidance power and sets the stage for the state law outcome. Recent decisions have held that this duty to surrender is consequential and pre-empts state law; that is, the ground lessor does not need to seek relief from the stay nor file an eviction action in state court.<sup>31</sup>

Congress has decided that the effect of a commercial tenant's breach is to require the tenant to immediately surrender possession to the landlord. The state law outcome in commercial leases for a tenant rejection should flow from this surrender of possession. So, then, this question arises: If under the Code the rejection requires the debtor to surrender its possessory interest, and the possessory interest reverts back to the landlord, has the real estate interest terminated under state law?

Mission Product did not truly address this issue. Both the congressional scheme, and the state law outcome that flows from this scheme, do not mirror the intellectual property scheme. The amicus brief in Mission Product, co-authored by Prof. Jay L. Westbrook of the University of Texas School of Law, the leading scholar on the issue of rejection/termination, does not cite nor address § 365(d)(4)(A), 22 nor is § 365(d)(4)(A) discussed in the petitioner's principal brief. Given this, is it correct to view Mission Product as controlling the outcome under a different statutory scheme?

In balance, it is doubtful that the court will reach the question of leasehold rejection given the number of ongoing barriers to this case. If for some reason it does, it would also seem that *Mission Product* and *Austin may* convince the court that the rights of the mortgage lender survive, but that the enforceability of such rights must be fought out in state court. abi

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<sup>26</sup> Id. at 1666.

<sup>27</sup> Id. at 1661 and 1662.

<sup>28 &</sup>quot;Whether, under § 365 of the Bankruptcy Code, a debtor/licensor's rejection of a license agreement — which "constitutes a breach of such contract," 11 U.S.C. § 365(g) — terminates rights of the licensee that would survive under applicable nonbankruptcy law." Petition for a Writ of Certiorari filed by Mission Product Holdings Inc. at (i).

<sup>29</sup> Cert. Pet. at (i).

<sup>30</sup> Brief of Law Professor as Amici Curiae Supporting Petitioner, at 3.

<sup>31</sup> See, e.g., In re Jeffrey Collins, 2019 WL 103774 (Bankr. E.D.N.C. 2019) (Case No. 18-02021-5-DMW).

<sup>32</sup> See Brief of Law Professor as Amici Curiae Supporting Petitioner.

In re Cortlandt Liquidating LLC, 648 B.R. 137 (2023)

648 B.R. 137 United States Bankruptcy Court, S.D. New York.

> IN RE: CORTLANDT LIQUIDATING LLC, et al., Debtors.

Case No. 20-12097 (MEW) (Jointly Administered) Signed February 2, 2023

### **Synopsis**

Background: Chapter 11 debtor's plan administrator objected to landlords' proof of claims that were based on lease rejection damages.

Holdings: The Bankruptcy Court, Michael E. Wiles, J., held that:

- [1] statutory cap on landlords' lease rejection damages claims had to be calculated by reference to rents reserved under relevant leases for first 15% of remaining lease terms;
- [2] landlord's proof of claim for store cleanup costs that arose from termination of lease was subject to statutory cap;
- [3] landlord's claim for mechanics' liens did not arise from termination of lease, and therefore it was not subject to statutory cap;
- [4] landlord's claim for window repair costs and "other repairs" such as "façade repairs and restoration costs" did not arise from termination of lease, and therefore it was not subject to statutory cap;
- [5] statutory cap on proofs of claim filed by landlord for lease termination damages did not apply to additional damages that did not constitute "rent" reserved under lease; and
- [6] rents reserved under lease, which included requirements that lessee pay real estate taxes and certain operating expenses, were not legal issues to be decided in absence of factual record.

Objection granted.

**Procedural Posture(s):** Objection to Proof of Claim.

West Headnotes (9)

#### **Bankruptcy** $\Longrightarrow$ Rejection of executory [1] contract or lease

Statutory cap on landlords' lease rejection damages claims had to be calculated by reference to rents reserved under relevant leases for first 15% of remaining lease terms, provided, that such amounts could not be less than rents reserved for first remaining year of relevant lease terms, and could not be greater than rents reserved for first three remaining years of relevant lease terms. 11 U.S.C.A. § 502(b)(6).

#### **Bankruptcy** $\Longrightarrow$ Rejection of executory [2] contract or lease

Phrase "15 percent," as used in the section of the Bankruptcy Code setting forth a cap on lessors' lease rejection damages claims, which provides that a court is to allow a lessor's claim for such damages except to the extent that the claim exceeds "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease," refers to 15% of the time remaining on the lease from the date of surrender, not to 15% of the remaining rent due under the lease. 11 U.S.C.A. § 502(b)(6).

#### **Bankruptcy** Pejection of executory [3] contract or lease

The statutory cap on proofs of claim filed by landlords for lease termination damages applies only to damages that are attributable to the fact that the term of the lease has come to an end; for this purpose, a court considers whether the landlord would have the same claim against the tenant if the tenant were to assume the lease, rather than rejecting it, assuming all other conditions remain constant. 11 U.S.C.A. § 502(b)(6).

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### 1 Case that cites this headnote

#### **Bankruptcy** Pejection of executory [4] contract or lease

Landlord's proof of claim for store cleanup costs that arose from termination of lease was subject to statutory cap, since landlord would not have such claim if lease had been assumed. 11 U.S.C.A. § 502(b)(6).

#### [5] **Bankruptcy** $\longrightarrow$ Rejection of executory contract or lease

Where a lease provides that the obligation to remove furniture and fixtures and leave the store in broom clean condition only arises upon termination of the lease, the related damages arise from the termination of the lease and are subject to the statutory cap on proofs of claim filed by landlords for lease termination damages.

11 U.S.C.A. § 502(b)(6).

1 Case that cites this headnote

#### [6] **Bankruptcy** ightharpoonup Rejection of executory contract or lease

Landlord's claim for mechanics' liens did not arise from termination of lease, and therefore it was not subject to statutory cap on proofs of claim filed by landlord for lease termination damages, since lease required tenant to discharge any mechanic's lien filed against property for work done for, or materials furnished to, tenant within 30 days after receiving notice thereof.

11 U.S.C.A. § 502(b)(6).

#### **Bankruptcy** $\Longrightarrow$ Rejection of executory [7] contract or lease

Landlord's claim for window repair costs and "other repairs" such as "façade repairs and restoration costs" did not arise from termination of lease, and therefore it was not subject to statutory cap on proofs of claim filed by landlord for lease termination damages, since lease

required tenant to maintain leased premises, including framing and glass of exterior of building, and provided that tenant would be responsible for repairs of any damage caused by negligence, neglect, or improper conduct of tenant or its invitees or licensees. 11 U.S.C.A. § 502(b)(6).

#### [8] **Bankruptcy** ightharpoonup Rejection of executory contract or lease

Statutory cap on proofs of claim filed by landlord for lease termination damages did not apply to additional damages that did not constitute "rent" reserved under lease. 11 U.S.C.A. § 502(b) (6).

1 Case that cites this headnote

#### [9] **Bankruptcy** $\longrightarrow$ Rejection of executory contract or lease

In calculating amount of statutory cap on proofs of claim filed by landlord for lease termination damages, rents reserved under lease, which included requirements that lessee pay real estate taxes and certain operating expenses, were not legal issues to be decided in absence of factual record, but instead were factual issues to be decided after evidence was submitted to court, since such amounts were subject to change over time, and parties disagreed as to what reasonable assumptions were with respect to future escalations. 11 U.S.C.A. § 502(b)(6).

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**DECISION REGARDING SECTION 502(B)** (6) COMPUTATION ISSUES RAISED BY PLAN ADMINISTRATOR'S OBJECTIONS TO PROOFS OF CLAIM FILED BY AAC CROSS COUNTY MALL, LLC AND LINCOLN TRIANGLE COMMERCIAL HOLDING CO. LLC

MICHAEL E. WILES, UNITED STATES BANKRUPTCY JUDGE

On November 5, 2021, Alan D. Halperin, the Plan Administrator of the Debtors (the \*139 "Plan Administrator") filed (i) the Plan Administrator's Objection to Proof of Claim Nos. 1268 and 1443 Filed by AAC Cross County Mall, LLC [ECF No. 1082] (the "AAC Objection") and (ii) the Plan Administrator's Objection to Proof of Claim No. 1066 Filed by Lincoln Triangle Commercial Holding Co. LLC [ECF No. 1083] (the "Lincoln Triangle Objection"). On May 20, 2022, Judge Chapman entered interim orders [ECF Nos. 1260 and 1261] holding, among certain other things, that the relevant leases had terminated for purposes of the application of section 502(b)(6) of the Bankruptcy Code, and directing the parties to meet and confer as to the proper calculation of the claims. This case subsequently was reassigned from Judge Chapman to me. The parties have informed the Court that they have been unable to agree on the following issues:

- (1) Whether the "cap" on AAC's and Lincoln Triangle's rejection damages claims pursuant to section 502(b) (6) of the Bankruptcy Code should be calculated in accordance with the "time" or "rent" approach;
- (2) In the case of Lincoln Triangle, whether certain store cleanup, mechanics' liens, window repairs, and "other repairs" (collectively, the "Additional Damages") arose from the termination of the lease such that they are
- (3) In the case of Lincoln Triangle, whether the Additional Damages qualify as "rent reserved" such that they should be included in calculating the amount of the cap that is applicable pursuant to \$\frac{1}{2}\$\) 502(b)(6); and

(4) In the case of Lincoln Triangle, whether the projected future rent assumptions for real estate taxes and operating expense escalation should be calculated as outlined in Clam Number 1066 or in accordance with the historical data and assumptions outlined in the Plan Administrator's Objection.

The parties briefed certain of these issues in connection with the Plan Administrator's objections to the AAC and Lincoln Triangle claims, and Lincoln Triangle and the Plan Administrator were permitted to file supplemental submissions regarding these issues. Each of the open questions is addressed in turn in this Decision.

# **Discussion**

# I. Whether the Section 502(b)(6) Cap Is Based On a "Time" or "Rent" Approach

- [1] Section 502(b)(6) of the Bankruptcy Code states as follows:
  - (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that
  - (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds -
    - (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of -
      - (i) the date of the filing of the petition; and
      - (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
    - \*140 (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6) (emphasis added). The parties disagree on the meaning of the italicized language

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in subsection (A) of section 502(b)(6). The Plan Administrator contends that the relevant language imposes a "cap" equal to the rent that is reserved under the relevant lease for a specified time period; that time period is equal to 15 percent of the remaining lease term, so long as that time period is at least one year and no more than three years. The Plan Administrator's interpretation has often been referred to as the "Time Approach" to the calculation of the section 502(b)(6) cap. Lincoln Triangle contends, by contrast, that the relevant language imposes a "cap" equal to 15 percent of the total dollar amount of the rent that would be payable for the entire remaining term of the lease, so long as that dollar amount is at least equal to the rent reserved for one year rent and does not exceed the rent reserved for the next three years of the lease term. This interpretation has often been referred to as the "Rent Approach" to the calculation of the section 502(b)(6) cap.

The differences between the Time Approach and the Rent Approach are irrelevant in cases where it is clear that the section 502(b)(6) cap must be based either on the one-year rent minimum or the three-year rent maximum. In other cases, however, the Time Approach and the Rent Approach can yield significantly different outcomes. Rents under a lease often escalate over time. The Time Approach imposes a cap that is based on the rents that are specified for the first 15% of the remaining lease term; it thereby ignores rent escalations that would occur in later years. The Rent Approach, by contrast, imposes a cap that is based on 15% of all of the rents that are specified for the entire remaining least term. The Rent Approach thereby captures an element of rent escalations that the Time Approach does not capture, and in doing so it results in a higher cap on the relevant parts of a landlord's claim.

There are a few decisions in this District that address whether the Rent Approach or the Time Approach should be used. In 1993, the court in In re Financial News Network, *Inc.* applied the Rent Approach in calculating the landlord's allowable damages, without any discussion of the alternative approach. See In re Financial News Network, Inc., 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993). In that case, however, the debtor had objected to the amount of the landlord's claim on other grounds. Id. Whether the Time Approach or Rent Approach should be used in calculating the \$502(b)(6) cap was not at issue and was not addressed in the decision. It.

In 1999, the court in In re Andover Togs, Inc. discussed both the Rent Approach and the Time Approach. See In re Andover Togs, Inc., 231 B.R. 521, 547 (Bankr. S.D.N.Y, 1999). After determining that the legislative history was unhelpful and that the Rent Approach was then the majority view, the court held that the Rent Approach was the correct one. The Andover Togs decision also held that the Rent Approach was the "logically sounder" approach, and noted that at the time the Rent Approach was supported by the Collier's treatise and the Norton Bankruptcy Law treatise. *Id.* at 545-547.

The courts in this District next addressed the relevant question in 2011. See In re Rock & Republic Enters., 2011 WL 2471000, 2011 Bankr. LEXIS 2401 (Bankr. S.D.N.Y. Jun. 20, 2011). In that case, the court declined to depart from the precedents established by the Financial News Network and Andover Togs decisions, and held that the Rent Approach should govern \*141 the calculation of the section 502(b) (6) cap. [1] Id.

So far as our research and inquiries have been able to determine, there are no other relevant decisions in this District with respect to this issue. In the ten years since the entry of the decision in the *Rock & Republic Enters*. case, however, the weight of the relevant authorities in other districts has shifted very strongly in favor of the Time Approach. All of the reported decisions that we have found that have addressed this issue since the beginning of 2012 have concluded that the Time Approach is the correct one. See In re Keane, 2020 WL 6122296, at \*2 (Bankr. E.D.N.C. Oct. 14, 2020); In re Denali Family Servs., 506 B.R. 73, 83 (Bankr. D. Alaska); In re Filene's Basement, LLC, 2015 WL 1806347, at \*7, 2015 Bankr. LEXIS 1350, at \*18; In re Shane Co., 464 B.R. 32, 39 (Bkrtcy. D. Colo. 2012). The Collier's Treatise now also endorses the Time Approach rather than the Rent Approach. See e.g. 4 COLLIER ON BANKRUPTCY ¶ 502.03[7][c] (16th ed. 2022). So, too, do other authorities. See, e.g., American Bankruptcy Institute Commission to Study the Reform of Chapter 11, ISBN: 978-1-937651-84-8, Section V.A.6, pp. 129-30, 135 (concluding that the Time Approach as the correct way to calculate the 502(b)(6) cap); S. Deshpande, A Fresh Look at the Bankruptcy Code's Limitation on Landlords' Rejection Claims, 2011 Ann. Surv.

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Of Bankr. Law 11 (2011) (concluding that the Time Approach represents the correct interpretation of the statute).

[2] We have reviewed the language of the statute and the decisions that have endorsed each of the relevant approaches. I do not lightly depart from prior precedent in this District. After considering the statutory language and the relevant authorities, however, I am convinced that the Time Approach represents the correct view.

First, and most importantly, the plain language of the statute makes clear that the Time Approach is the correct one.

Section 502(b)(6) refers to the rent reserved by a lease, without acceleration, "for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease." 11 U.S.C. § 502(b)(6). The entire phrase is worded in terms of periods of time. Plainly the words "one year" and "three years" modify the words "of the remaining term of such lease." In context, the words "15 percent" plainly modify the same phrase. The result is to impose a limit on allowable damages that is computed by reference to a period of time. That period of time is equal to 15 percent of the remaining term of the lease, so long as that period is more than one year but less than three years.

If section 502(b)(6) were intended to impose a cap that is based on 15% of a dollar amount (as the proponents of the Rent Approach suggest), then the words "15 percent" would not have been sandwiched between two other time periods, and they would not have been used as a modifier of the phrase "of the remaining term of such lease." Instead, if the Rent Approach had been intended, the statute would have stated that the allowable rejection damages would not exceed "15 percent of the rent reserved for the remaining term of such lease, provided that such amount will not be less than the rent reserved for the next year of the lease term, and shall not be more than the rent reserved for the next three years of the lease term." Those are not the words that are set forth in the statute, and they cannot reasonably be derived from the language that does appear.

The Collier's Treatise once endorsed the Rent Approach, but since at least 2015 it has endorsed the Time Approach. The current \*142 treatise concludes that the Rent Approach is not in accord with the language of the statute:

The 15 percent limitation of section 502(b)(6) speaks in terms of time, not in terms of rent ... Grammatically, the "greater of" phrase contemplates two time periods, one year and 15 percent of the remaining term. But the latter period (15 percent of the remaining term) is further limited to three years, so that if the remaining lease term exceeds 20 years, the allowable damage claim will not increase.

Id. 4 COLLIER ON BANKRUPTCY ¶ 502.03[7][c] (16th ed. 2022). The better-reasoned decisions have reached the same conclusion. As the District Court for the Northern District of California has explained:

Structurally, in comparing the greater or lesser of two things, the measurements of those things must be parallel, e.g. time versus time. The statute allows landlords to claim damages in the amount of rent reserved for the greater of one year or 15% of the remaining term. Because "one year" is inherently temporal, the phrase "remaining term" necessarily refers to time. This establishes that the statute measures "rent reserved within time periods." Therefore, the sentence structure of the statute supports the time approach.

An ordinary reading of the statute is consistent with this reasoning. The phrase "term of a lease" commonly refers to the length of a lease based on time rather than rent. In addition, the statute is generally written in terms of time: the calculation of the cap begins following the earlier of two dates, the date of petition or repossession, the maximum cap is worded in terms of time, three years, and the statute requires the rent to be calculated "without acceleration."

In re Heller Ehrman LLP, 2011 WL 635224, at \*3, 2011 U.S. Dist. LEXIS 19552, at \*6 (N.D. Cal. Feb. 11, 2011) (citations omitted); see also Shane Co., 464 B.R. at 40 ("To read  $\stackrel{\text{read}}{\triangleright}$  \$ 502(b)(6)(A) as referring to 15% of the total rent due over the full remaining term of the lease is inconsistent with the natural reading of the remainder of that subsection."); In re Filene's Basement, LLC, 2015 WL 1806347, at \*5, 2015 Bankr. LEXIS 1350, at \*12, 14 (Bankr. Del. Apr. 16, 2015) In re Cortlandt Liquidating LLC, 648 B.R. 137 (2023)

(concluding that the Time Approach reflects the "natural reading" and the "plain language" of the statute).

The current consensus view is that the Time Approach (not the Rent Approach) represents the correct interpretation of the wording of section 502(b)(6). I agree, and I hold that the Time Approach is the proper method by which to calculate the amount of the section 502(b)(6) cap.

Second, while I agree with those courts that have held that the language of section 502(b)(6) is clear and that a resort to other interpretive aids is not required, I take comfort in the fact that the Time Approach finds strong support in the legislative history. See Filene's Basement, 2015 WL 1806347, at \*5-7, 2015 Bankr. LEXIS 1350, at \*14-17 (citing In re Connectix Corp., 372 B.R. 488, 493-94 (Bankr. N.D. Cal. 2007)); see also 4 COLLIER ON BANKRUPTCY ¶ 502.03[7][c] (16 th ed. 2022). The Filene's Basement decision incorporated a detailed summary of the legislative history that had been set forth in the *Connectix* decision, and concluded as follows:

"Prior to 1934, a landlord's claim for future rent damages due to premature lease termination was not recognized in bankruptcy because it was considered contingent and not capable of proof." Connectix, 372 B.R. at 491. A compromise was reached in the 1934 and 1938 \*143 amendments to the Bankruptcy Act to allow "landlords to assert some amount as a claim for future rent, but with limited sacrifice on the part of general creditors." at 492. The Bankruptcy Act ... limited a landlord's claim in a rehabilitation case to rent for "the three years next succeeding" surrender or reentry. Id. The draft of the 1978 Bankruptcy Code continued the Act's limitation on landlord claims for lease rejection damages, but introduced the percentage calculation. Id. However, as noted by the Connectix Court:

[T]he percentage calculation was intended to replace the dual time provisions employed in the Bankruptcy Act. There is no indication, however, that Congress intended to move away from calculating the cap based on the rent that would become due within a time period immediately succeeding the statutory trigger date. Because there is no clear expression of an intent to change from a time approach to a "total rent" based formula, it cannot be presumed that Congress intended to make that shift.

Fourco Glass Co. v. Transmirra Prods. Corp., 353 U.S. 222, 227, 77 S. Ct. 787, 791, 1 L.Ed. 2d 786 (1957) (" 'no changes in law or policy are to be presumed from changes of language in the revision unless an intent to make such changes is clearly expressed.")

Connectix, 372 B.R. at 493.

See Filene's Basement, 2015 WL 1806347, at \*4-6, 2015 Bankr. LEXIS 1350, at \*14-16.

A House Judiciary Report that related to an earlier version of the statute further supports the notion that the Code applies the Time Approach and not the Rent Approach. The Report

> The damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or ten percent of the remaining lease term, not to exceed three years after the earlier of [the petition date or the date of surrender or repossession.]

See H.R.Rep. 95-595 at 353, 1978 U.S.C.C.A.N. 5963, 6309; see also Connectix, 372 B.R. at 493-94.

Third, I disagree with those courts that have held that considerations of equity or fairness somehow favor the Rent Approach over the Time Approach, and therefore that the Rent Approach somehow better implements Congressional intent or the purposes of section 502(b)(6). The plain "intent" of section 502(b)(6) was to limit landlords' claims. Identifying that general intent is of no help in deciding whether Congress intended that the Rent Approach or the Time Approach would be used. As to statutory purposes: Congress plainly sought to strike a balance between the interests of landlords and the interests of other creditors, whose claims might be diluted if landlords were allowed to assert very large lease termination claims. Identifying that particular "purpose" sheds no light on how Congress elected to strike the balance, or on whether the Rent Approach or

the Time Approach better reflects the balance that Congress struck. Similarly, I do not believe that considerations of "fairness" or "equity" are helpful in figuring out whether the Rent Approach or the Time Approach represents the better interpretation of the statute. From the point of view of landlords, I suspect that any interpretation of the statute that results in a lower cap (and therefore a lower landlord claim) might be considered unfair or inequitable. On the other hand, from the point of view of other creditors, I suspect that any interpretation of the statute that results in a higher cap (and therefore a larger allowed landlord claim) would be regarded as unfair or inequitable. Only \*144 Congress was empowered to strike the balance between these competing equities, and we must always be on guard not to substitute our own views of fairness in place of what a statute's plain language demands.

For the foregoing reasons, I hold that the Time Approach is the correct interpretation of section 502(b)(6). Accordingly, the section 502(b)(6) caps with respect to the AAC and Lincoln Triangle claims are to be calculated by reference to the rents reserved under the relevant leases for the first 15% of the remaining lease terms, *provided*, that such amounts shall not be less than the rents reserved for the first remaining year of the relevant lease terms, and shall not be greater than the rents reserved for the first three remaining years of the relevant lease terms.

# II. Damages That Are Subject to the Section 502(b)(6) Cap

Section 502(b)(6) speaks of damages arising from the "termination" of a lease. As a preliminary matter, Lincoln Triangle questions whether its Lease was "terminated." However, this question has already been decided. *See* Interim Order 8-9, ECF No. 1261. In the Interim Order, Judge Chapman found that the Lease was "functionally dead" and concluded that "the Court need not reach the question of whether the Lease was terminated pursuant to New York law in order to conclude that, once the Lease was 'functionally dead,' it can be considered 'terminated' for purposes of section 502(b)(6)." *Id.* Pursuant to Judge Chapman's ruling, therefore, the Lincoln Triangle lease has been rejected and terminated for purposes of

[3] Section 502(b)(6) provides that "damages resulting from the termination of a lease of real property" are subject to

the statutory cap. See 11 U.S.C. § 502(b)(6). Some courts have held that the section 502(b)(6) cap applies to all damages of any kind that are sought by a landlord, regardless of whether the damages are attributable to a lease termination or instead are attributable to other events or factors. See, e.g., In re Foamex Intern., Inc., 368 B.R. 383, 393-394 (Bankr. D. Del. 2007) (holding that a rejection results in a breach of all covenants of a lease and that any claim for breach of any covenant is covered by the section 502(b)(6) cap). The better view, and the one dictated by the plain language of the statute, is that the statutory cap applies only to damages that are attributable to the fact that the term of the lease has come to an end. The Court of Appeals for the Ninth Circuit has adopted a simple test for this purpose: "Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?" See In re Rock & Republic Enters., 2011 WL 2471000, at \*25, 2011 Bankr. LEXIS 2401, at \*80 (quoting Saddleback Valley Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.), 504 F.3d 978, 980-981 (9th Cir. 2007)). I agree that this is the appropriate test and I will apply it in ruling upon the various categories of damages that Lincoln Triangle has sought.

### A. Store Cleanup

[5] Lincoln Triangle has asserted a claim for store cleanup costs. It argues that this amount arises from the tenant's prior use and occupancy of the leased premises, not from the termination of the Lease. See Lincoln Triangle Mem [ECF No. 1302] at 5. However, the Lease expressly states that: "[u]pon expiration or other termination of this Lease, Tenant shall quit and surrender to Landlord the Premises, vacant, broom clean, in good order and condition, ordinary wear and \*145 tear and damage for which Tenant is not responsible under the terms of this Lease excepted ..." Lease, § 23.22 (emphasis added). Under the *El Toro* test, Lincoln Triangle would not have a claim for store clean up damages if the lease had been assumed. See El Toro, 504 F.3d at 980-981. Where a lease provides that the obligation to remove furniture and fixtures and leave the store in broom clean condition only arises upon termination of the lease, the related damages arise from the termination of the lease and are subject to the \$\sim\_{\}\$ 502(b)(6) cap. See In re Filene's Basement, LLC, 2015 WL 1806347, at \*9-10, 2015 Bankr. LEXIS 1350, at \*30. Therefore, any claim for store cleanup costs arose from

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the termination of the Lease and shall be subject to the 502(b)(6) cap.

As a practical matter the application of the section 502(b) (6) cap may make it unnecessary to consider or to resolve any factual disputes over the alleged store cleaning costs. However, to the extent that any factual issues need to be resolved as to whether store cleanup costs were incurred, and as to the amounts of such damage claims, those would require resolution through an evidentiary hearing.

[6] Lincoln Triangle has asserted a claim for mechanics'

# B. Mechanics' Liens

liens placed on the leased premises by unpaid contractors engaged by the tenant. Apparently none of the lienors has commenced any foreclosure or other proceedings, which may mean there are open issues as to the amount of damages that Lincoln Triangle can properly claim. However, any damages associated with a mechanic's lien plainly would have existed regardless of whether the lease was terminated. The lease required the tenant to discharge any mechanic's lien filed against the property for work done for or materials furnished to the tenant within thirty days after receiving notice thereof. Lease, § 7.1(c). Therefore, under the El Toro test, any (6) cap. See El Toro, 504 F.3d at 980-981; see also In re Filene's Basement, LLC, 2015 WL 1806347, at \*10, 2015 Bankr, LEXIS 1350, at \*32 (applying the El Toro test in finding that a mechanic's lien claim exists independent of whether the lease is terminated and therefore is not subject

If any factual exists exist as to the validity and amount of any mechanic's lien claims, those must be determined through an evidentiary hearing.

# C. Window and Other Repairs

[7] Lincoln Triangle has also asserted a claim for window repair costs and "other repairs" such as "façade repairs and restoration costs." See Lincoln Triangle Memorandum 4, ECF No. 1302. Lincoln Triangle has not elaborated on the nature or scope of such repairs and has not pointed to a basis for such a claim under the Lease. Finding no other basis, the Court assumes Lincoln Triangle is relying on Article 8 of the Lease

which required the tenant to maintain the leased premises, including framing and glass of the exterior of the building, and provided that the tenant would be responsible for the repairs of any damage caused by the negligence, neglect, or improper conduct of the tenant or its invitees or licensees. See Lease, § 8(c). Applying the El Toro test, the Court finds that a claim for damages under Article 8 of the Lease does not arise from termination of the Lease. See El Toro, 504 F.3d at 980-981. To the extent Lincoln Triangle has a valid claim for damages resulting from window and/or other repairs for which the tenant was responsible under Article 8, such claim is not subject to the \$502(b)(6) \*146 cap. For the avoidance of doubt, however, to the extent Lincoln Triangle seeks damages for these repairs on any other basis, the Court does not have sufficient information to determine whether the § 502(b)(6) cap is applicable.

If any factual issues need to be resolved as to the validity or amounts of the claims for various repairs, those matters must be resolved through an evidentiary hearing.

# III. Do The Additional Damages Constitute "Rent Reserved" Under the Lease for Purposes of Calculating

# the Amount of the Section 502(b)(6) Cap?

[8] The third question before the Court is whether any of the Additional Damages constitute "rent reserved" under the Lease such that they may be included in the calculation of the amount of the cap that is imposed by section 502(b) (6). The parties now appear to be in agreement that none of the Additional Damages constitute "rent" reserved under the Lease. See Objection [ECF No. 1083] at 15; Lincoln Triangle Mem. [ECF No. 1302] at 5. Accordingly, none of the Additional Damages shall be included in the calculation of the cap that is applicable under section 502(b)(6).

# IV. How Should The "Rents Reserved" for Future **Periods Be Calculated?**

[9] The rents reserved under the Lincoln Triangle lease include requirements that the lessee pay real estate taxes and certain operating expenses. It is proper to include such items in calculating the "rent reserved" under the lease and therefore in calculating the amount of the section 502(b) (6) cap. See In re Andover Togs, Inc., 231 B.R. at 541-542 (real estate tax escalations and operating expense escalations

claim).

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are properly included in "rent reserved" where these items appear in the Lease as charges the tenant is obligated to pay). However, such amounts are subject to change over time, and the parties disagree as to what the reasonable assumptions are with respect to future escalations. Their differences may be less significant in light of the Court's rulings with respect to the application of the Time Approach to the calculation of the section 502(b)(6) cap, but the parties' differing assumptions still will generate different projections as to what the relevant rents would be.

Lincoln Triangle has projected that real estate taxes would increase over the next ten years at rates ranging from 5.6% to 19.1% per year and that relevant operating expenses would increase 20.2% in 2021 and between 8% and 16.47% thereafter. See Claim Number 1066 7. The Plan Administrator argues that these projected future rent assumptions are unreasonable and not based in historical data. Objection 15, ECF No. 1083. Relying on "the five prior years of real estate taxes for Class 4 properties obtained from the NYC Department of Finance," the Plan Administrator submits that "real estate taxes decreased or remained static from 2016 to 2019, and only increased by 0.2% and 1.5% in 2020 and 2021, respectively." Objection 15-16, ECF No. 1083. With respect to operating expenses, the Plan Administrator asserts that Lincoln Triangle cannot justify how such amounts would grow at the rates projected and submits that more reasonable assumptions derived from actual historical charges made under the Lease should be applied. See Id. at 16.

Contrary to the parties' suggestions, these are not legal issues to be decided in the absence of a factual record. Instead, they are factual issues to be decided after evidence is submitted to the Court. I note that a significant amount of the relevant 502(b)(6) period has already passed, so that actual changes in taxes and other \*147 expenses ought to be known.

Nevertheless, the amounts of the increases that ought to be assumed in calculating the section 502(b)(6) cap cannot be determined without a factual hearing.

# Conclusion

For the foregoing reasons, the Plan Administrator's Objection is granted to the extent it asks that the section 502(b) (6) cap be calculated using the Time Approach. The Store Cleanup Costs sought by Lincoln Triangle (if proved) would constitute damages arising from the termination of the lease for purposes of section 502(b)(6), but the alleged damages due to mechanic's liens and allegedly necessary repairs would not. None of the "Additional Damages" would constitute "rent" for purposes of calculating the amount of the section 502(b)(6) cap that is applicable to Lincoln Triangle's claims. All other issues relating to the amounts of the damage claims asserted by AAC and Lincoln Triangle, if not settled by the parties, will require a factual hearing in order to be resolved.

The parties are directed to confer and to determine whether it is now possible to settle their differences. They are further directed to appear at a status conference on February 28, 2023 at 10:00 a.m. to inform the Court as to whether they have agreed to a resolution or whether a factual hearing will be required. If a factual hearing is required, the court will issue a schedule on February 28, 2023 for the submission of a Joint Pretrial Order and for the conduct of the hearing.

A separate Order will be issued to this effect.

**All Citations** 

648 B.R. 137

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# **BANKRUPTCY 2024: VIEWS FROM THE BENCH**

In re Andover Togs, Inc., 231 B.R. 521 (1999)

KeyCite Red Flag - Severe Negative Treatment Declined to Follow by In re Cortlandt Liquidating LLC, S.D.N.Y., March 26, 2024

> 231 B.R. 521 United States Bankruptcy Court, S.D. New York.

In re ANDOVER TOGS, INC., et al., Reorganized Debtors.

Bankruptcy Nos. 96 B 41437(TLB) to 96 B 41440(TLB). March 12, 1999.

## **Synopsis**

Chapter 11 debtor-tenant objected to proof of claim filed by its former landlord. The Bankruptcy Court, Tina L. Brozman, Chief Judge, held that: (1) "downtime" had to be included in calculation of landlord's damages for debtor's rejection of lease; (2) in computing its damages claim, landlord could include capital costs which it necessarily expended to obtain successor tenants, but not costs which represented longterm capital improvements; (3) landlord acted reasonably in completely gutting the floor used by debtor-tenant in its garment manufacturing business; and (4) minimum base charge for electric usage that debtor was required to pay did not constitute "rent reserved," such as landlord could include in its claim for lease rejection damages.

Objections granted in part and denied in part.

West Headnotes (47)

#### [1] **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

Sixth floor rental space was not properly deleted from debtor-tenant's lease prior to debtor's rejection thereof, so that such space was properly included in calculating landlord's rejection claim against Chapter 11 estate, where debtor did not notify landlord that it was exercising its right to delete this sixth floor space until less than 90 days before lease was rejected, and lease specifically required 90-day notice period.

Bankr.Code, 11 U.S.C.A. § 502(b)(6).

#### [2] **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

Forty-second floor rental space was not properly deleted from debtor-tenant's lease prior to debtor's rejection thereof, so that such space was properly included in calculating landlord's rejection claim against Chapter 11 estate, where debtor's letter signifying that space should be deleted was not mailed to proper party, and was mailed at time when debtor was in default in payment of rent, contrary to terms of lease provision that authorized debtor to delete space only if it was not in default. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

#### [3] **Landlord and Tenant** P Nature of the contract

Under New York law, lease is contract containing provisions or clauses for protection of both parties, and terminates upon definite date agreed to by parties.

#### [4] **Landlord and Tenant** Extent of premises

Under New York law, options which were granted to commercial tenant to delete space from lease had to be strictly construed, when exercised in good faith.

#### **Landlord and Tenant** Particular Kinds of [5] Covenants

Under New York law, notice provisions of lease are to be strictly construed, especially when substantive rights, such as possession of all or part of leased premises, are in question.

#### [6] Landlord and Tenant Prime of Accrual

Under New York law, if lease provides that tenant is obligated to make rent payments on specified day, then tenant is in default if rent payment is not made on date specified, regardless of whether there has been any demand by landlord for

In re Andover Togs, Inc., 231 B.R. 521 (1999)

rental payment, unless it is otherwise specifically provided in lease.

#### [7] Estoppel 📂 Silence

Commercial landlord was not barred, on equitable grounds such as estoppel or laches, from asserting that Chapter 11 debtor-tenant was in default and thus disqualified from exercising its contractual right to delete space from lease, simply because landlord did not promptly advise debtor that its default in payment of rent disqualified it from exercising option when debtor purported to do so; debtor had actual or constructive knowledge of its rent arrearages, and was not in any way prejudiced by landlord's inaction.

#### [8] **Estoppel** $\longrightarrow$ Essential elements

Under New York law, essential elements of equitable estoppel relating to the party to be estopped are (1) conduct which amounts to a false representation or concealment of material facts or which gives the impression that facts are otherwise than asserted, (2) an intention or expectation that such conduct will be relied upon by the other party, and (3) actual or constructive knowledge of true facts, while the elements relating to party asserting estoppel defense are (4) lack of knowledge of true facts, (5) reliance on conduct of party to be estopped, and (6) action based thereon resulting in prejudicial change of position.

#### [9] **Estoppel** Default or wrongful act of person setting up estoppel

Under New York law, in order for court to invoke estoppel principle against landlord, party claiming injury must show that it acted in good faith.

#### [10]**Equity** > Nature and elements in general

Under New York law, doctrine of laches is available when right is not asserted for an unreasonable and unexplained amount of time, which delay causes prejudice to adverse party, and renders it inequitable to permit exercise of right.

# **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

To quantify, as of moment of Chapter 11 debtor's rejection of its lease, the value of returned premises to landlord, for purposes of calculating landlord's rejection claim, bankruptcy court had to consider the likely, as opposed to the actual, expenses that landlord would incur to realize this value by reletting premises to another tenant; landlord's actual expenses were not proper test, as it might not use reasonable judgment in incurring them. Bankr.Code. 11 U.S.C.A. § 502(b)(6).

# **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

"Downtime," such as landlord would likely incur before it could relet premises and begin receiving rent from new tenant, had to be included in calculation of landlord's damages claim following Chapter 11 debtor-tenant's rejection of

lease. Bankr.Code. 11 U.S.C.A. § 502(b)(6).

2 Cases that cite this headnote

#### [13] **Bankruptcy** ightharpoonup Rejection of executory contract or lease

In computing its damages claim following Chapter 11 debtor-tenant's rejection of lease, commercial landlord could include capital costs which it necessarily expended to obtain successor tenants, but not costs which represented long-term capital improvements that yielded a betterment to leasehold. Bankr.Code,

11 U.S.C.A. § 502(b)(6).

4 Cases that cite this headnote

# **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

In re Andover Togs, Inc., 231 B.R. 521 (1999)

Commercial landlord acted reasonably in completely gutting the floor used by Chapter 11 debtor-tenant in its garment manufacturing business rather than trying to find successor tenant that could have made use of this space as it was configured for debtor's business, so that demolition cost was properly included as component of landlord's lease rejection claim, given expert testimony that it would be difficult to find tenant to relet entire floor, and that gutting of floors was appropriate marketing device when it might be difficult to visualize rental space reconfigured from prior use. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

#### [15] Bankruptcy 🗪 Rejection of executory contract or lease

Commercial landlord would not be allowed to include, in its claim for damages sustained as result of Chapter 11 debtor-tenant's rejection of lease, the cost of constructing common corridor to permit floor previously occupied by debtor in its garment manufacturing business to be relet to multiple tenants; common corridor was improvement of substantial and permanent character, which benefitted landlord and enhanced value of premises. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

#### **Bankruptcy** $\Longrightarrow$ Rejection of executory [16] contract or lease

To decide whether the minimum base charge for electric usage that Chapter 11 debtor was required to pay constituted "rent reserved," which landlord could include in its claim for lease rejection damages, bankruptcy court had to look beyond mere labels used in lease.

Bankr.Code, 11 U.S.C.A. § 502(b)(6).

# **Bankruptcy** $\longrightarrow$ Rejection of executory contract or lease

To decide whether the minimum base charge for electric usage that Chapter 11 debtor was required to pay constituted "rent reserved," which landlord could include in its claim for lease rejection damages, bankruptcy court would consider the following: (1) whether charge was (a) designated as "rent" or "additional rent" in lease, or (b) provided as debtor-tenant's obligation in lease; (2) whether charge was related to value of property or the lease thereon; and (3) whether charge was properly classifiable as rent because it was fixed, regular or periodic.

Bankr, Code, 11 U.S.C.A. § 502(b)(6).

### 2 Cases that cite this headnote

#### [18] **Bankruptcy** Pejection of executory contract or lease

Minimum base charge for electric usage that Chapter 11 debtor was required to pay, pursuant to Electricity Rent Inclusion Factor (ERIF) in its lease, did not constitute "rent reserved," such as landlord could include in its claim for lease rejection damages; while charge was fixed and regular and specifically designated as additional rent in lease, it had nothing to do with value of rental property or lease. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

### 1 Case that cites this headnote

#### [19] **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

Escalation charges for real estate taxes, which Chapter 11 debtor was required to pay on periodic basis pursuant to terms of its lease, qualified as "rent reserved," which landlord could include in its claim for lease rejection damages; because nonpayment of charges would diminish landlord's equity in property, their payment clearly went to maintenance of value of property or lease. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

# 1 Case that cites this headnote

#### [20] **Bankruptcy** $\Longrightarrow$ Rejection of executory contract or lease

Operating expenses at rate of \$1.50 for each square foot of property rented, which Chapter In re Andover Togs, Inc., 231 B.R. 521 (1999)

11 debtor-tenant was required to pay, as "additional rent" under lease, for services such as window-washing, elevator maintenance and cleaning, qualified as "rent reserved," which landlord could include in its claim for lease rejection damages; charges were for upkeep and maintenance of premises and were related to value of property. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

#### [21] **Bankruptcy** ightharpoonup Rejection of executory contract or lease

By reentering leased premises, gutting the floor used by Chapter 11 debtor in its garment manufacturing business, and attempting to relet premises, debtor's landlord did not effect a surrender and acceptance of premises, of kind which would release bankruptcy estate from liability for any lease rejection damages; regardless of whether this may have been the case under state law, debtor's bankruptcy changed this equation since, when debtor rejected lease, landlord had no other choice but

to accept return of premises. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

1 Case that cites this headnote

#### [22] **Landlord and Tenant** Mitigation of damages

Under New York law, landlord has no duty to mitigate its damages upon commercial tenant's breach of lease and failure to pay rent.

#### [23] **Bankruptcy** $\longrightarrow$ Rejection of executory contract or lease

"Fifteen percent" language in bankruptcy statute limiting landlord's claim for damages resulting from debtor's rejection of lease, pursuant to which landlord may recover "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease," restricted landlord, in case in which lease provided for escalation in rent over time, to 15 percent of total rents that remained due under lease, and not to rent that would be owing over the next 15 percent of remaining lease term.

Bankr.Code. 11 U.S.C.A. § 502(b)(6).

6 Cases that cite this headnote

# **Bankruptcy** ightharpoonup Rejection of executory contract or lease

Legislative history behind statutory cap on landlord's claim for lease rejection damages suggests that cap is akin to liquidated damages provision, which is intended to give fair remedy to both debtor and landlord, taking into account that landlord retains property at end of lease while ensuring that landlord does not get lion's share of bankruptcy estate to detriment of other creditors. Bankr.Code, 11 U.S.C.A. § 502(b)

1 Case that cites this headnote

#### Statutes 👺 Superfluousness [25]

Statute should be interpreted so as not to render one part inoperative.

[26] Statutes 🗽 Language and intent, will, purpose, or policy

> language; construction as written

Statutes Plain, literal, or clear meaning; ambiguity

To determine Congress' intent in drafting statute, court must first examine language of statute before turning to its legislative history; if statute is clear and unambiguous on its face, then it should be enforced according to the terms outlined.

Statutes Plain Language; Plain, Ordinary, [27] or Common Meaning

> Statutes PRelation to plain, literal, or clear meaning; ambiguity

# **BANKRUPTCY 2024: VIEWS FROM THE BENCH**

In re Andover Togs, Inc., 231 B.R. 521 (1999)

Plain meaning of statute should be followed unless this would produce absurd result or result at odds with intent of Congress.

# **Statutes** What constitutes ambiguity; how determined

Ambiguity is evident when statute may be understood by reasonably well informed persons in two or more different senses.

#### [29] **Statutes** > What constitutes ambiguity; how determined

If statute may be interpreted differently by separate courts, it is evident that statute is unclear and ambiguous.

1 Case that cites this headnote

# Statutes Peason, reasonableness, and rationality

Statutes Plain, literal, or clear meaning; ambiguity

If a reading of plain language of statute reflects an unreasonable conclusion, an alternative reasonable conclusion should be adopted in its stead despite statute's ambiguity or legislative history.

#### **Bankruptcy** Production of documents [31]

For item to be subject to discovery under Bankruptcy Rule, it must be in the possession, custody, or control of party from whom discovery is sought. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

#### [32] **Bankruptcy** Production of documents

Term "control" should be interpreted broadly, for purposes of deciding whether item which is subject of discovery request is in the possession, custody, or control of party from whom discovery is sought. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

#### [33] **Bankruptcy** Production of documents

Party is deemed to have "control" over documents, and may be required to produce them upon discovery request pursuant to Bankruptcy Rule, if party has the right, authority, or ability to obtain documents upon demand. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

1 Case that cites this headnote

#### [34] **Bankruptcy** Production of documents

Legal limitations which may limit party's ability to obtain requested item do not necessarily preclude a determination that party does in fact have "possession, custody or control" over item for discovery purposes in bankruptcy. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

#### [35] **Bankruptcy** Production of documents

While a party may not be compelled to produce documents that do not exist, where it is beyond dispute that party who is served with discovery demand to produce documents has both access to, and ability to obtain, documents, party must produce documents pursuant to discovery demand. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

1 Case that cites this headnote

#### [36] **Bankruptcy** Production of documents

Party from whom discovery is sought may not be permitted to present nothing more than conclusory statements to show that requested documents are not in its custody or control. Fed.Rules Bankr.Proc.Rule 7034, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 34, 28 U.S.C.A.

In re Andover Togs, Inc., 231 B.R. 521 (1999)

#### **Bankruptcy** Frivolity or bad faith; [37] sanctions

# **Bankruptcy** ightharpoonup Examination and Discovery

Failure to cooperate during discovery may subject party to sanctions under Bankruptcy Rule. Fed.Rules Bankr.Proc.Rule 7037, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 37, 28 U.S.C.A.

#### [38] **Bankruptcy** Frivolity or bad faith; sanctions

# **Bankruptcy** Examination and Discovery

Sanctions may be imposed for discovery violations in bankruptcy to penalize those whose conduct may be deemed to warrant such a sanction, and to deter those who might be tempted to such conduct in the absence of such a deterrent. Fed.Rules Bankr.Proc.Rule 7037, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 37, 28 U.S.C.A.

#### [39] **Bankruptcy** Frivolity or bad faith; sanctions

# **Bankruptcy** Examination and Discovery

Bankruptcy Rule which applies to disclosure and discovery disputes permits sanctions even if no court order compelling disclosure or discovery has been entered; however, available sanctions are limited to expenses incurred in connection with making or resisting the motion to compel. Fed.Rules Bankr.Proc.Rule 7037, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 37, 28 U.S.C.A.

# [40] **Bankruptcy** Frivolity or bad faith;

# **Bankruptcy >=** Examination and Discovery

To the extent feasible, sanctions imposed for discovery violations under Bankruptcy Rule should be tailored to fit circumstances in which the disobedience occurred. Fed.Rules Bankr.Proc.Rule 7037, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 37, 28 U.S.C.A.

### 1 Case that cites this headnote

#### [41] **Bankruptcy** Frivolity or bad faith; sanctions

# **Bankruptcy** Examination and Discovery

While some sanction was warranted for landlord's unjustified failure to produce management agreement in response to Chapter 11 debtor's discovery request, sanction requested by debtor, of disallowing landlord's lease rejection and other claims, was too severe, where debtor did not argue that landlord's failure to produce document before trial prevented debtor in any way from preparing for trial; more appropriate sanction was to compensate debtor for the added expense that it likely incurred as result of having to repeatedly request production of this document. Fed.Rules Bankr.Proc.Rule 7037, 11 U.S.C.A.; Fed.Rules Civ.Proc.Rule 37, 28 U.S.C.A.

#### [42] **Bankruptcy** Amendment or withdrawal

Decision to permit amendment of proof of claim rests within sound discretion of bankruptcy judge.

2 Cases that cite this headnote

#### **Bankruptcy** ightharpoonup Amendment or withdrawal [43]

While amendments to proofs of claim should, in absence of contrary equitable considerations or prejudice to opposing party, be freely permitted, such amendments are not automatic, but are allowed where the purpose is to cure defect in claim as originally filed, to describe claim with greater particularity, or to plead new theory of recovery on facts set forth in original claim.

3 Cases that cite this headnote

#### [44] **Bankruptcy** $\longrightarrow$ Amendment or withdrawal

Amendments to proofs of claim are disallowed when their purpose is to create new claim.

1 Case that cites this headnote

In re Andover Togs, Inc., 231 B.R. 521 (1999)

#### [45] **Bankruptcy** Amendment or withdrawal

In deciding whether to allow amendment to proof of claim, bankruptcy court must first determine whether there was a timely assertion of similar claim evidencing an intention to hold estate liable; if there was, court will then balances the equities, looking to such factors as the following: (i) undue prejudice to opposing party; (ii) bad faith or dilatory behavior on part of claimant; (iii) whether other creditors would receive windfall if amendment is not allowed; (iv) whether other claimants might be harmed or prejudiced; and (v) justification for claimant's inability to file amended claim at same time that original claim was filed.

1 Case that cites this headnote

#### [46] **Bankruptcy** *>* Amendment or withdrawal **Bankruptcy** Presumptions and burden of proof

Even if amended claim is "new" so as not to relate back, it may still be allowed if the failure to file was result of "excusable neglect," and burden is on claimant to prove that it did not timely file its proof of claim because of excusable neglect.

12 Cases that cite this headnote

#### **Bankruptcy** Amendment or withdrawal [47]

Amended proof of claim, to extent that it corrected inadvertent mistake by landlord in its original proof of claim in calculating Chapter 11 debtor's prepetition rent arrearages and liability for charges for air conditioning, cleaning and other services, would be allowed; original claim provided debtor with notice that landlord intended to hold estate liable for such prepetition charges.

**Attorneys and Law Firms** 

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OPINION DENYING IN PART AND **GRANTING IN PART THE DEBTOR'S OBJECTIONS TO THE REJECTION, GENERAL** UNSECURED AND ADMINISTRATIVE CLAIMS OF MID-CITY ASSOCIATES

TINA L. BROZMAN, Chief Judge.

#### Introduction

During the course of its successful chapter 11 proceedings, Andover Togs, Inc. ("Andover"), a garment manufacturer, attempted to negotiate with Mid-City Associates ("Mid-City"), its landlord, more favorable terms which would have allowed the debtor to remain at the premises which it had occupied as its executive offices for almost twenty years. Failing to achieve agreement, Andover rejected the lease. When Andover vacated the space to move to more modest headquarters, Mid-City, with an eye towards its perception of what the open market preferred, promptly demolished Andover's improvements. \*527 Some time later, Mid-City relet a portion of the space—at a price per square foot higher than what Andover was paying-but only after Mid-City had offered a variety of concessions to its new tenant and paid for substantial construction. Mid-City subsequently filed against Andover claims for damages sustained from the lease's rejection as well as an administrative claim. Andover objected to the various claims on a number of different theories including that the gutting of the space contributed in substantial part to the landlord's damages and that the higher rent per foot precluded any finding of damage to Mid-City. Unfortunately, the unsuccessful outcome of the parties' negotiations seems to have permeated all aspects of their relationship, culminating not only in Andover's objection to the claims filed by Mid-City, but in a request that Mid-City be sanctioned for its trial conduct.

By way of damages from the rejection of the lease under section 365 of the Bankruptcy Code, Mid-City seeks \$1,356,670 (the "rejection claim"). The administrative claim, which arises out of 9 days' rent which Andover incurred as a holdover tenant until it vacated the premises, asks from Andover \$35,811.31 (the "administrative claim"). Mid-

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City also asserts a general, unsecured claim in the amount of \$195,803.95 for prepetition rent arrears and charges for air conditioning, cleaning and other services provided by Mid-City (the "unsecured claim"). Andover does not dispute \$137,426.23 of the \$195,803.95 unsecured claim and \$28,650.68 of the \$35,811.31 administrative claim. However, Andover requests that I disallow these admittedly valid claims as a sanction for Mid-City's denial that there existed any management agreement regarding the building housing Andover's former headquarters, a denial which Mid-City steadfastly maintained until one of Mid-City's own employees conceded the agreement's existence during trial, not long after which Mid-City produced it. For the reasons set forth below, Andover's motion regarding the unsecured and rejection claims is denied in part and granted in part, and its motion regarding the administrative claim is denied.

I.

On March 19, 1996, Andover and its affiliates filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. Andover, which is primarily engaged in the design, manufacture, import and sale of popular-priced children's active wear, had streamlined many of its operations and overhead as part of its bankruptcy case. On April 10, 1997, I confirmed their First Amended Plan of Reorganization, which provided for a 100 percent payout, including interest, to all creditors.

Back in August, 1994, Andover had executed a nonresidential real property lease with Mid-City, which was subsequently modified three times in 1995 (the "Lease"). The Lease covered the entire 46th floor and approximately 1,390 square feet on the 6th floor in the building in Manhattan known as One Penn Plaza. Andover used the space on the 46th floor for its executive offices as well as for its production, showroom, computer, designer and sewing sample operations, and the 6th floor space for storage. (Tr. 6/2/97 at 528–529). The 46th floor is a tower floor comprising 33,287 square feet with expansive views of the city spanning the East and Hudson Rivers. (Tr. 5/14/97 at 137-138). The Lease, which expires on April 30, 2004, requires Andover to make the following annual base rent payments, payable in monthly installments:

\$765,601 through February 28, 1997;

\$832,175 for the period of March 1, 1997 through February 28, 2000;

\$898,749 for the period of March 1, 2000 through February 28, 2002; and

\$932,036 for the period from March 1, 2002 through April 30, 2004.

(Trial Exhibit 1). With the inclusion of the 6th floor space, the annual rent increased by \$21,570. The base rent set forth in the Lease does not include charges for electricity, real estate tax escalations or operating expense escalations, although these items appear in the Lease as additional charges which Andover is obligated to pay. (Trial Exhibit 1).

As part of the streamlining of its operations and overhead during the bankruptcy \*528 case, Andover sought to reduce its rent and the amount of space it was occupying. Because Andover had been a tenant at One Penn Plaza for nearly 20 years, it had approached Mid-City to further modify the Lease. (Tr. 5/14/97 at 124-125). When negotiations failed, Andover rejected the Lease (Tr. 5/14/97 at 125-126), effective as of August 31, 1996 (the "Rejection Date"), but vacating the premises on September 9, 1996. As of the Rejection Date, approximately 7 3/4 years of the Lease term remained.

II.

#### A. The Rejection Claim

Although the primary issue centers on the proper calculation of Mid-City's rejection claim under section 502(b)(6) of the Bankruptcy Code, there are subsidiary issues, such as whether certain spaces were effectively deleted from the Lease by Andover, whether various charges set forth in the Lease may be included in Mid-City's calculation of its rejection claim, and whether Mid-City's gutting of the 46th floor space delayed its reletting of the premises, prevented Mid-City from mitigating its damages and inflated the cost of Mid-City's tenant improvements (included as part of its rejection claim). We begin with those lesser issues.

#### 1. The Purported Deletion of Space

Article 49 of the Lease and Section 5(c) of the Second Lease Modification Agreement provide that Andover may exercise options to delete nearly 6,900 square feet, or approximately 20 percent, of the 46th floor space and the entire 6th floor space from the Lease upon proper and timely written notification, if and so long as Andover is not in default under the Lease beyond any grace period. (Trial Exhibits 1 and 3).

[1] Andover contends that the rejection claim is overstated because it includes \$24,724.61 in damages for the 6th floor space which Andover asserts was deleted from the Lease on proper notice to Mid-City. Section 5(c) of the Second Lease Modification Agreement provides that Andover may delete the 6th floor space from the premises upon 90 days' written notice to Mid-City. William Cohen, Chairman and President of Andover, testified that Andover provided actual notice to Mid-City that Andover intended to delete the 6th floor storage space by virtue of having filed its lease rejection motion and providing a copy of it to Mid-City in August, 1996, the same time that Andover notified Mid-City that Andover was going to reject the Lease and vacate the premises (Tr. 5/14/97 at 122-123). No other written notice was provided. (Tr. 5/14/97 at 123).

Article 26 of the Lease details the type and manner of service of any notice required to be given under the Lease, or by any law or governmental regulations. Specifically, Article 26 provides that Mid-City will be deemed to have been served once Andover sends the required notice by registered or certified mail. Because the lease rejection motion was filed less than one month prior to the effective rejection date of August 31, 1996, Andover did not provide Mid-City with the requisite 90 days' notice required to exercise the option, assuming, but not deciding, that Andover did not need to comply with the requirement for registered or certified mail. In any event, had Andover given good notice, the space would not have been deleted from the Lease until sometime in November, 1996, more than 2 months after rejection of the Lease. Thus, the 6th floor space was still part of the Lease at the time it was rejected.

Andover also contends that the rejection claim is overstated because it includes \$207,612.37 in damages for that portion of the 46th floor space which Andover asserts was effectively deleted. The Lease provides that Andover may exercise its option to delete this space if the following conditions are met: (i) at least six months' written notice of Andover's exercise of this option must be given to Mid-City (Lease, Article 49); (ii) the notice must be provided by registered or certified mail and addressed to Mid-City at 60 East 42nd Street, New York, New York, or to such other address as Mid-City may designate (Lease, Article 26); and (iii) Andover is not in default under the Lease beyond any grace period (Lease, Article 49). Andover contends that it

complied with these conditions by sending a certified letter dated February 26, 1996 (the "February 26th Letter") \*529 to Mid-City, six months prior to the date of rejection of the Lease, in which it advised Mid-City of Andover's election to exercise its option to relinquish and delete this portion of the 46th floor, and by hand-delivering a copy to Daniel E. North, Vice President of Helmsley–Spear, Inc. ("Helmsley–Spear"), the managing and leasing agent employed by Mid-City for One Penn Plaza. (Tr. 5/14/97 at 117-118, 153). Mr. Cohen testified that he also informed Mr. North in the fall of 1995 of Andover's need to reduce its space based upon a reduction in Andover's operations. (Tr. 5/14/97 at 114).

[5] It is hornbook law that a lease is a contract containing provisions or clauses for the protection of both parties and terminates upon a definite date agreed upon by the parties. 74 N.Y.Jur.2d Landlord and Tenant § 3 (1988). It frequently contains "provisions giving the parties, or one of them, the election, privilege or option to terminate the lease either at will or on the happening of some contingency, such as the destruction of the premises, or the decision of the landlord to sell, alter or improve the premises." 74 N.Y.Jur.2d Landlord and Tenant § 763 (1988). These options granted by the provisions of a lease contract will be strictly construed where they are exercised in good faith.

Id.; In re Royal Yarn Dyeing Corp., 114 B.R. 852, 856 (Bankr, E.D.N.Y.1990). Similarly, the notice provisions of a lease are to be strictly construed, especially where such substantive rights, i.e. possession of all or part of the premises, is in question. D.A.D. Restaurant, Ltd. v. Anthony Operating Corp., 139 A.D.2d 485, 526 N.Y.S.2d 590, 591 (1988), appeal denied, 72 N.Y.2d 806, 529 N.E.2d 177, 532 N.Y.S.2d 847 (1988).

Whereas the letter was addressed to Mid-City, it was sent to Helmsley-Spear at One Penn Plaza rather than to Mid-City at 60 East 42nd Street, as the Lease required. (Andover's Motion For An Order Disallowing and Expunging Claim 303, Exhibit D). It is undisputed that Mid-City eventually received the February 26th Letter, in which Andover advised Mid-City of Andover's intent to delete a portion of the 46th floor from the Lease, for Mary Gartland, Controller for Mid-City, testified that she discovered Andover's certified letter by "sheer accident" in the file of another tenant on the eve of the trial. (Tr. 3/19/97 at 75-76,154-155). The original letter was produced by Mid-City on March 19, 1997 after Ms. Gartland retrieved the letter from Mid-City's own files. (Tr. 3/19/97 at 154). However, Mid-City argues that because the February 26th Letter was sent by certified or registered mail

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to Helmsley-Spear, instead of in accordance with the terms of the Lease, Andover failed to provide proper notice of its intent to exercise the option.

[6] Mid-City further contends that Andover could not have exercised its option to delete the 46th floor space because it was in default on its rent. Under New York law, when a lease provides that a tenant is obligated to make a rent payment on a specified day, the tenant is in default under the lease if the rent payment is not made by the end of that day. Henninger v. Clay, 4 Misc. 2d 795, 162 N.Y.S. 2d 230 (2d Dept. 1956). No demand by a landlord is necessary in order for the tenant to be in default if the tenant does not make the required rent payment,

unless otherwise specifically provided in the lease. Fifty States Management Corp. v. Pioneer Auto Parks, Inc., 46 N.Y.2d 573, 415 N.Y.S.2d 800, 389 N.E.2d 113 (1979).

Andover claims that its default may be disregarded because Mid-City never served Andover with any notice of default as required by the Lease. 1 Because Mid-City did not do so, Andover continues, Mid-City acted in bad faith, depriving Andover of an opportunity to cure. Putting aside, for the moment, whether Mid-City had any obligation \*530 to serve notice of default, the evidence demonstrates that Andover was well aware of its rental default, such that Mid-City's failure to notify Andover of a default did not deprive Andover of anything. Stephen Golding, Assistant Comptroller of Mid-City, testified that, according to Mid-City's rent bills to Andover, the last payment made by Andover to Mid-City was on February 1, 1996, several weeks prior to the filing of Andover's bankruptcy petition (Tr. 5/14/97 at 98-99), and that after this payment, Andover still owed \$78,815.32 in rent. (Tr. 5/14/97 at 99). Mr. Cohen testified on cross-examination that he knew in March 1996 that Andover owed almost \$200,000 in past rent but that he had no knowledge one month earlier that Andover owed any rent to Mid-City (Tr. 5/14/97 at 164-165). I do not find persuasive Mr. Cohen's testimony that he did not know that Andover was not current in its rent obligations on February 26, 1996, especially since less than one month after Andover sent the February 26th Letter, Andover filed its bankruptcy schedules listing Helmsley-Spear as its second largest creditor, having an undisputed, liquidated and noncontingent claim in the amount of \$196,365.37 for unpaid rent, an amount well in excess of one month's rent. (Tr. 5/14/97 at 160; Trial Exhibit 13).

Returning to the issue which we temporarily put aside, that is, whether Mid-City had an obligation to notify Andover

of its default, Andover called an expert witness by the name of Harold S. Grace, Jr., Ph.D., who testified that it was "his feeling" that a landlord has an obligation to notify a tenant very quickly if it believes that the tenant does not have the right to exercise an option. (Tr. 6/2/97 at 406-407). Nowhere does the Lease here impose such an obligation; rather, Andover reads such an obligation into the Lease through the doctrines of equitable estoppel and laches. Andover contends that, having failed to notify Andover-until it objected to Mid-City's claim a little less than a year later—that it disputed Andover's purported exercise of the option in February 1996, Mid-City is barred from contesting the deletion of the space

Plainly, Mr. Grace's testimony notwithstanding, the terms of the Lease do not require Mid-City to serve a notice of default for Andover to be precluded from exercising its option to delete space. Rather, Mid-City is required under Article 14 of the Lease to provide Andover with notice of its default for nonpayment of rent, thereby giving Andover a 15-day grace period before Mid-City may exercise its right to terminate the Lease. The Lease does not provide for any grace period relating to Andover's exercise of its option. Because the Lease requirement that Andover not be in default at the time of the exercise of the options was a condition precedent to its right to utilize the space deletion options, Andover's default in making its rent payments when due, unless engendered by Mid-City's

actions, rendered Andover's Lease options void. See In re Eastern Systems, Inc., 105 B.R. 219 (Bankr.S.D.N.Y.1989), aff'd, 89 Civ. 7934(MJL), 1991 WL 90733 (S.D.N.Y. May 23, 1991). Similarly, unless Mid-City can be said to have acted in bad faith, a proposition which Andover advances, Andover's failure to give proper notice of exercise of the option precluded it from exercising the option to delete space. So it is to equitable estoppel and then to laches that we turn.

[9] Under New York law, the essential elements of equitable estoppel relating to the party to be estopped are: "(1) conduct which amounts to false representation or concealment of material facts or which gives the impression that the facts are otherwise than asserted, (2) an intention or expectation that such conduct would be relied upon by the other party, and (3) actual or constructive knowledge of the real facts. The elements relating to the party asserting the estoppel defense are (4) lack of knowledge of the real facts, (5) reliance on the conduct of the party to be estopped, and (6) action based thereon resulting in a prejudicial change of position." Eastern Systems, 105 B.R. at 234 (citations

omitted). In addition, in order for a court to invoke the estoppel principle against a landlord, the party claiming injury must show that it acted in good faith. Id. at 235 (citation omitted). Andover has failed to meet its burden of proof under the theory of equitable estoppel. First, there was no conduct by Mid-City which amounted to a false representation \*531 or concealment of a material fact regarding the rental payments. To the contrary, the evidence demonstrates that Mid-City had notified Andover of its rent arrearages prior to Andover's attempt to exercise the options. (Trial Exhibits 9 and 10). Thus, Andover had actual or, at the very least, constructive knowledge of its rent arrearages. Moreover, Mid-City provided notice of Andover's default prior to Andover's attempt to exercise the options by providing Andover with copies of the monthly rent billings which indicated Andover's increasing rent arrearages. Because Andover had actual or constructive knowledge of its rent arrearages imparted to it by Mid-City, Andover could not rightfully rely upon Mid-City's failure to quickly advise Andover that the options could not be exercised to conclude that Mid-City would overlook the rent arrearages and allow exercise of the option. See Eastern Systems, 1991 WL 90733, at \*7.

Andover further contends that Mid-City should be estopped from arguing that Andover's deletion notices were invalid under the doctrine of laches. That doctrine is available when a right is not asserted for an unreasonable and unexplained amount of time, which delay causes prejudice to an adverse party and renders it inequitable to permit the exercise of that right. Airco Alloys Div. v. Niagara Mohawk Power Corp., 76 A.D.2d 68, 430 N.Y.S.2d 179, 187 (1980). Laches is no more availing to Andover than was equitable estoppel. First, Andover provided its purported notice of its intent to exercise its option to delete the 6th floor space only 3 weeks, instead of 90 days, before the Lease was rejected. Second, there is no evidence that Mid-City's silence regarding the February 26th Letter until Andover objected to its lease rejection claim prejudiced Andover in any way, for Mr. Cohen testified that Andover determined within one month of the chapter 11 filing that if Mid-City were unwilling to reduce the rent and the space demised under the Lease that Andover would have no other alternative but to reject it. (Tr. 5/14/97 at 125-126). Because Andover says it believed that it had reduced the amount of space prepetition through exercise of the options, its decision to reject must have been predicated on its inability to further reduce the space rather than on the deletion or failure to delete the 46th floor space through the option mechanism. Accordingly, Mid-City properly includes

damages in connection with Andover's rejection of both spaces in its rejection claim<sup>2</sup>.

#### 2. Whether Mid-City Sustained Compensable Damages

#### a. The Proper Standard

Andover argues that the rejection claim should be expunged because Mid-City did not sustain actual damages. Andover's argument is bottomed on the theory that the fair market rental value of the premises exceeded the remaining rent reserved under the Lease. Mid-City replies that it has sustained actual damages due to the breach of the Lease well and above its damages under the section 502(b)(6) cap. Relying on In re D. H. Overmyer Co. v. Irving Trust Co., 60 B.R. 391 (S.D.N.Y.1986), Andover responds that because Mid-City failed to overcome the presumption that the fair market rental value of the premises is at least equal to, if not greater than, the rent reserved under the Lease, its lease rejection claim should be expunged.

In Overmyer, the landlord filed a claim for damages following the debtor's rejection of its lease. The debtor objected to the landlord's claim, arguing that the landlord did not sustain any actual damages. The Overmyer court computed the landlord's damages by applying both the standard enunciated by the Supreme Court in City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433, 57 S.Ct. 292, 81 L.Ed. 324 (1937) and the damage clause in the lease which calculated damages in a bankruptcy context. In so doing, the court acknowledged that because the formulae were similar in nature, it did not need to decide whether the computation of damages provided for in the lease or in the dictum by \*532 the Supreme Court in Farmers Trust should control determination of a landlord's actual damages. Overmyer, 60 B.R. at 396. In In re W.T. Grant Co., 36 B.R. 939, 941 (S.D.N.Y.1984), a case involving an objection by a trustee to a landlord's proof of claim, the court explained that

"... the [Bankruptcy] Act itself does not provide a formula ascertaining the appropriate measure of damages (citations omitted). Therefore, absent a specific damage provision in a lease, courts apply the rule enunciated by the Supreme Court in City Bank Farmers Trust Co. v. Irving Trust Co., 299 U.S. 433, 57 S.Ct. 292, 81 L.Ed. 324 (1937), i.e., that the measure of damages which the landlord may recover as a result of the tenant's breach is 'the difference between the rental value of the remainder of the term

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and the rent reserved, both discounted to present worth.' Id. at 433, 57 S.Ct. at 297; (citations omitted). Thus, the landlord may recover only actual damages suffered as

a result of the tenant's breach. (citations omitted)." See also In re J. Bildner & Sons, Inc., 106 B.R. 8, 13

(Bankr.D.Mass.1989); Paper (Bankr.D.Mass.1989); (Ba B.R. 349, 352 (Bankr.S.D.N.Y.1993) ("Absent any specific provision in a lease, the general rule is that the measure of damages which a landlord may recover as a result of a tenant's rejection of the lease is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth."). Cf. In re Ames Department Stores, Inc., 209 B.R. 627 (S.D.N.Y.1997). See also In re Highland Superstores, Inc., 154 F.3d 573, 578 (6th Cir.1998) (although not deciding whether the formula approved in dicta in the Kuehner and Farmers Trust cases is necessarily the correct, or the only appropriate method for computing a lessor's rejection damage claim, the court stated that "we find nothing in [these cases] suggestive of the Supreme Court's intent to adopt a uniform federal rule governing computation of a lessor's rejection damages without regard to state law."); In re Financial News Network, Inc., 149 B.R. 348, 352 (Bankr.D.N.Y.1993) ("[T]he amount of the [rejection] claim is to be determined by the court in accordance with the state

Turning to Andover's Lease, we pause to look at the arguably relevant provisions. Not surprisingly, Andover and Mid-City differ as to which clause provides the proper methodology for computing Mid-City's actual damages. Andover argues that Section 13.04 applies whereas Mid-City contends that Section 15.01 governs. Section 13.04 provides that in the event the Lease is terminated in any of the bankruptcy contexts set forth in Sections 13.01, 13.02 and 13.03 therein, Mid-City shall be entitled to recover from Andover as and for liquidated damages:

law and the contract between the parties.")

"an amount equal to the difference between the rent reserved hereunder for the unexpired portion of the term demised and the then fair and reasonable rental value of the demised premises for the same period, if lower than the rent reserved at the time of termination."

Section 15.01 of the Lease specifies the amount of damages to be paid to Mid-City "in case of re-entry, expiration and/ or dispossess by summary proceedings or otherwise as set forth in Article 14 hereof." As mentioned earlier, Article 14 of the Lease describes the types of default which could lead to termination of the Lease and Andover's and Mid-City's obligations and rights in connection therewith. Section 15.01(c) computes the amount of damages to be paid for Andover's failure to observe and perform its covenants contained in the Lease as the

> "deficiency between the rent hereby reserved and/or covenanted to be paid and the net amount, if any, of the rents collected on account of the lease or leases of the demised premises for each month of the period which would otherwise have constituted the balance of the term of this Lease. The failure or refusal of Landlord to re-let the premises or any part of parts thereof shall not release or affect Tenant's liability for damages. In computing such damages there shall be added to the said deficiency such expenses as landlord may incur in connection with re-letting, such as legal expenses, reasonable attorneys' fees, brokerage and for keeping the demised premises \*533 in good order or for preparing the same for re-letting."

Mid-City argues that because Andover voluntarily commenced its chapter 11 proceeding, none of the bankruptcy situations described in Sections 13.01, 13.02 and 13.03 of the Lease, that is, the occurrence of Andover's bankruptcy prior to the commencement of the term of the Lease, the service of a notice by Mid-City terminating the Lease because of Andover's bankruptcy, and the commencement of an involuntary bankruptcy proceeding against Andover which was not vacated or stayed by Andover within a certain time period, occurred, thereby precluding the application of the liquidated damages formula set forth in Section 13.04. Mid-

City elevates form over substance. It is evident from Section 13.02 that the parties intended to apply the liquidated damage computation found in Section 13.04 in the event Andover was involved in one of the types of bankruptcy situations described therein, including Andover's filing of a voluntary petition in bankruptcy during the term of the Lease. 3 In addition, it is irrelevant that Mid-City did not serve a notice upon Andover terminating the Lease because Mid-City is automatically stayed from so doing pursuant to resection 362 of the Bankruptcy Code. Therefore, I find, as did the Overmyer court with respect to a similar damage clause contained in the lease before it, that Article 13, designated in the Lease as "Bankruptcy," is the proper liquidated damage provision to be applied in this case.

Because the measure of damages found in Section 13.04 of the Lease is similar to the standard enunciated in Farmers Trust, I may apply either to determine whether Mid-City sustained actual damages from Andover's rejection. The parties offered differing evidence regarding the fair market rent for Andover's space after rejection of the Lease and significantly disagreed as to how to compare the remaining rent reserved under the Lease against the fair market value of the premises, particularly with respect to: (i) how long it would take for Mid-City to relet the premises and start to receive an income stream from the new tenant; (ii) the appropriate amount per square foot to utilize in computing the cost of new tenant improvements; and (iii) whether the Electricity Rent Inclusion Factor ("ERIF") charges may be included in determining the future rental stream that Mid-City would have received from Andover.

Sharon Locatell, an expert witness for Mid-City and the managing director of the commercial division of Brown Harris Stevens Appraisal & Consulting (Tr. 5/14/97 at 10), testified that, based upon Mid-City's lease with P.S.I., Inc., dated July 28, 1997, for approximately half of the 46th floor (Tr. 9/11/97 at 707, 709), the current fair market value of the Lease is \$30 per square foot. (Tr. 9/11/97 at 757). The P.S.I. lease provides for a base rent payment of \$30 a square foot for approximately the first 4 ½ years, and then steps up to \$32 per square foot for the next two years, and for the remaining term moves to \$34 per square foot. (Tr. 9/11/97 at 709). She also testified that on September 1, 1996, the market rate for the 46th floor was \$29 per square foot. (Tr. 9/11/97 at 757), whereas the face rent Andover was paying under the Lease was \$26 per square foot. (Tr. 3/19/97 at 69). Stephen Marotta, project manager with Zolfo Cooper, L.L.C., Andover's courtapproved financial advisors, testified that Mr. North informed him that Andover was paying \$25 a square foot under the Lease. (Tr. 6/2/97 at 359).

Ms. Locatell further testified that the methodology ordinarily used to determine net fair market value rent is to deduct from the average gross rent, which is the average per square foot rent over the term of the lease, the landlord's capital costs and the concessions that the landlord must offer a tenant to obtain rent. (Tr. 5/14/97 at 24-26). She included in the capital costs the construction \*534 of a common corridor on a multitenant floor. (Tr. 9/11/97 at 710). Those costs to the landlord also include, she said, its contribution to the tenant's initial installation, the brokerage commission incurred to obtain the lease, "downtime" and free rent. (Tr. 5/14/97 at 34-35, 38-39) 4. Mr. North testified that in 90 percent of the cases where he leased space at One Penn Plaza, the landlord made some contribution to the cost of tenant improvements, although not necessarily the cost of a full build-out. (Tr. 3/19/97 at 121-122). As part of Ms. Locatell's methodology to compute Mid-City's actual damages, she assumed, based upon the P.S.I. lease, annual increases of 3 ½ percent in real estate taxes, operating expenses and ERIF. (Tr. 9/11/97 at 716). The P.S.I. lease provides for ERIF in the base amount of \$3,000. (Tr. 9/11/97 at 709).

Ms. Locatell compared the net present value of the income stream provided by the Lease with the net present value of the fair market rent for the premises to compute the amount of Mid-City's actual damages. (Tr. 9/11/97 at 711). Using a discount rate of 12 percent, she arrived at the net present value of the income stream under the Lease of \$5.6 million. (Tr. 9/11/97 at 720–721). She testified that she used a discount rate of 12 percent because the discount rate as of May 1996 for a midtown office ranged from 9 to 18 percent, with the reported average being 11.9 percent. (Tr. 5/14/97 at 52). Ms. Locatell computed the net present value of the fair market for the premises to be \$3 million by totaling the cost of "breaking up" the 46th floor, determining the net present value of the space occupied by P.S.I. pursuant to the terms of the P.S.I. lease<sup>5</sup>. including real estate tax and operating expense escalations based upon historical data, determining the net present value of the remaining 17,309 square feet on the 46th floor, based upon market assumptions as to when the space will lease, at what rent it will lease, the terms of tenant installation and leasing commissions, as well as real estate tax and operating expense escalations and ERIF charges, and the net present value of the storage space on the 6th floor. (Tr. 9/11/97 at 711–714). With respect to the remainder of the 46th floor, Ms. Locatell testified that she assumed that Mid-City would begin

to collect income as of April 1, 1998, with an initial base rent of \$31 per square foot and a step-up in the sixth year of the lease at an amount equal to "20 percent of the \$30 per square foot", operating expenses and real estate tax escalation with annual increases of 3 ½ percent, and ERIF charges at \$3 per square foot, increasing at 3 ½ percent annually. (Tr. 9/11/97 at 715–716). Ms. Locatell further assumed tenant improvements at \$35 a square foot based upon the P.S.I. lease, and a full broker's leasing commission equal to 32 percent of the first year's rent. (Tr. 9/11/97 at 715-718). However, she did not make separate assumptions regarding the total amount of time for free rent and building out Andover's space, rather, she utilized one, two and three year assumptions for combined downtime, free rent and construction. (Tr. 9/11/97 at 717).

Using her methodology, Mid-City's actual damages were \$2.6 million, the difference between the discounted net present value of the income stream under the Lease at a discount rate of 12 percent (\$5.6 million) and the discounted net present value of the fair market rent for the premises using a discount rate of 12 percent (\$3 million). (Tr. 9/11/97 at 720-721). Using a 9 percent discount factor, the correct discount rate according to Andover's expert, she testified that Mid-City's damages remained at \$2.6 million although the net present value of Andover's rental stream under the Lease and the net present value of the fair market rent for the premises each increased by \$500,000. (Tr. 5/19/97 at 204-205; Tr. 9/11/97 at 720-721).

\*535 Andover's expert witness, Arthur Nelkin, a real estate advisor and investor, agreed with Ms. Locatell's overall approach, but, as just mentioned, testified that the correct discount rate to be used is 9 percent (Tr. 5/19/97 at 204-205). Mr. Nelkin testified that had he been advised in June, 1996 that the 46th floor would become vacant shortly, there was an 80 percent chance that he could have leased the 46th floor by the end of 1996. (Tr. 5/19/97 at 195). To that, Mr. Nelkin testified that an additional 6 months for construction and free rent would be added for "a 10 month total, slightly less." (Tr. 5/19/97 at 195, 313). Mr. Nelkin further testified that had he leased the 46th floor by the end of 1996, the rental would have been \$29 to start, increasing in the later years of a new lease to an average of \$31.50 (Tr. 5/19/97 at 195-196), and that he believed that the market average rent in May, 1997 on that space would be \$34 a foot. (Tr. 5/19/97 at 195-196). Therefore, based upon Mr. Nelkin's testimony, it would appear that Mid-City could have started to receive rental income in connection with Andover's premises by June 1, 1997, or even sooner had Mid-City decided to modify the

Lease to permit Andover to occupy less space at a reduced rent as hoped for by Andover. 6

Andover argues that I should disregard the testimony of both experts as contrary to the Farmers Trust formula, which compares the discounted rental value—and not discounted actual income—with the discounted rent reserved.

Farmers Trust, 299 U.S. at 443, 57 S.Ct. 292. In line with this argument, Andover contends that "downtime" is irrelevant in determining a landlord's damages under Farmers Trust. In response, Mid-City contends that "downtime" necessarily affects the fair market value of the property because the landlord does not receive any income from the property while it is relet. Both parties rely upon In re Ames Department Stores, Inc., 209 B.R. 627 (S.D.N.Y.1997) in support of their respective positions.

In Ames Department Stores, a case brought under Florida law, the debtor rejected a lease with 13 years yet to run for 60,200 square feet of commercial retail space in a shopping center. The lease required the debtor to pay a minimum annual rent of \$2.15 per square foot. About a year and a half later, the landlord leased 51,500 square feet to a tenant for a 90-day term at \$9,000. Subsequent to the expiration of the 90 day lease, the landlord leased another 25,600 square feet to a second tenant for a term of 5 years at an annual rent of \$75,000. Two and one-half years after the rejection, the landlord leased 34,600 square feet to a third tenant for 7 years at an annual rent of \$93,770.04 for the first five years and \$101,402.04 for the last 2 years. The landlord incurred renovation costs of approximately \$104,000 to accommodate one of the tenants. The total amount of annual rent that the landlord received from the replacement tenants, once all were installed at the premises, exceeded the amount of rent due annually under the original lease. The landlord estimated that the current market rent of the premises was no less than \$3 per square foot. Following rejection of the lease, the landlord filed a rejection claim seeking one year's rent. Thereafter, the landlord moved for summary judgment, arguing that, under state law, it was entitled to damages from the debtor's rejection of the lease. The debtor cross-moved for summary judgment disallowing the claim, responding that the landlord had not suffered any damages because the rental value of the premises exceeded the rent reserved under the lease. The debtor appealed the Bankruptcy Court's Memorandum Decision and Order granting summary judgment to the landlord and denying its cross-motion for summary judgment disallowing the claim. The District Court vacated the Memorandum Decision and Order and "remanded

the action to the Bankruptcy Court for a trial on the issue of the landlord's damages and its efforts to mitigate damages as they may bear upon that determination." \*536 Id. In reaching its decision, the district court reasoned that the "rent received by the [landlord] from the New Leases permits the rational inference that the [landlord] could have rented the premises earlier at a rate less than the New Leases but higher than the reserved rent. On the other hand, the [landlord's] initial failure to re-let the Premises permits a competing rational inference that the fair market value of the remainder of the leases was less than the reserved rent, because the lessor, as a prudent business person, might not have let the premises remain vacant if he or she could have recouped the rent by a timely re-rental. Since either inference would be rational, summary judgment is inappropriate." *Id.* at 631. In a footnote the court remarked that it "rejects the landlord's argument that damages can or should be measured by the rents received or not received, in the period following rejection of a lease." Id. at 631, n. 6.

[11] Andover's argument that one looks at only rental value under Farmers Trust begs the question, for Andover ignores the testimony of both experts and assumes that the premises could be relet in the moment following rejection. Obviously, that cannot be what rental value means. This is not to suggest that the court must continually refine the damages based on what the future brings for the landlord, an approach which would stymie efforts to liquidate claims and, possibly, to reorganize. But some effort must be made to quantify, as of the moment of rejection, the value of returned premises to the landlord, a concept which necessarily includes the likely expenses that the landlord would incur to realize the value. Indeed, that seems to be what the Farmers Trust formula aims to do, taking into account the predicted future usability

of the premises and probable future rent. See Palmer v. Connecticut Ry. & Lighting Co., 311 U.S. 544, 559, 61 S.Ct. 379, 85 L.Ed. 336 (1941). ("Future rental value cannot be susceptible of precise proof. As it depends, so far as the amount of damages for breach of a lease is concerned, upon future profits, it partakes of the nature of loss of earning capacity or of credit. To require proof of rental value approaching mathematical certitude would bar a recovery for an actual injury suffered. All that can be done is to place before the court such facts and circumstances as are available to enable an estimate to be made based upon judgment and not guesswork. Every anticipatory breach of an obligation, and every appraisal of damage involving the present value of property involves a prediction as to what will occur in the future. Present market value of property is but the resultant of

the prediction of many minds as to the usability of property and probable financial returns from that use, projected into the future as far as reasonable, intelligent men can foresee the

future."); see also Kuehner v. Irving Trust Co., 299 U.S. 445, 57 S.Ct. 298, 81 L.Ed. 340 (1937). I agree that actual expenses ought not be the test, for the landlord may or may not have used reasonable judgment in incurring them. It is possible, for example, that in a market which seemed to have been rising the landlord may have refused tenancies which may have made the landlord whole, in favor of holding out for a tenant who would demand more concessions but would, in turn, agree to a higher rent than what the debtor was paying.

To compute the gross fair market value of the premises under a hypothetical new lease from the Rejection Date of the Lease until its expiration on April 30, 2004, Ms. Locatell utilized the actual base rent of \$30 per square foot as well as additional rent step-ups to be paid under the terms of the P.S.I. lease. (Tr. 9/11/97 at 717). Because the projected fair market value of Andover's premises is to be determined as of the time of rejection of the Lease, Mid-City may not utilize in its calculation the actual rent to be received under the P.S.I. lease, which was executed in July, 1997. Therefore, I give greater weight to Mr. Nelkin's testimony that the fair market rent would have been \$29 per square foot to start, with an average rental over the term of the lease of \$31.50. (Tr. 5/19/97 at 195), which is precisely what Ms. Locatell had testified to prior to Mid-City's entry into the P.S.I. lease. (Tr. 9/11/97 at 717, 757).

[12] For the reasons discussed below, I also conclude that "downtime" should be included in the landlord's calculation of its \*537 rejection claim. Both experts differ regarding the appropriate amount of downtime. Whereas Mr. Nelkin testified that there was an 80 percent chance that he could have leased the 46th floor within 4 months of rejection of the Lease, his confidence in his ability may not be truly representative of the market and is not without uncertainty. On the other hand, Ms. Locatell testified that she did not agree with the assumption that a tenant should have been found by January 1, 1997 based upon the "historical record" that the premises was not relet until at least 10 months after Andover's vacatur. (Tr. 9/11/97 at 741–743, 767). I do not agree that "20–20 hindsight" is the correct measure of downtime. Because the opinions of the experts appear to be at the opposite ends of the downtime spectrum, I find that the reasonable amount of downtime to be included in the computation of Mid-City's rejection claim is at the midway point of 7 months. With respect to the correct measure of time for free rent and construction, I will give greater weight to Mr. Nelkin's

testimony that the combined time is 6 months. So it is to the expenses that we now proceed.

#### b. Which expenses are properly a component of the claim

#### (i) Demolition cost

[13] [14] City, at its option, to alter, repair or make replacements in the premises as Mid-City, "in [its] sole judgement, considers advisable and necessary for the purpose of re-letting the demised premises." Mid-City may include in its computation of damages the capital costs which it necessarily expended to obtain successor tenants, but not which represent long term capital improvements which yield a betterment to the leasehold. See In re Handy Andy Home Improvement Centers, Inc., 1998 WL 603252, at \*5, 1998 Bankr.LEXIS 1175 at \*14

(Bankr.N.D.Ill.1998); accord In re Stewart's Properties. Inc., 41 B.R. 353, 356 (Bankr.D.Haw.1984); Matter of Parkview-Gem, Inc., 465 F.Supp. 629 (W.D.Mo.1979); see also C.D. Stimson Co. v. Porter, 195 F.2d 410, 414 (10th Cir.1952) (changes to the premises, such as dividing it into two rental units, installing two restrooms and other major alterations, are improvements of substantial and permanent character which redound to the landlord's benefit and enhance the premises' value.)

Mid-City contends that the tenant installation cost in connection with the P.S.I. lease was \$35 a square foot and the total capital costs, including the tenant installation, leasing commissions, building a common corridor, and 3 ½ months of free rent, total approximately \$1.1 million. (Tr. 9/11/97 at 710-711). Mid-City projects that an approximately equal sum will be incurred by Mid-City to relet the balance of the premises. (Mid-City Reply Memorandum, p. 10). Mid-City also acknowledged that the building will have the benefit of the corridor if the market is such that the space will be leased to multi-tenants. (Tr. 9/11/97 at 755). Andover argues that the costs of Mid-City's new tenant improvements were improperly and unreasonably inflated because Mid-City completely demolished the space, and, as a result, the difference between the tenant improvement costs that would have been incurred if Mid-City had not gutted the premises (\$20-\$25 per square foot) and the full cost of the installation now required as a result of the demolition (\$35-\$40 per square foot) should be waived. Once again, this argument ignores the testimony of Andover's own expert.

Mid-City unilaterally decided to demolish the 46th floor. (Tr. 3/19/97 at 96). According to testimony provided by Mid-City, it is common practice to demolish space which does not lend itself to reletting as currently configured. (Tr. 3/19/97 at 59). The testimony established that because Andover was in the garment business, its installation was not typical of other tenant installations in One Penn Plaza or fully functional for a different tenant. (Tr. 6/2/97 at 512-513, 516-517; Tr. 6/18/97 [15] Article 15 of the Lease permits Mid- at 694). Mr. Nelkin, Andover's expert witness, agreed that there are certain circumstances when it would be appropriate for the landlord to gut the existing installation as part of its reletting efforts, (Tr. 5/19/97 at 288-289), and that it is easier for a landlord to lease vacant space compared to occupied space. (Tr. 5/19/97 at 292). However, he further testified that although there was a "possibility" that a tenant could have been found that wanted Andover's installations \*538 as is, it was more likely that Mid-City could have found a tenant who needed modest alterations, instead of completely gutted space. (Tr. 5/19/97 at 202-203).

> Mr. Nelkin's opinion was based on the type of installation which Andover had. Approximately 25 percent of Andover's space on the 46th floor was renovated in 1995-1996. (Tr. 6/18/97 at 574). The renovation consisted of demolishing the space, removing existing walls, ceilings, lighting, and the existing supplementary air conditioning unit, and building new walls, ceilings, lights, a kitchen, a computer room with a special electric installation, conference room, and a new supplementary air conditioning unit. (Tr. 5/14/97 at 140; Tr. 6/2/97 at 511–512; Tr. 6/18/97 at 574). When the space was demolished after rejection of the Lease, the major components of the building remained, such as the supplementary air conditioning unit, the sprinkler system and the electrical system. (Tr. 6/18/97 at 581-582). Although Andover's original installation was 20 years old, approximately 50 to 70 percent of the space was renovated over the years, inclusive of the space renovated in 1995-1996. (Tr. 6/2/97 at 510-511). Andover provided testimony that the areas renovated in 1995-1996 were in good shape (Tr. 6/2/97 at 513) and none of the space was outdated in any way. (Tr. 6/2/97 at 514).

> Mid-City's reletting efforts with respect to the 46th floor were geared primarily to finding a successor tenant for the entire floor (Tr. 3/19/97 at 81); it was prepared, however, to divide up the floor if a single tenant could not be found. (Tr. 3/19/97 at 111). Mr. North, Mid-City's witness, testified that it would cost substantially more to divide up a floor than to lease it to a single tenant, because of the need to create a public corridor

with proper demising walls and shared facilities. (Tr. 3/19/97 at 111-112). He justified the length of time it took Mid-City to find an appropriate tenant on the then-current vacancy rate at One Penn Plaza, approximately 11 percent (Tr. 6/18/97 at 672), which was higher than the vacancy rates of the other buildings in midtown Manhattan, especially Two Penn Plaza. (Tr. 5/19/97 at 306-307).

Andover's experts testified that Andover's space was not relet as quickly as it could have been because of the insufficiency of Mid-City's and Helmsley-Spear's marketing efforts for the premises (Tr. 6/2/97 at 415-17) and "turmoil in the market" caused by "battles" at the top of Helmsley-Spear, the managing agent and a general partner of Mid-City. (Tr. 5/19/97 at 196-97; Tr. 9/11/97 at 779; Trial Exhibits EE -HH).  $^{7}$ 

\*539 Because of: (i) the difficulty of locating a tenant to relet an entire floor, especially in a building which has a higher vacancy rate than other buildings in midtown Manhattan; (ii) both experts' opinions that gutting of floors is an appropriate marketing device where it may be difficult to visualize space reconfigured from what the previous tenant used it for; (iii) the twenty-year age of much of Andover's installation; and (iv) the possibility that multiple tenants would have to be found for the space, I find that Mid-City acted reasonably when it gutted the 46th floor and I will permit Mid-City to include the cost of the tenant improvements at \$35 per square foot. However, because the construction of the common corridor is an improvement of substantial and permanent character which benefits Mid-City and enhances the value of the premises by permitting Mid-City to relet the premises to multiple tenants, I will not permit Mid-City to include in its rejection claim the cost of constructing the corridor.

#### (ii) ERIF, real estate tax escalations and operating expenses

Mid-City's calculation of reserved rent is said by Andover to be overstated because it improperly includes claims totaling \$330,381.63 for post-rejection ERIF charges and escalations in real estate tax and operating expenses, which are neither related to the value of the Lease or the underlying building nor payable in fixed, regular or periodic charges.

Section 1.01 of the Lease provides that "[a]ll sums other than fixed annual rent payable by Tenant hereunder shall be deemed additional rent...." ERIF is defined in the Lease as a

component of rent. (Tr. 5/19/97 at 221; Lease, § 27.04(a) and (b)). 8 Instead of having its usage measured by a direct meter, Andover agreed to pay the amount of ERIF to Mid-City to compensate Mid-City "for obtaining and making available to [Andover] the redistribution of electric current as an additional service," through the presently installed electrical facilities, "[i]f and so long as [Mid-City] provides electricity to the demised premises on a rent inclusion basis." (Lease, § 27.04(b)).

The inclusion of a charge for the ERIF in Andover's Lease arises out of an old New York law which terminated the sub-metering of electricity by landlords in 1940 and required instead that landlords provide electricity to tenants and monitor their use, thereby making it unnecessary to maintain a direct meter for each tenant. (Tr. 5/19/97 at 206-207). Currently, tenants renting large spaces receive electricity through direct meters. (Tr. 5/19/97 at 207). However, when Andover negotiated its lease with Mid-City, electricity was still distributed according to an ERIF. (Tr. 5/19/97 at 207). Pursuant to the Lease, the amount of the ERIF charge is fixed at \$3 per rentable square foot, payable in equal monthly installments. (Lease, § 27.04(b)). The amount of the ERIF, however, is subject to adjustment depending on any increases in energy costs, reclassification of service or imposition of taxes on Mid-City's purchases, and these adjustments, either increases or decreases, are passed along to all tenants of the building, including Andover. Id. Under no circumstance would Andover ever pay less than \$3 per rentable square foot. Id. And if Andover were required to obtain electricity usage on its own, the ERIF charge would be eliminated. (Lease, § 27.04(c)). Mr. Grace, one of Andover's experts, testified that a landlord does not continue to incur charges in connection with electrical usage in a space once the tenant vacates and, therefore, does not have any electricity expense against which to offset the ERIF charge. (Tr. 6/2/97 at 422–23). According to Mid-City's expert, Sharon Locatell, the ERIF charge "is rent for delivery of the electricity. It's payable whether the tenant uses the electricity or not." (Tr. 5/14/97 at 67).

\*540 The courts have grappled for a long time with the question of what expenses other than "pure rent" constitute

"reserved rent" under a lease. In Kuehner v. Irving Trust Co., 299 U.S. 445, 455, 57 S.Ct. 298, 81 L.Ed. 340 (1937), the Supreme Court commented that the test to determine the components of "reserved rent" include items having a relationship to the value of the property and the value of the lease. However, in more recent years, three tests have evolved to determine whether a certain charge ought to be included as rent. In the first test, a charge in a lease is part of the rent if it is (i) expressly labeled as "rent" in the lease, and (ii) payable in fixed, regular or periodic amount. In re Conston Corp., 130 B.R. 449, 455 (Bankr.E.D.Pa.1991). In the second test, the court expanded the first test by including as a third factor whether the questionable charge relates directly to or increases the value of the property. In re Farley, 146 B.R. 739, 746 (Bankr.N.D.Ill.1992). A later court which expressly rejected the Conston test but adopted the Farley test, declined to include the requirement that the rent be payable in fixed, regular periods. In re Rose's Stores, Inc., 179 B.R. 789, 790 (Bankr.E.D.N.C.1995).

The third test to evolve was articulated by the court in Kuske v. McSheridan (In re McSheridan), 184 B.R. 91 (9th Cir. BAP 1995). Under this test, an expense found in a lease may be properly considered part of the "rent reserved" under the lease if:

- 1) the charge is: (a) designated as "rent" or "additional rent" in the lease, or (b) provided as the tenant's obligation in the lease;
- 2) the charge is related to the value of the property or the lease thereon; and
- 3) the charge is properly classifiable as rent because it is a fixed, regular or periodic charge.

Id. at 99.

[16] [17] [18] Mid-City argues that under any of the factually supported. three tests, Farley, Conston or McSheridan, Mid-City's methodology for computing its lease rejection damage claim pursuant to section 502(b)(6) of the Bankruptcy Code properly takes into consideration the ERIF, and the real estate and operating escalation charges included in the Lease. To determine whether these charges are part of the rent reserved under the Lease, I am required to look beyond the mere labeling of the charge in the Lease as a form of rent.

McSheridan, 184 B.R. at 99 (citing Oldden v. Tonto Realty Corp., 143 F.2d 916, 920 (2d Cir.1944)). To make this determination, I will apply the McSheridan test which, because it includes the factors found in the Conston and Farley tests, will result in a more comprehensive analysis.

The first and third factors of the McSheridan test are plainly met. The ERIF charge is included in the Lease on a "rent

inclusion basis" to be paid by Andover in equal fixed, regular monthly payments of \$3 per rentable square foot, subject to adjustment based upon Andover's electrical usage. (Tr. 5/19/97 at 206-207; Lease, § 27.04(a) and (b)). Thus, the issue then becomes whether the ERIF charge is related to the value of the property or the lease thereon.

Although one case does suggest that electrical usage can be considered as part of the "rent reserved" in limited circumstances, Rose's Stores, 179 B.R. at 791 (a "mandatory minimum [utility] charge required to preserve the value of the property, if properly documented, would be includable in the rent reserved."), there is no evidence to suggest that this is the case here. Unlike insurance or real estate taxes which courts have determined to constitute "rent reserved," finding that they have a relationship to the value of the property and the value of the lease thereon; see, e.g., Heck's, Inc. v. Cowron & Co. (In re Heck's, Inc.), 123 B.R. 544, 546 (Bankr.S.D.W.Va.1991) and Rose's Stores, 179 B.R. at 791, the amount of the ERIF charge to be paid by Andover is only related to its electrical usage. But for Mid-City's legal obligation at the time it negotiated the Lease to provide electricity to Andover through this method, Andover would have obtained electricity from Con Edison directly and been linked to a direct meter to monitor its usage. Therefore, once Andover vacated the premises, it would no longer incur any electrical charges. Similarly, the next tenant or tenants occupying Andover's former space would have the benefit of a direct electrical \*541 meter or a different ERIF charge based upon usage. Thus, Mid-City's attempt to include the ERIF charge as a component of the "rent reserved" is not

My conclusion is not changed by Empire State Bldg. v. State Dep't of Taxation & Finance, 81 N.Y.2d 1002, 599 N.Y.S.2d 536, 615 N.E.2d 1020 (1993). In Empire State Bldg., the court considered the issue of whether a landlord was engaged in the sale of electricity to its tenants by virtue of using an ERIF mechanism in its leases with tenants and thus was liable for sales tax. The New York Court of Appeals found that the landlord was not liable for sales tax because the electricity expense was incident to the rent (which is specifically defined in the New York City Administrative Code for business and professional tenants for the purpose of determining what component of rent is taxable) and not a separate transaction for utilities.

Through the ERIF mechanism, Andover was required to pay a minimum base amount for electric usage which is capable of being adjusted upward if it uses more electricity than what was originally forecast. This seems no different than if Andover had gone into the marketplace itself, negotiated an electrical usage contract on its own with a utility and paid a base monthly price subject to increase if it used more power. Plainly, Andover's electrical usage has nothing to do with the value of the property or the Lease. Therefore, notwithstanding ERIF's denomination as rent in the Lease, I find that the ERIF charge does not constitute "rent reserved" to be included in Mid-City's rejection claim.

[19] With respect to Mid-City's inclusion of escalation charges for real estate taxes, Article 45 of the Lease provides that Andover "shall pay to Landlord, as additional rent, tax escalation and operating expense escalation." As previously stated, many courts have held that real estate tax charges are properly included in the "rent reserved" because their payment goes to the maintenance of the value of the property or lease. See, e.g. Heck's, 123 B.R. at 546 and Rose's Stores, 179 B.R. at 791. If they are not paid, then the landlord's equity in the property diminishes. As a consequence, these charges are properly included in Mid-City's claim.

[20] As for the operating expenses, Article 45(ix) of the Lease denominated as additional rent operating services which Mid-City provided to Andover as a tenant in its building, such as window-washing, elevator maintenance, cleaning services, and replacement and improvements in the building infrastructure. 10 Although Mr. Nelkin, one of Andover's expert witnesses, testified that Andover's vacancy resulted in a \$1.50 square foot savings to Mid-City with respect to cleaning expenses attributable (Tr. 5/19/97 at 209), Mid-City contends that Andover's vacancy "possibly" may have resulted in a savings of cleaning supplies (Tr. 6/18/97 at 663), but not a reduction in the cleaning staff. (Tr. 6/18/97 at 663; Tr. 9/11/97 at 734). Again, as with the ERIF, simply because a lease denominates an item as rent does not make it necessarily so. McSheridan, 184 B.R. at 99 n. 7 (court's independent determination of what constitutes "rent reserved" eliminates the possibility that a lease would be drafted designating all charges as rent).

Under the first prong of the McSheridan analysis, the operating expense escalation charges are denominated as "additional rent" and are Andover's obligations under the Lease. In addition, they are classified in the Lease as fixed, regular charges, meeting the second prong of the formulation. But here, \*542 again, we must pause to consider whether the operating expense escalation charges are related to the value of the property. The operating expense escalation charges are for the upkeep and maintenance of One Penn Plaza akin to a common area maintenance expense, and thus, I believe them to be related to the value of the property. See Heck's, 123 B.R. at 546. Therefore, I find that Mid-City may properly include the operating expense escalation charges in its damage claim.

### c. Whether Mid-City's Alleged Failure to Mitigate Precludes its Recovery

As previously mentioned, Andover argues that Mid-City is not entitled to actual damages under New York law because it failed to exercise its duty to mitigate those damages and by gutting the premises, actually exacerbated its damages. Mid-City argues in response that New York law does not impose a duty on a commercial landlord to mitigate its damages after a tenant breaches its lease and that, even if such a duty were to exist, Mid-City made a diligent and reasonable effort to find a successor tenant.

Historically, under New York law, a commercial landlord faced with a defaulting tenant had no duty to mitigate his damages, but was permitted to stand by and watch them accrue as the property lay vacant. See Rubin v. Dondysh, 146 Misc.2d 37, 549 N.Y.S.2d 579, 580-81 (Civ.Ct.1989), rev'd, 153 Misc.2d 657, 588 N.Y.S.2d 504 (1991). Observing that more than a dozen other states had rejected the traditional rule in favor of a duty to mitigate, see 21 A.L.R.3d 534 § 7, some lower courts began to attribute to a landlord the same duty to mitigate imposed on other contracting parties. Grays v. Brooks, 148 Misc.2d 646, 561 N.Y.S.2d 515, 516 (Civ.Ct. Queens Co.1990) (under the emerging rule, which the court adopts prior to the Appellate Division's reversal of the Rubin case, the trend is to place an affirmative duty on the landlord to mitigate his loss in both residential and commercial leases); 7437 Madison Ave. Assocs. v. A.T. Kearney, Inc., 120 Misc.2d 944, 466 N.Y.S.2d 931, 933 (Civ.Ct.N.Y.Co.1983) (extending duty to mitigate damages to [commercial] landlord-tenant relationship), aff'd, 127 Misc.2d 37, 488 N.Y.S.2d 950 (App.Div.1985). Notwithstanding these cases, other courts held fast to the traditional rule. See Sage Realty Corp. v. Kenbee Management-New York Inc., 182 A.D.2d 480, 582

N.Y.S.2d 182 (1st Dept.1992) ("[t]his court has repeatedly held that 'in a commercial lease the lessor is not under a duty to mitigate damages' ") (quoting Mitchell & Titus Assocs. v. Mesh Realty Corp., 160 A.D.2d 465, 554 N.Y.S.2d 136 (1st Dept.1990)); Rubin, 588 N.Y.S.2d at 505 ("although there may be a duty upon residential landlords to attempt to rerent and thereby mitigate damages, no such requirement exists in the context of commercial leases"). And, as late as 1993, although the Southern District decried the lack of an authoritative Court of Appeals decision on the issue, it was nonetheless still inclined to find that the duty to mitigate had not yet been imposed on commercial landlords by New York law. Kahn v. Taco Bell Corp., No. 92 Civ. 6304(JSM), 1993 WL 313055 at \*4 (S.D.N.Y. Aug. 10, 1993).

The District Court's plea for guidance was granted in 1995 by the New York Court of Appeals. Holy Properties Ltd. v. Kenneth Cole Productions, Inc., 87 N.Y.2d 130, 637 N.Y.S.2d 964, 661 N.E.2d 694 (1995); see also, American Transtech, Inc. v. U.S. Trust Corp., 933 F.Supp. 1193, 1199 (S.D.N.Y.1996). Citing the fact that in real property law established precedents are not lightly to be set aside, the court confirmed that "once the lease is executed, the lessee's obligation to pay rent is fixed ... and the landlord is under no obligation or duty to the tenant to relet or attempt to relet abandoned premises in order to minimize damages." Holy Properties, 637 N.Y.S.2d at 966, 661 N.E.2d 694. The Court of Appeals explained that when a lease is terminated prior to its expiry a landlord has three options: (i) it can do nothing and collect the full rent due under the lease, (ii) it can accept the tenant's surrender, reenter the premises and relet them for its own account, thereby releasing the tenant from further liability, or (iii) it could notify the tenant that it was entering and reletting the premises for the tenant's benefit. Id.

Relying on Holy Properties, Andover argues that because Mid-City reentered, \*543 demolished and relet the premises to P.S.I., a new lessee, for Mid-City's own benefit, it elected to mitigate its damages, which efforts, as a matter of law, were insufficient and by so doing effected a surrender and acceptance of the premises, releasing Andover's bankruptcy estate from all liability. Andover's reliance is misplaced. If Andover's reading were correct, then the Holy Properties decision is essentially an invitation to landlords like Mid-City to leave the premises as they were on the day a tenant leaves after rejecting the lease and file a claim at the statutory maximum without trying to find a new tenant. The court in Holy Properties envisioned that a departing tenant would be

relieved of further liability once the landlord actually had relet the premises to a new tenant. The court did not tell tenants that damages would be cut off as soon as a landlord reenters its premises and begins to seek a replacement tenant. The tenant by its breach of the lease has disrupted the landlord's business and forced it into incurring unanticipated damages; there is no authority in the Holy Properties decision cutting off the landlord's recovery for those damages at such an early date as Andover seeks. Moreover, there is no evidence in the record that the parties intended to effect a surrender and acceptance of the Lease. To accept Andover's argument would also be inconsistent with the plain meaning

of section 365(g)(1) of the Bankruptcy Code, which states that rejection of an unexpired, unassumed lease constitutes a breach of the lease. Application of the doctrine of surrender and acceptance would have the effect of allowing state law to supersede bankruptcy law, thereby violating the Supremacy

Clause. See In re McLean Enterprises, Inc., 105 B.R. 928, 933 (Bankr.W.D.Mo.1989)(court determined that application of state doctrine of surrender would be inconsistent with

section 365(g)(1) of Bankruptcy Code where parties intended to reject lease.)

Andover further argues, without any supporting authority, that Mid-City is not entitled to file a claim for damages because it commenced efforts to find a new tenant for the premises. Andover relies on New York state court cases for the proposition that once the landlord accepts surrender of the premises, the landlord/tenant relationship terminates and

the tenant has no further payment obligations. See Gotlieb v. Taco Bell Corp., 871 F.Supp. 147 (E.D.N.Y.1994); Centurian Dev. Ltd. v. Kenford Co., 60 A.D.2d 96, 400

N.Y.S.2d 263, 264 (1977). While this is true enough in the non-bankruptcy context, bankruptcy changes the equation because where the debtor/tenant rejects a lease, the landlord has no other choice but to accept the return of the premises.

See 11 U.S.C. § 365(d)(4); In re Iron–Oak Supply Corp., 169 B.R. 414, 418 (Bankr.E.D.Cal.1994) (lessor is implicitly stripped of power to reject surrender). Once the premises are returned to the landlord, albeit many times involuntarily, the landlord, faced with the economic realities of the marketplace and the business necessities of having an income stream to operate the building, will seek to relet the premises. To then argue, as Andover has, that by so doing, Mid-City has relinquished its lease rejection damage claim is unfounded and contrary to the purposes of the Bankruptcy Code.

[22] Despite the holding in Holy Properties that a landlord of a New York commercial lease does not have a duty to the tenant to relet or attempt to relet an abandoned premises in order to minimize damages, Andover urges that the equitable principles under the former Bankruptcy Act, as expressed in Overmyer and the legislative history of section 502(b)(6), create a background upon which the Bankruptcy Code and section 502(b)(6) must be read. The argument continues that, in the bankruptcy arena, a landlord should be held to a duty to mitigate its damages to insure an equitable distribution to all unsecured creditors and prevent a windfall to the landlord. Andover's novel argument, however, is contrary to the state of the law in New York today, as harsh as this rule may be, that upon a commercial tenant's breach of a lease and failure to pay rent, the landlord has no duty to mitigate its damages. See Holy Properties, 87 N.Y.2d 130, 637 N.Y.S.2d 964, 661 N.E.2d 694; see also In re Episode USA, Inc., 202 B.R. 691, 696 (Bankr.S.D.N.Y.1996) and In re Ames Department Stores, Inc., 158 B.R. 35, 36 (Bankr.S.D.N.Y.1993) (two recent cases in \*544 which the courts applied the holding of Holy Properties that a commercial landlord does not have a duty to mitigate damages upon the tenant's abandonment of the premises.) Moreover, the other creditors are already protected against unduly large claims by the statutory cap which the Bankruptcy Code places upon a landlord's claim. See In re O-Masters Inc., 135 B.R. 157, 159 (Bankr.S.D.Fla.1991); In re The Monetary Group, 91 B.R. 138, 142 (M.D.Fla.1988); In re Communicall Central, Inc., 106 B.R. 540, 544 (Bankr.N.D.III.1989), quoting H.R.Rep. No. 595, 95th Cong., 1st. Sess. 63 (1978). Because Mid-City did not have a duty to

# d. How is section 502(b)(6) to be computed?

efforts to relet the premises were reasonable.

[23] Having determined the amount of Mid-City's actual damages, I will now turn to whether the statutory limitation on the amount of damages allowable for termination of a lease under section 502(b)(6) is 15 percent of the rent remaining under the Lease or 15 percent of the time remaining under the Lease, an issue with which the courts have grappled.

mitigate its damages, I need not decide whether Mid-City's

Section 502(b)(6) provides in pertinent part:

- (b) the court, after notice and a hearing, shall determine the amount of such claim ... as of the date of the filing of the petition, and shall allow such claim in such amount except to the extent that—
- (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds-
- (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of-
  - (i) the date of the filing of the petition; and
  - (ii) the date on which the lessor repossessed, or the lessee surrendered, the leased property; plus
- (B) any unpaid rent due such under lease, without acceleration, on the earlier of such date.

## 11 U.S.C. § 502(b)(6).

As a debtor-in-possession, Andover has "all the rights ... and shall perform all the functions and duties" of a trustee. 11 U.S.C. § 1107(a). Among those rights is the ability, subject to the court's approval, to assume or reject any unexpired lease.

11 U.S.C. § 365(a). When, as Andover did here, a debtor rejects an unexpired lease, the breach is deemed to occur at the time the bankruptcy petition was filed, 11 U.S.C. § 365(g) (1), and the result of the breach is to give the landlord a general unsecured claim for damages caused by that rejection. U.S.C. § 502(g). In re Financial News Network, Inc., 149 B.R. 348, 350 (Bankr.S.D.N.Y.1993).

A landlord can claim any and all unpaid amounts due it under the lease as of the petition date. 4 L. King et al., Collier on Bankruptcy, ¶ 502.03 [7] [e] at p. 502-47 (15th ed. rev. 1998). However, because commercial leases are typically of long-term duration, which could lead to an astronomical calculation of damages engendered by a lease's premature termination, Congress capped the maximum amount that a landlord can claim as damages caused by a debtor's rejection of a lease by means of section 502(b) (6). This provision limits a landlord's claim for damages to the rent reserved under the lease for one year, without acceleration, or 15 percent of the remaining term of the lease

for a total period not to exceed three years, whichever amount is greater. See In re Ames Department Stores, Inc., 209 B.R. 627, 630 (S.D.N.Y.1997). "The cap is designed to prevent a landlord's single unsecured claim—which, depending on the length of the lease, may be enormous—to elbow aside the other unsecured creditors." Nostas Assocs. v. Costich ( In re Klein Sleep Products, Inc.), 78 F.3d 18, 26 (2d Cir.1996); see Episode USA, 202 B.R. at 693. As the legislative history to this section states, "the limitation on allowable claims was based on two considerations. First, the amount of the lessor's damages on breach of a real estate lease was considered contingent and difficult to prove.... Second, ... the lessor retains all the risk and benefits \*545 as to the value of the real estate at the termination of the lease. Historically, it was, therefore, considered equitable to limit the claims of a real estate lessor." S.Rep. No. 95-989, 95th Cong., 2d Sess. 63, 64 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5849; see Kuehner v. Irving Trust Co., 299 U.S. 445, 455, 57 S.Ct. 298, 81 L.Ed. 340 (1937)(a sufficient ground for limiting a landlord's claim is that, unlike other unsecured creditors, a landlord gets back its property). The legislative history suggests that the section 502(b)(6) cap is akin to a liquidated damages provision, intended to give a fair remedy to both the debtor and the landlord, taking into account the fact that the landlord retains the property at the end of the lease while ensuring that the landlord does not get the lion's share of the estate to the detriments of the estate's creditors. See id.; Leslie Fay Co. Inc. v. Corporate Property Assocs. 3 (In re Leslie Fay Co., Inc.), 166 B.R. 802, 808 (Bankr.S.D.N.Y.1994).

Courts applying section 502(b)(6) have adopted one of two positions in calculating the amount of damages a landlord may receive when a debtor tenant rejects a lease. Some hold that the reference to "15 percent" corresponds to either rent accruing for 15 percent of the remaining time under the lease, others, to 15 percent of the total rent remaining under the lease. The second of these views is the majority one. See, e.g.

Financial News Network, 149 B.R. at 351; In re Today's Woman of Florida, Inc., 195 B.R. 506 (Bankr.M.D.Fla.1996);

In re Gantos, 176 B.R. 793, 796 (Bankr.W.D.Mich.1995);

In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 232 (Bankr.D.N.D.1992); Communicall Central, 106 B.R. at 544; McLean Enterprises, 105 B.R. at 936–37. This view is also supported by respected treatises. See, e.g., 4 L. King

et al., Collier on Bankruptcy, ¶ 502.03[7] [c] at p. 502-46 to 47(15th ed. rev.1998); Norton Bankruptcy Law and Practice 2d § 41.24 (1997). Courts following this approach agree that section 502(b)(6) does not provide a formula for calculating damages, but merely provides a cap. See Financial News Network, 149 B.R. at 352; Gantos, 176 B.R. at 794. As in the present case, the debtors in Gantos argued that because the rent provided within the lease increased throughout the lease term, a damage award which calculated 15 percent of the aggregate rent reserved would exceed the amount calculated according to the rent reserved for 15 percent of the remaining term. Gantos. 176 B.R. at 795. However, the Gantos court rejected the debtors' argument as well as the debtors' assertion that the landlord was attempting to gain an increased damage award. Instead the court subscribed to the majority view, holding it was reasonable for the landlord to receive damages for rent which the parties had bargained for in the lease. Id. at 796. In addition, the court believed that calculating damages in this way would preserve Congress' intent to protect other general creditors from excessively worse claims of landlords, because allowing landlords to collect damages based on 15 percent of the aggregate rent in the court's opinion, "will more accurately compensate them for their loss while the 15 percent limitation on the rent recoverable will concomitantly ensure that other general creditors will have an opportunity to recover from the estate." Id. at 795. Lastly, the Gantos court recognized that the statute is not a "model of clarity," but held that its reasoning was the most "natural" reading of the language of the statute. Id. at 795. See also, McLean Enterprises, 105 B.R. 928; Communicall Central, 106 B.R. 540; Q–Masters, 135

B.R. 157; Financial News Network, 149 B.R. 348.

Courts hewing to the majority view hold landlords should not

Courts hewing to the majority view hold landlords should not be "deprived of their statutory rights because debtors might not do what Congress said they must do— 'timely perform all the obligations ... under any unexpired lease of nonresidential real property, until such lease is assumed or rejected.'

Financial News Network, 149 B.R. at 352; 11 U.S.C. § 365(d)(3). Courts in the majority posit that Congress intended to provide landlords with both actual past damages as well as limited future damages, hence the calculation of 15 percent of

the reserved rent remaining under the lease. In re Vause, 886 F.2d 794, 801–802 (6th Cir.1989).

A minority of courts defend the reasoning outlined in [1] re Allegheny Int'l, Inc., 136 B.R. 396 (Bankr.W.D.Pa.1991) aff'd \*546 145 B.R. 823 (W.D.Pa.1992) which bases damages on 15 percent of the total amount of time remaining as opposed to the amount of rent reserved under the lease. In affirming the decision of the bankruptcy court, the district court in Allegheny reasoned that damages ought to be measured according to the total amount of time remaining under the lease because the statute references time periods when speaking about the amount of rent due once the lease has been surrendered. Id. at 828. "Specifically, the statute provides that claims cannot exceed the greater of one year, or 15 percent, not to exceed three years, of the remaining term, following the earlier of the date of the filing of the petition and the date surrendered." Id. The court concluded that from the legislative history 11 it appeared that Congress intended the phrase "remaining term" to measure damages as a function of time and not rent. Id.; see also, In re Watkins Management Group, Inc., 120 B.R. 586, 587 (Bankr.S.D.Ala.1990). In addition, the bankruptcy court in Allegheny distinguished landlords from other creditors because a landlord is able to recover its property upon the filing of bankruptcy and may relet the space. Allegheny, 136 B.R. at 403. The bankruptcy court interpreted the statute to reflect Congress' awareness of this possibility by allowing a landlord a specific amount of time to relet the premises and, "restore itself to the same position as if the lease had not been terminated." Id. The court also cited to cases interpreting the previous law from which section 502(b)(6) evolved. These cases involved leases which included escalation clauses as in the present case, but calculated the damage cap based upon rent due the succeeding year rather than 15 percent of the rent due for the remainder of the lease. *Id.* at 402, (citing In re Bonwit Lennon & Co., 36 F.Supp. 97, 99 (D.Md.1940)). Further, the bankruptcy court in Allegheny relied on the fact that the statute provides for damages to be calculated "without acceleration" in holding that the statute's language applies to the next succeeding term remaining in the lease. Id. Therefore, the bankruptcy court determined that Congress included this phrase in order to prevent all remaining rent from becoming due immediately upon the breach of the lease by the debtor tenant. Id.

canon of construction that a statute should be interpreted so as not to render one part inoperative." Mountain States Telephone & Telegraph Company v. Pueblo Santa Ana, 472

U.S. 237, 249, 105 S.Ct. 2587, 86 L.Ed.2d 168 (1985) (quoting Colautti v. Franklin, 439 U.S. 379, 392, 99 S.Ct. 675, 58 L.Ed.2d 596 (1979)). To determine Congress' intent in drafting a statute, a court must first examine the language of the statute before turning to its legislative history. U.S. v. Iron Mountain Mines, Inc., 812 F.Supp. 1528, 1557 (E.D.Cal.1992). If a statute is clear and unambiguous on its face, it should be enforced according to the terms outlined. Patterson v. Shumate, 504 U.S. 753, 759, 112 S.Ct. 2242, 119 L.Ed.2d 519 (1992). Therefore, the plain meaning of a statute should be followed unless it will produce an absurd result or a result at odds with the intent of Congress. In re Episode USA, Inc., 202 B.R. 691, 695 (Bankr.S.D.N.Y.1996) (citing U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989)). ("The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.' "). Where this is the case, Congress' intent, (which can be divined from legislative history) rather than a strict reading of the plain language of the statute, controls. Iron Mountain Mines, 812 F.Supp. at 1557. Ambiguity is evident when the statute may be understood by "reasonably well informed persons in two or more different senses." Id., citing 2A Sutherland, Statutory Construction, § 45.02 at 5 (5th ed.1992). Additionally, if a statute may be interpreted differently by separate courts, it is evident that \*547 the statute is unclear and ambiguous. Firon Mountain Mines, 812 F.Supp. at 1557. Lastly, if a reading of the plain language of the statute reflects an unreasonable conclusion,

an alternative reasonable conclusion should be adopted in its stead despite the statute's ambiguity or legislative history.

Id. at 1558.

The majority and minority interpret the meaning of section 502(b)(6) and Congress' intent differently. They disagree as to whether the reference to "15 percent" refers to the time remaining under the lease or the rent reserved under the lease. Because the statute is unclear and ambiguous, I would turn to the statute's legislative history for guidance, were there any that answered the question whether the drafters intended [26] [27] [28] [29] [30] It is "an elementary limitation to hinge on time or rent. Unfortunately, the legislative history is unilluminating and we are left with only judicial interpretation of what Congress must have intended. In that regard, because I find that it is the logically sounder approach, I concur with the majority view that in calculating

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damages pursuant to the section 502(b)(6) cap, a landlord must determine 15 percent of the total rents due under the lease, through the expiration date of the lease.

#### B. The Remaining Claims

#### 1. Whether Mid-City Should Be Sanctioned

As mentioned, Mid-City denied the existence of any management agreement covering One Penn Plaza until, during trial, one of its own witnesses admitted that there was such an agreement, a copy of which was promptly thereafter delivered to Andover's counsel. Because of this conduct, Andover asks that I sanction Mid-City with disallowance of its administrative and unsecured claims, although Andover concedes that portions of these claims are valid.

[33] [34] [35] [36] Fed.R.Bankr.P. 7034 [32] governs a party's request for production of documents and things. To be subject to discovery pursuant to Fed.R.Civ.P. 34, the item must be in the "possession," "custody," or "control" of a party. James Wm. Moore, Moore's Federal Practice, § 34.14[2][a] at 34–61 (3d ed.1998). The term "control" should be interpreted broadly. Scott v. Arex, Inc., 124 F.R.D. 39, 41 (D.Conn.1989). A party is deemed to have control over documents that it has the, "right, authority, or ability to obtain upon demand." Id. at 41. However, legal limitations which may limit a party's ability to obtain a requested item do not necessarily preclude a determination that the party does in fact have possession, custody or control over the document or thing. Id. Yet a party may not be compelled to produce an item that does not exist because it is clearly not within the party's possession, custody or control. Moore's Federal

Practice, § 34.14[2][a] at 34–62; see S.E.C. v. Canadian Javelin Ltd., 64 F.R.D. 648, 651 (S.D.N.Y.1974) (holding that where transcripts of documents did not exist they therefore could not be produced). However, where it is beyond dispute that a defendant served with a discovery demand to produce documents had both access to, and the ability to obtain the documents for, its usual business, the defendant must produce

the documents pursuant to the discovery demand. Cooper Industries, Inc. v. British Aerospace, Inc., 102 F.R.D. 918, 919 (S.D.N.Y.1984). A defendant may not be permitted to present nothing more than conclusory statements to show that the requested documents are not in its custody or control. Id. (defendant can not hold crucial discovery documents by storing them with defendant's affiliate abroad.)

[37] [38] [39] Failure to cooperate during discovery may subject a party to sanctions under Fed.R.Bankr.P. 7037. *In re Krontz*, 158 B.R. 684, 685 (Bankr.N.D.Ohio 1993). Sanctions pursuant to Fed.R.Civ.P. 37 may be applied "to penalize those whose conduct may be deemed to warrant such a sanction, (and) to deter those who might be tempted to such conduct in the absence of such a deterrent." *National Hockey League v. Metropolitan Hockey Club, Inc.*, 427 U.S. 639, 643, 96 S.Ct. 2778, 49 L.Ed.2d 747 (1976). Fed.R.Bankr.P. 7037(c) (1) provides, in pertinent part, that:

A party that without substantial justification fails to disclose information required by Rule 26(a) or 26(e)(1) shall not, unless such failure is harmless, be permitted to \*548 use as evidence at trial, at a hearing, or on a motion any witness or information not so disclosed. In addition to or in lieu of this sanction, the court, on motion and after affording an opportunity to be heard, may impose other appropriate sanctions.

"For purposes of this subdivision an evasive or incomplete disclosure, answer, or response is to be treated as a failure to disclose, answer or respond." Fed.R.Bankr.P. 7037(a) (3). "Rule 37(a), which applies to disclosure and discovery disputes, permits sanctions even if no court order compelling the disclosures or discovery has been entered, but the available sanctions are limited to expenses incurred in connection with making or resisting the motion to compel." *Moore's Federal Practice*, § 37.40 at 37–59.

Prior to and on the eve of the trial, Andover served subpoenas upon Mid–City for the production of the management agreement between Helmsley–Spear and Mid–City. (Tr. 3/19/97 at 70–71). The management agreement, however, was not produced until near the trial's completion. (Tr. 6/18/97 at 636). Andover contends that Mid–City denied the agreement's existence in response to each of the subpoenas. (Tr. 6/18/97 at 618–619). Mr. Grace testified that he was "startled when we were told that there was no management agreement." (Tr. 6/2/97 at 419). During the trial, Daniel North, a Vice–President of Helmsley–Spear and the general manager of the operation and leasing for the property, testified that he

had "no knowledge of any" management agreement between Helmsley–Spear and Mid–City. (Tr. 3/19/97 at 72). However, Ronald Zeccardi, director of operations for One Penn Plaza, testifying as a witness for Mid–City, stated that he had found the management agreement in the desk of his predecessor and had given it to Mary Gartland several years ago. (Tr. 6/18/97 at 603–604).

Following Mr. Zeccardi's testimony, Andover made an oral application to this court for the imposition of sanctions on the grounds that Mid-City intentionally withheld the management agreement. In response to the issue raised at trial as to what the appropriate sanction might be under these circumstances, Andover, in its post-trial memoranda, requested that I disallow Mid-City's administrative and unsecured claims in full, although Andover has admitted the validity of portions of these claims. Mid-City did not offer any explanation for the withholding of the management agreement and the inconsistent testimony of its witnesses, Mssrs. North and Zeccardi, except to argue that "two witnesses can differ in their knowledge as to whether an agreement exists." (Tr. 6/18/97 at 627). Mid-City argues that the non-production of the management agreement was inadvertent and unintentional. Despite Andover's contention otherwise, there is no evidence in the record demonstrating that Mid-City intentionally withheld its production until trial. (Tr. 6/18/97 at 632-640). Therefore, I find that Mid-City's repeated laxity in responding to Andover's document requests warrants the imposition of sanctions.

[41] "To the extent feasible, sanctions should be tailored to fit the circumstances in which the disobedience occurs." Moore's Federal Practice, § 37.41 at 37-61. Although Mid-City's failure to produce the management agreement is unjustified, Andover did not argue that Mid-City's failure to produce the document before trial prevented Andover in any way from preparing for trial. Even after the management agreement had been produced during trial, Andover did not request additional time to review the document or to prepare its case. Thus, to disallow Mid-City's claims, as Andover had requested, is too severe a punishment in response to the nature of Mid-City's culpability and actions. However, Andover should be compensated for the added expense it likely incurred by repeatedly requesting the production of this document. Therefore, I direct Andover to submit within 30 days of the date of this Order, an appropriate affidavit of its counsel, with supporting documentation, detailing the added and reasonable attorneys' fees Andover incurred in its efforts to secure Mid-City's

compliance with Andover's discovery requests for a copy of the management agreement. This leaves for discussion the validity of Andover's objections to Mid-City's administrative and unsecured claims.

# \*549 2. Whether Mid-City's unsecured and administrative claims should be fully allowed?

In addition to Mid–City's rejection claim for damages sustained from rejection of the Lease, Mid–City also filed timely an administrative claim in the amount of \$35,811.31, which arises out of 9 days' rent which Andover incurred as a holdover tenant until it vacated the premises, and an unsecured claim in the amount of \$195,803.95 for prepetition rent arrears and charges for air conditioning, cleaning and other services provided by Mid–City. Andover disputes \$58,377.72 of the unsecured claim and \$7,160.63 of the administrative claim, conceding the validity of the balance of these claims.

#### a. Mid-City's unsecured claim

Mid-City initially filed its unsecured claim (claim no. 6) on June 5, 1996 for rent arrears and charges for air-conditioning. cleaning and other services in the amount of \$137,426.23 for the period July 7, 1995 through March 18, 1996. (Trial Exhibit 41). On February 14, 1997, subsequent to the August 19, 1996 deadline to file prepetition unsecured claims, Mid-City filed an amended claim (claim no. 310) for rent arrears and air conditioning, cleaning and other services charges in the amount of \$195,803.95. (Trial Exhibit 42). Andover argues that claim no. 310 should be disallowed and expunged because it is a "thinly-disguised" attempt to assert new claims after the August 19th filing deadline. The amendment was filed 9 months after the original claim was filed and 6 months after the last day for creditors to file prepetition unsecured claims. The issue is whether the amendments constitute new claims or instead relate back to the originally-filed proofs of claim.

[42] [43] [44] "It is well settled that the decision to permit an amendment of a proof of claim rests within the sound discretion of the bankruptcy judge." *Integrated Resources, Inc. v. Ameritrust Co. National Association (In re Integrated Resources, Inc.)*, 157 B.R. 66, 69 (S.D.N.Y.1993) (citations omitted). As I have observed before "[a]lthough amendments to proofs of claim should in the absence of contrary equitable considerations or prejudice to the opposing party be freely permitted, such amendments are not automatic but are allowed, 'where the purpose is to cure a defect in the

claim as originally filed, to describe the claim with greater particularity or to plead a new theory of recovery on the facts set forth in the original claim.' " (citations omitted) In re Macmillan Inc., 186 B.R. 35, 49 (Bankr.S.D.N.Y.1995); see also Drexel Burnham Lambert Group Inc., 151 B.R. 684, 694 (Bankr.S.D.N.Y.1993). Amendments are disallowed when their purpose is to create a new claim. In re Houbigant, Inc., 188 B.R. 347, 357 (Bankr.S.D.N.Y.1995); In re W.T. Grant Co., 53 B.R. 417, 422 (Bankr.S.D.N.Y.1985).

In deciding whether or not to allow an [45] [46] amendment to a proof of claim the court must first determine whether there was a timely assertion of a similar claim evidencing an intention to hold the estate liable. If there was such an assertion, the court then balances the equities, looking to such factors as: (i) undue prejudice to the opposing party; (ii) bad faith or dilatory behavior on the part of the claimant; (iii) whether other creditors would receive a windfall where the amendment not allowed; (iv) whether other claimants might be harmed or prejudiced; and (v) the justification for the inability to file the amended claim at the time the original claim was filed. Macmillan, 186 B.R. at 49 (citing Integrated Resources, 157 B.R. at 70). If, however, a claim is "new" and therefore fails to relate back, it may be allowed if the failure to file was the result of excusable neglect. Macmillan, 186 B.R. at 49; see also In re Alexander's Inc., 176 B.R. 715, 719 (Bankr.S.D.N.Y.1995). The burden is on the claimant to prove that it did not timely file its proof of claim because of excusable neglect. Macmillan, 186 B.R. at 49, citing In re Nutri\*Bevco, Inc., 117 B.R. 771, 786 (Bankr.S.D.N.Y.1990).

[47] Here the original claim provided Andover with notice that Mid-City intended to hold the estate liable for rent arrears and charges for air conditioning, cleaning and other services provided to Andover in accordance with the Lease in connection with the \*550 6th and 46th floors for the period July 7, 1995 through March 18, 1996. Thus, Andover was on notice that Mid-City sought to hold them liable pursuant to the terms of the Lease for rent, rubbish and operating expense escalations with respect to the 6th and 46th floors which it occupied during this period. The space on the 10th floor was not deleted from Andover's Lease until July 17, 1995. (Second Lease Modification Agreement). Mr. Golding testified that he inadvertently omitted these damages from the original claim. (Tr. 5/14/97 at 89). There is no evidence in the record that Mid-City acted in bad faith in connection with the amendment of its claim or that the inclusion of these additional charges caused undue prejudice

to Andover. Moreover, because Andover's confirmed First Amended Plan of Reorganization provided for a 100 percent payout, including interest, to all creditors, there is no evidence that they might be harmed or prejudiced by the allowance of this portion of Mid-City's amended claim. Accordingly, I will allow that portion of the amendment which seeks additional damages in connection with the 6th and 46th floors during the period July 7, 1995 through March 18, 1996. Because it is apparent that Mid-City had filed its original claim to include prepetition damages in connection with the premises demised under Andover's Lease, and had inadvertently failed to include operating expense escalations for the 10th floor space, I will allow that portion of the amendment which seeks damages for the 10th floor operating expense escalation during the period July 7, 1995 through March 18, 1996. The amendment seeking \$40,039.84 in damages in connection with the intermediate level space suffers a different fate, however. During the trial, Mr. Golding testified that Mid-City's dispute with Andover regarding the payment of this sum was resolved by May, 1995 (Tr. 6/18/97 at 611-614). Therefore, based upon Mid-City's own admission, I will disallow this portion of Mid-City's amended claim on this ground, and need not decide whether these damages relate back to Mid-City's initial claim or if they should be allowed under the theory of excusable neglect.

#### b. Mid-City's administrative claim

Andover objects to Mid-City's administrative claim, as amended (Trial Exhibits 43, 44 and 45) on the grounds that the claim includes damages for rent and other charges in connection with nearly 6,900 square feet of the 46th floor which, as Andover has argued, it effectively deleted. Based upon my determination early on in this decision that Andover had not effectively deleted this portion of the 46th floor space from its Lease, I will deny Andover's objection to this claim and allow Mid-City's \$35,811.31 administrative claim in full.

#### **CONCLUSION**

Mid-City has no duty under its commercial lease with Andover to mitigate its damages. Andover's objection to Mid-City's inclusion of ERIF charges and operating expense escalation charges in its rejection claim is GRANTED; Andover's objection to the inclusion of real estate tax escalation charges is DENIED; Andover's objection to the inclusion of damages relating to the 6th floor storage space is DENIED; Andover's objection to the inclusion of damages

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relating to the 46th floor space is DENIED; Andover's objection to Mid-City's unsecured claim is GRANTED IN PART and DENIED IN PART; and Andover's objection to Mid-City's administrative claim is DENIED. Andover's request for sanctions is GRANTED to the extent set forth herein.

Andover and Mid-City are to agree on an amended calculation of the section 502(b)(6) damages and the unsecured claim incorporate them into an order allowing these claims in the amount consistent with this decision.

SETTLE ORDER.

**All Citations** 

231 B.R. 521

#### **Footnotes**

- Article 14 provides, "If Tenant defaults in fulfilling any of the covenants of this Lease, including the payment of rent or additional rent, or if the demised premises become vacant or deserted, then, in any one or more of such events, upon Landlord serving written 15 days' notice upon Tenant specifying the nature of said default and upon the expiration of said 15 days, if Tenant shall have failed to comply with or remedy such default, or if the said default or omission complained of shall be of such a nature that the same cannot be completely cured or remedied ... then Landlord may serve a written 5 days' notice of cancellation of this Lease upon Tenant, and, upon the expiration of said 5 days, this Lease and the term ... shall end and expire."
- 2 To the extent that Andover continued to occupy space on the 6th and 46th floors after it rejected the Lease, the same result obtains.
- 3 Section 13.02 provides in relevant part:
  - Subject to then applicable law and to the provisions of Section 13.03, if at the date fixed as the commencement of the term of this Lease or if at any time during the term hereby demised there shall be filed by ... Tenant in any court pursuant to any statute ... of the United States ... a petition in bankruptcy or insolvency or reorganization ..., Landlord may at Landlord's option, serve upon Tenant ... a notice in writing stating that this Lease and the term hereby granted shall cease....
- "Downtime" is the length of time it would take a landlord to find a tenant, negotiate and document the lease and rent out space; "free rent" is what a landlord offers the tenant once the tenant is in occupancy. (Tr. 5/14/97 at 39)
- 5 Ms. Locatell testified that pursuant to the terms of the P.S.I. lease, Mid-City incurred a tenant installation cost of \$35 a square foot or approximately \$559,000, approximately \$175,000 in capital costs to construct a common corridor on the 46th floor for multi-tenant occupancy, approximately \$230,000 in commissions paid to an outside broker, and free rent of approximately 3 ½ months or \$139,000. (Tr. 9/11/97 at 710–711).
- 6 Andover further argues that if Mid-City had agreed to accept Andover's post-petition proposal, Mid-City already would have been paid more than \$300,000 in rent, without suffering any detrimental impact upon its ability to find a long-term replacement tenant. This argument, however, goes to the issue of whether Mid-City has a duty under New York law to mitigate its damages, which I will discuss later in this decision.
- 7 In an attempt to bolster the testimony of its expert witnesses, Andover has also sought to admit into evidence as admissions against Helmsley-Spear's interest (Tr. 9/11/97 at 784-789), whose status as a partner in Mid-City is also disputed by the parties, allegations made by Peter L. Malkin in an unverified complaint

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filed in a state court action commenced in New York in June, 1997. (Tr. 9/11/97 at 784-92; Trial Exhibit XX). I admitted the Malkin complaint into evidence subject to Andover providing me with authority that the statements contained therein are admissions. I informed the parties that if I were to determine that the complaint should not be admitted, I would ignore it. (Tr. 9/11/97 at 789). Andover argues that the allegations in the Malkin complaint are highly probative with respect to the One Penn Plaza building and, therefore, may be admitted into evidence under Rule 801(d)(2)(D) of the Federal Rules of Evidence because they constitute admissions against interest by a party-opponent. In support of its contention, Andover relies upon

U.S. v. Saks, 964 F.2d 1514, 1524 (5th Cir.1992) and Guccione v. Hustler Magazine, Inc., 632 F.Supp. 313, 320 (S.D.N.Y.1986). In each of these cases, the litigants sought to admit into evidence the sworn deposition testimony of a party-opponent, unlike Andover, who sought to admit unsworn allegations made by Malkin. The problem is that the allegations in the Malkin complaint may not be proven at trial as the evidence unfolds. See McCormick on Evidence § 257 ch. 25 at 149-150 (4th ed.1992). Even if I were to find that the allegations in the Malkin complaint are admissions by a party-opponent under Rule 801, "an admission is subject to exclusion if its probative value is outweighed by its potential for unfair prejudice." McLaughlin, Weinstein's Federal Evidence, § 801.20[3] at 801-44 (2d ed.1998). As part of its case, Andover had elicited the testimony of two of its expert witnesses to prove Andover's contention that the vacancy rate at One Penn Plaza was comparatively higher than other office buildings in mid-town Manhattan due to Helmsley-Spear's mismanagement and incompetency in its marketing and leasing efforts. Because I believe that the potential for unfair prejudice to Mid-City from admitting the allegations into evidence outweighs their probative value, I will exclude the proposed exhibit.

- 8 Article 27, section 27.04(b) of the Lease defines the "Electricity Rent Inclusion Factor" as "the amount determined by applying the estimated connected electrical load of tenant, which shall be deemed to be the demand (KW), and the hours of use thereof, which shall be deemed to be the energy (KWH), as determined by the electrical consultant as hereinafter provided, to the rate charged for such load an energy usage in the SC-4, Rate 1 Classification in effect on May 1, 1994 (and not the time-of-day rate schedule, if any), as increased or decreased by all electricity cost changes of Landlord since May 1, 1994."
- Article 45, section vi of the Lease provides that real estate taxes "shall mean the total of all taxes and special or other assessments levied, assessed or imposed at any time by any governmental authority upon or against the building project, and also any tax or assessment levied, assessed or imposed at any time by any governmental authority in connection with the receipt of income of rents from said building project to the extent that same shall be in lieu or a portion of any of the aforesaid taxes or assessments, or additions or increases thereof, upon or against said building project."
- 10 Article 45, section ix of the Lease states "'expenses' shall mean the total of all the costs and expenses incurred or borne by the Landlord with respect to the operation and maintenance of the building project and the services provided tenants therein."
- 11 "The damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or ten percent of the remaining lease term ... after ... the date of surrender." H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 353 (1977); U.S.Code Cong. & Admin.News 1978, pp. 5787, 6309. The statute was later amended to increase the cap from 10 percent to 15 percent.

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In re Filene's Basement, LLC, Not Reported in B.R. Rptr. (2015)

73 Collier Bankr.Cas.2d 899

2015 WL 1806347 United States Bankruptcy Court, D. Delaware.

IN RE: FILENE'S BASEMENT,

LLC, et al., <sup>1</sup> Reorganized Debtors.

Case No. 11-13511 (KJC) (Jointly Administered) Signed April 16, 2015

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(Re: D.I. 2707)

#### MEMORANDUM<sup>2</sup>

BY: KEVIN J. CAREY, UNITED STATES BANKRUPTCY **JUDGE** 

\*1 In this contested matter arising in the jointly administered chapter 11 cases of Filene's Basement, LLC and its affiliates (collectively, the "Debtors"), the Debtors objected (the "Objection" (D.I.2707)) to the proof of claim filed by former landlord Connecticut/DeSales LLC (the "Landlord"). The Objection raises two issues concerning the proper interpretation and scope of Bankruptcy Code § 502(b)(6): (1) whether the "15 percent" referred to in \$\frac{1}{2}\$ \$502(b)(6) (A) refers to 15 percent of the remaining term of the lease or 15 percent of the remaining rent due under the lease; and (2) whether the limitation on lease termination damages in § 502(b)(6) encompasses a lessor's claims for removal of abandoned furniture and fixtures and for satisfaction of a mechanic's lien.

For the reasons stated below, the Court concludes that (i) reference to "15 percent" in \$\frac{1}{2}\$ \$502(b)(6)(A) is a measure of the remaining term of the lease, (ii) the Landlord's claim for removal of abandoned furniture and fixtures falls within the \$\frac{1}{2}\$\\$ 502(b)(6) cap and is not allowed as a separate claim, and (iii) the Landlord's claim for satisfaction of a mechanic's lien does not fall within the limitation of \$502(b)(6) and may be asserted as a separate claim.

#### I. BACKGROUND<sup>3</sup>

#### A. The Debtors' Chapter 11 Case

The Debtors collectively owned and operated forty-six "offprice" retail stores under the "Syms" and "Filene's Basement" names. 4 Many of the store locations were in commercial properties leased by Filene's Basement or Syms. 5 On November 2, 2011, the Debtors filed voluntary chapter 11 bankruptcy petitions.

On August 30, 2012 the Court entered the Order Confirming the Modified Second Amended Joint Chapter 11 Plan of Reorganization of Syms Corp. and its Subsidiaries (the "Plan") (D.I.1983). The Plan provides that holders of Class 4 general unsecured claims of Filene's Basement, LLC will receive 100% payment in cash, and holders of Class 5 lease rejection claims of Filene's Basement, LLC will receive 75% payment in cash. (Plan, § V.D.4 and 5).

#### B. The Lease

On October 7, 1986, Connecticut/DeSales Partnership (the "Original Landlord") and Raleigh Stores Corporation (the "Original Tenant") executed a retail lease (the "Retail Lease") for nonresidential real property located at 1133 Connecticut Avenue NW, Washington, D.C. 20013 (the "Leased Premises"). The original term of the Retail Lease was 20 years, with four options to renew for additional terms of 10 years each. The Original Landlord and the Original Tenant modified the Retail Lease three times. 6

\*2 On February 7, 2008, the Original Landlord and Filene's Basement, Inc., as successor-in-interest to the Original Tenant, entered into the Third Amendment to the Retail Lease to expand the leased premises and to provide for certain improvements to be made by Filene's Basement, Inc.

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On March 10, 2010, Connecticut/DeSales LLC ("Landlord"), as successor-in-interest to the Original Landlord, and Filene's Basement, LLC ("Filene's") entered into the Fourth Amendment (the Retail Lease, together with all amendments and modifications thereto, is referred to herein as the "Lease"). The Fourth Amendment settled state court litigation between the Landlord and Filene's concerning a disagreement over the Minimum Annual Rent provision. The Fourth Amendment notes that Filene's exercised its First Option Term under the Retail Lease, which began on February 1, 2009, and would have expired on January 31, 2019.

The Lease defines "rent" to include "minimum annual rent," "percentage rent," and "additional rent." During the then current Lease term, the minimum annual rent was \$1,736,961 until January 31, 2014, after which date the minimum annual rent would increase by 6.46% for a total of \$1,849,168 per year. (Fourth Amendment, § 4.b.)

Upon the expiration or termination of the Lease, the Debtors were required to surrender the Property "broom clean, free of debris and Tenant's personal property, in good order, condition and state of repair." (Lease Section 26.01.) In addition, § 26.01 states:

Any property of Tenant not promptly

removed shall be deemed to have \*3 Reserved Rent

been abandoned by Tenant and to have become the property of Landlord and may be retained by Landlord or disposed of at Tenant's expense (Tenant hereby agreeing to remain liable for the cost thereof even though this Lease shall have terminated) as Landlord shall so desire....

In December 2011, the Court approved rejection procedures for leases that the Debtors were unable to sell (the "Rejection Procedures Order," D.I. 505). Pursuant to the Rejection Procedures Order, leases were to be "deemed rejected as of the later of December 31, 2011 or the date the Debtors have unequivocally surrendered their leasehold interests." (D.I.505, ¶ J).

#### C. The Claim

On January 20, 2012, the Landlord timely filed a proof of claim in the amount of \$2,788,393.57 for amounts due in connection with the Lease (Claim No. 1680). The Landlord calculated its claim as follows:

Base Rent	\$ 13,009,242.00
Operating Expense Reimbursement	\$ 5,053,810.00
Utilities, HVAC, and Vertical Transportation	\$ 279,538.00
	\$ 18,342,590.00
	x 0.15
Total as Capped by § 502(b)(6)(A)	\$2,751,388,50
Unpaid Rent	
November 2011 Stub Rent Not Previously Paid	\$ 6,494.07
Removal of Abandoned Furniture & Fixtures	\$12,000.00
Mechanic's Lien Filed by Kone, Inc.	\$18,511.00
Total Under § 502(b)(6)(B)	\$37,005.07

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**TOTAL CLAIM** \$2,788,393.57

To narrow the issues relating to the Objection, the Landlord filed an amended proof of claim for "Lease Rejection" Reserved Rent

on December 10, 2013 (the "Claim," D.I. 2726), with the following revised breakdown:

Base Rent	\$ 13,009,242.00
Operating Expense Reimbursement	\$ 4,573,519.00
Utilities, HVAC, and Vertical Transportation <sup>8</sup>	\$ 243,513.00
	\$ 17,826,274.00
	x 0.15
Total as Capped by § 502(b)(6)(A)	\$2,673,941.10
Unpaid Rent	
November 2011 Stub Rent Not Previously Paid	\$6,494.07

Total § 502(b)(6) Rejection Claim Additional Claims

Removal of Abandoned Furniture & Fixtures \$5,000.00 Removal of Mechanic's Lien Filed by Kone, Inc. \$ 18,511.00

\$23,511.00

\$2,680,435.17

**TOTAL CLAIM** \$2,703,946.17

In the Attachment to the proof of claim, the Landlord explains that the " 'Operating Expense reimbursements' are now based on 2012 actual numbers, except for actual 2013 real estate taxes, and have been divided into the following categories: real estate taxes, insurance and common-area maintenance expenses. All general and administrative costs other than insurance that were included [in the original claim] as operating expense reimbursements have been excluded from this amended proof of claim." (D.I. 2726-1, p. 2.)

The Court heard oral argument on the Objection, and the parties submitted supplemental letter briefs. The matter is ripe for decision.

## II. JURISDICTION

The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper in this Court pursuant to 28 U.S.C. § 1409. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B).

#### III. DISCUSSION

The Debtors' Objection to the Landlord's Claim asserts that the Claim exceeds the amount allowed by Bankruptcy Code § 502(b)(6) for claims resulting from the termination of a real property lease. Section 502(b)(6) provides, in pertinent part:

(b) [I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the

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date of the filing of the petition, and shall allow such claim in such amount, except to the extent that-

\*4 ....

- (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
  - (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
  - (i) the date of the filing of the petition; and
  - (ii) the date on which such lessor repossessed, of the lessee surrendered the leased property; plus
  - (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6).

#### A. Time vs. Rent

The Landlord's Claim calculates the amount of the 502(b)(6)(A) cap by determining the total Base Rent and other "rent" amounts due for the remaining term of the Lease and multiplying that total by 15 percent. The Debtors argue measure of time remaining under the lease term, pointing out that the context of the provision is temporal.

Both parties' views find support in the decisions by other courts, which are divided over the proper interpretation of \$\sqrt{8}\sqrt{502(b)(6)(A)}\cdot \textit{Compare} In re Connectix Corp., 372 B.R. 488, 491–93 (Bankr.N.D.Cal.2007) (following the "time" approach); In re Iron–Oak Supply Corp., 169 B.R. 414, 420 (Bankr.E.D.Cal.1994) (same); Sunbeam Oster Co. v. Lincoln Liberty Ave., Inc. (In re Allegheny Intern., Inc.), 145 B.R. 823, 828 (W.D.Pa.1992) (same); with In re New Valley Corp., 2000 WL 1251858, at \*11-12 (following the "rent" approach"); In re Andover Togs, Inc., 231 B.R. 521, 540–41 (Bankr.S.D.N.Y.1999) (same); In re Cantos, Inc., 176 B.R. 793, 795–96 (Bankr, W.D.Mich, 1995) (same). <sup>9</sup> The Third Circuit has not ruled on this question, although in dicta

the Court has explained that under the § 502(b)(6)(A) cap, "a landlord-creditor is entitled to rent reserved from the greater of (1) one lease year or (2) fifteen percent, not to exceed three years, of the remaining lease term." In re PPI Enterprises (U.S.), Inc., 324 F.3d 197, 207 (3d Cir.2003).

"The starting point in interpreting a statute is its language, for '[i]f the intent of Congress is clear, that is the end of the matter.' " Good Samaritan Hosp. v. Shalala, 508 U.S. 402, 409, 113 S.Ct. 2151, 124 L.Ed.2d 368 (1993) quoting Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842, 104 S.Ct. 2778, 2781, 81 L.Ed.2d 694 (1984). "If the terms of a statute are unambiguous, the plain meaning of the statue will govern." Estate of Palumbo v. U.S., 675 F.3d 234, 238-39 (3d Cir.2012). If the Court finds that a statute is ambiguous, the Court must then turn to legislative intent and other supplementary canons of interpretation to discern Congress' intent. U.S. v. Gilchrist, 215 F.3d 333, 336 (3d Cir.2000).

\*5 Is \$\frac{8}{502(b)(6)(A)}\$ ambiguous? Courts have interpreted this Code section in different ways. Yet, "just because a particular provision may be, by itself, susceptible to differing constructions does not mean that the provision is therefore ambiguous." Price v. Delaware State Police Federal Credit Union (In re Price), 370 F.3d 362, 369 (3d Cir.2004). In *Price*, the Third Circuit Court of Appeals determined:

[A]mbiguity does not arise merely because a particular provision can, in isolation, be read in several ways or because a Code provision contains an obvious scrivener's error. Lamie v. United States Trustee, 540 U.S. 526, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004). Nor does it arise if the ostensible plain meaning renders another provision of the Code superfluous. It at 1031. Rather, a provision is ambiguous when, despite a studied examination of the statutory context, the natural reading of a provision remains elusive. In such situations of unclarity, "[w]here the mind labours to discover the design of the legislature, it seizes every thing from which aid can be derived," United States v. Fisher, 6 U.S. (2 Cranch) 358, 386, 2 L.Ed. 304 (1805) (Marshall, C.J.), including pre-Code practice, policy, and legislative history.

Yet policy, pre-Code practice, and such other tools of construction are to be relied upon only when, ultimately,

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the meaning of a provision is not plain. When, however, we can arrive at a natural reading of a Code provision, informed not only by the language of the provision itself but also by its context, the burden to persuade us to adopt a different reading is "exceptionally heavy." Hartford Underwriters [Ins. Co. v. Union Planters Bank, N.A.], 530 U.S. [1], at 9, 120 S.Ct. 1942 [2000] quoting Patterson v. Shumate, 504 U.S. 753, 760, 112 S.Ct. 2242, 119 L.Ed.2d

Price. 370 F.3d at 369 (bold emphasis added).

The text at issue here provides that a claim for lease termination damages should be disallowed to the extent it exceeds "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease ... " A natural reading of this language supports the "time" approach:

Structurally, in comparing the greater or lesser of two things, the measurements of those things must be parallel, e.g. time versus time. The statute allows landlords to claim damages in the amount of rent reserved for the greater of one year or 15% of the remaining term. Because "one year" is inherently temporal, the phrase "remaining term" necessarily refers to time. This establishes that the statute measures "rent reserved within time periods." Therefore, the sentence structure of the statute supports the time approach.

An ordinary reading of the statute is consistent with this reasoning. The phrase "term of a lease" commonly refers to the length of a lease based on time rather than rent. In addition, the statute is generally written in terms of time: the calculation of the cap begins following the earlier of two dates, the date of petition or repossession, the maximum cap is worded in terms of time, three years, and the statute requires the rent to be calculated "without acceleration."

In re Heller Ehrman LLP, 2011 WL 635224, at \*2-3 (N.D.Cal. Feb. 11, 2011) (citations omitted); accord In re Blatstein, 1997 WL 560119, at \*15 (E.D. Pa. Aug 26, 1997) ("Because 'not to exceed three years' immediately follows '15 percent,' the 15% figure must apply to the time remaining and not the rent remaining.); In re Shane Co., 464 B.R. 32, 40 (Bankr.D.Colo.2012) ("To read \ \ \ \ \ \ \ \ 502(b)(6)(A) as referring to 15% of the total rent due over the full remaining term of the lease is inconsistent with the natural reading of the remainder of that subsection."). A leading treatise, Collier on Bankruptcy, also supports the "time" approach:

> \*6 Grammatically, the "greater of" phrase contemplates two time periods, one year and 15 percent of the remaining term. But the latter period (15 percent of the remaining term) is further limited to three years, so that if the remaining lease term exceeds 20 years, the allowable damage claim will not increase. The paraphrasing of this provision in the legislative history supports this interpretation. This reading therefore appears to be the better view.

4 COLLIER ON BANKRUPTCY ¶ 502.03[7][c] (16 th ed.2015).

Furthermore, the phrase "without acceleration" in \$502(b) (6)(A) lends further support to the "time" approach because the "rent" approach would render this phrase superfluous: "[t]aking 15 percent of all the rent for the remaining term, especially where escalation clauses are present, would be tantamount to effecting an acceleration." [Iron-Oak] Supply, 169 B.R. at 420. "It is a black letter rule of statutory interpretation that, if possible, a court should construe a statute to avoid rendering any element of it superfluous." First Bank Nat. Ass'n v. F.D.I.C., 79 F.3d 362, 367 (3d Cir.1996)

(citing United Steelworkers of Am. v. North Star Steel Co., Inc., 5 F.3d 39, 42 (3d Cir.1993), cert. denied, 510 U.S. 1114, 114 S.Ct. 1060, 127 L.Ed.2d 380 (1994)).

Based on a reading of the plain language of [8] 502(b)(6), there is no need to employ other tools of statutory construction; however, other decisions note that the legislative history and policy behind capping a landlord's claim for lease termination damages also support the "time" approach. Heller Ehrman, 2011 WL 635224, \*4-\*6, Connectix Corp., 372 B.R. at 493–94; In re Allegheny

Int'l, 136 B.R. 396, 402 (Bank, W.D.Pa.1991) aff'd 145 B.R. 823 (W.D.Pa.1992).

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The detailed discussion of the legislative history of \[ \bigcup\_{\sigma} \] 502(b)(6)(A) found in the Connectix case traces use of the "time" approach for calculating a landlord's claim. "Prior to 1934, a landlord's claim for future rent damages due to premature lease termination was not recognized in bankruptcy because it was considered contingent and not capable of proof." Connectix, 372 B.R. at 491. A compromise was reached in the 1934 and 1938 amendments to the Bankruptcy Act to allow "landlords to assert some amount as a claim for future rent, but with limited sacrifice on the part of general creditors." Id. at 492. The Bankruptcy Act limited a landlord's claim in a liquidation case to rent for the "year next succeeding" the date of surrender or reentry, and limited a landlord's claim in a rehabilitation case to rent for "the three years next succeeding" surrender or reentry. Id. The draft of the 1978 Bankruptcy Code continued the Act's limitation on landlord claims for lease rejection damages, but introduced the percentage calculation. Id. However, as noted by the Connectix Court:

[T]he percentage calculation was intended to replace the dual time provisions employed in the Bankruptcy Act. There is no indication, however, that Congress intended to move away from calculating the cap based on the rent that would become due within a time period immediately succeeding the statutory trigger date. Because there is no clear expression of an intent to change from a time approach to a "total rent" based formula, it cannot be presumed that Congress intended to make that shift. Fourco Glass Co. v. Trammirra Products Corp., 353 U.S. 222, 227, 77 S.Ct. 787, 791, 1 L.Ed.2d 786 (1957) ("no changes in law or policy are to be presumed from changes of language in the revision unless an intent to make such changes is clearly expressed.")

\*7 Connectix, 372 B.R. at 493. The Connectix Court also quoted the House Judiciary Report regarding an earlier version of the statute, which supports the view that the Code's computation of a landlord's future rent claim is based on time:

> The damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or 10% of the remaining lease term, not to exceed three years after the

earlier of [the petition date or the date of surrender or repossession.]

Connectix, 372 B.R. at 493–94 (emphasis in Connectix) quoting H.R.Rep. No. 595, 95 th Cong., 1 st Sess. 353 (1977), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5849 reprinted in Collier on Bankruptcy (15 th Rev. Ed.), vol. C, App. Pt. 4(d)(i).

Other courts have reasoned that the "rents" approach is more equitable because it allows landlords to recover damages based upon rent increases the parties bargained for when they entered into the lease. In re Gantos, Inc., 176 B.R. 793, 795–96 (Bankr, W.D.Mich, 1995). See also New Valley, 2000 WL 1251858 at \*11-12 (agreeing with Gantos). However, the Connectix Court points out that the "time" approach "better serves the economic forces that Congress was trying to address when it enacted the landlord damage cap" in the Bankruptcy Code:

> Although Congress wanted to continue the Bankruptcy Act's decision to give landlords some claim for future rent in bankruptcy, it also recognized the historical belief that it was equitable to limit the claims of landlords. The legislative history indicates that Congress started from the premise that, historically, landlords had no claim at all. It was also influenced by the fact that landlords, unlike other general unsecured creditors, have added protection at the termination of a lease arrangement. Landlords get the property back. As one court concluded, \( \bigcip\_{\{\bigsigma}} \) 502(b)(6) provides landlords with a certain period of time to relet their property. If successful, the landlord suffers no real economic detriment, because reletting the premises restores the landlord to the position it was in prior to lease termination. See In re Allegheny

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International, Inc. 136 B.R. at 402, aff'd, 145 B.R. 823 (W.D.Pa.1992).

*Connectix*, 372 B.R. at 494.

I conclude that the text of \[ \bigsim\_{\quad} \gamma 502(b)(6)(A) \] requires application of the 15 percent cap based on the "time" approach. 10 Legislative history and policy offer further support for this conclusion.

#### **B.** Additional Claims

\*8 The Landlord's Claim asserts two claims separately from the \( \bigsip \) \( \sigma \) 502(b)(6) lease termination damages: (i) the cost (\$5,000) to remove abandoned furniture and fixtures left on the Leased Premises, pursuant to Section 26.01 of the Lease (the "Abandonment Claim"), <sup>11</sup> and (ii) the cost (\$18,000) to remove a mechanic's lien resulting from the Debtors' nonpayment of a contractor who serviced the elevators and escalators in the Leased Premises, in violation of Section 11.04 of the Lease <sup>12</sup> (the "Mechanic's Lien Claim" and. together with the Abandonment Claim, the "Additional Claims"). While the Debtors do not dispute that a landlord may assert separate claims that do not arise from termination of a lease, the Debtors argue that the Additional Claims do indeed arise from termination of the Lease and arc subject to 

Section 502(b)(6) provides that the claim of a lessor "for damages resulting from the termination of a lease of real property" should be disallowed to the extent that it exceeds Additional Claims resulted from the termination of the Lease, they are subject to the statutory cap. If the claims do not arise as a result of the Lease termination, then the claims may be asserted separately against the Debtors.

\*9 Courts are divided on how to determine which claims "result from termination" of a lease. The Debtors urge the Court to follow cases such as Foamex and McSheridan that interpret the phrase broadly. McSheridan decided that "rejection of the lease results in the breach of each and every (6) is intended to limit the lessor's damages resulting from the

rejection." Kuske v. McSheridan (In re McSheridan). 184 B.R. 91, 102 (9th Cir. B.A.P.1995) overruled in part by In re El Toro Materials Co., Inc., 504 F.3d 978 (9th Cir.2007). See also In re Foamex Int'l, Inc., 368 B.R. 383, 393-94 (Bankr, D.Del. 2007) (relying on McSheridan and deciding that lessors are entitled to one claim, capped by \$502(b) (6), for all prepetition and postpetition breaches of the lease and any resulting damages)

The Landlord argues that this Court should rely on the Ninth Circuit's El Toro decision, which overruled, in part, the Bankruptcy Appellate Panel's decision in McSheridan, holding "[t]o the extent that McSheridan holds resection 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term, it is overruled." El Toro, 504 F.3d at 981–82. 13 In El Toro, a debtor left one million tons of its wet clay "goo," mining equipment and other materials on the leased property after rejecting the lease. When the landlord brought an adversary proceeding seeking damages of \$23 million for the cost of removing the mess under theories of waste, nuisance, trespass and breach of contract, the bankruptcy court determined Bankruptcy Appellate Panel reversed the bankruptcy court and the landlord appealed. The Ninth Circuit determined that the landlord's claims for waste, nuisance and trespass did not result from the rejection of the lease—instead, those claims resulted from the "pile of dirt" allegedly left on the property:

> Rejection of the lease may or may not have triggered [the landlord's] ability to sue for the alleged damages. But the harm to [the landlord's] property existed whether or not the lease was rejected. A simple test reveals whether the damages result from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it? Here [the landlord] would still have the same claim it brings today had El Toro accepted the

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lease and committed to finish the term: The pile of dirt would still be allegedly trespassing on [the landlord's] land and [the landlord] still would have the same basis for its theories of nuisance, waste and breach of contract. The million-ton heap of dirt was not put there by the rejection of the leaseit was put there by the action and inactions of El Toro in preparing to turn over the site.

El Toro, 504 F.3d at 980–81 (emphasis added). The El Toro Court reasoned that allowing separate claims was consistent with the purpose of the statute:

The structure of the cap-measured as a fraction of the remaining term-suggests that damages other than those based on a loss of future rental income are not subject to the cap. It makes sense to cap damages for lost rental income based on the amount of expected rent: Landlords may have the ability to mitigate their damages by releasing or selling the premises, but will suffer injury in proportion to the value of their lost rent in the meantime. In contrast, collateral damages are likely to bear only a weak correlation to the amount of rent: A tenant may cause a lot of damage to a premises leased cheaply, or cause little damage to premises underlying an expensive leasehold.

\*10 One major purpose of bankruptcy law is to allow creditors to receive an aliquot share of the estate to settle their debts. Metering these collateral damages by the amount of the rent would be inconsistent with the goal of providing compensation to each creditor in proportion with what it is owed. Landlords in future cases may have significant claims for both lost rental income and for breach of other provisions of the lease. To limit their recovery for collateral damages only to a portion of their lost rent would leave landlords in a materially worse position than other creditors. In contrast, capping rent claims but allowing uncapped claims for collateral damage to the rented premises will follow congressional intent by preventing a potentially overwhelming claim for lost rent from draining the estate, while putting landlords on equal footing with other creditors for their collateral claims.

El Toro, 504 F.3d at 980 (footnotes omitted). See also Kupfer v. Salma (In re Kupfer), 526 B.R. 812 (N.D.Ca.2014) (following El Toro, and deciding that the landlord's attorney fees and costs from a pre-petition arbitration regarding lease default were collateral damages).

I find the reasoning of the Court of Appeals in El Toro persuasive and agree with the more narrow interpretation of § 502(b)(6). 14 The statute does not prevent a landlord from asserting a separate claim for damages that do not directly arise from termination of the lease. Accordingly, I will review each of the Additional Claims before me.

#### (1) The Abandonment Claim

(6)(A).

The Abandonment Claim covers the cost to remove abandoned furniture and fixtures from the Leased Premises, which (the Landlord argues) is a breach of the Debtors' obligation to surrender the premises in a broom-clean condition. The Landlord, relying on a narrower reading of § 502(b)(6), asserts that the Abandonment Claim is not subject to the statutory cap because it is not a claim for rent for the balance of the lease term. The Landlord's argument conflates the concepts of determining whether a claim results from termination of a lease and determining whether a claim falls within the "reserved rent" language of subsection 502(b)

"Non-rent damages potentially fall within the scope of section 502(b)(6)." Kupfer, 2014 WL 4244019, \*3. The El Toro Court's narrower reading of the statutory cap did not change this:

> \*11 [T]he Ninth Circuit's holding in El Toro did not purport to eliminate the possibility that non-rent damages can result from lease termination, nor did it remove non-rent lease termination damages from the section 502(b) (6) cap. The Court merely effected a correction of controlling precedent by giving meaning to the plain language of the statute, which speaks of a relationship between lease termination and lease damages.

*Id.* at \*4 citing *El Toro*, 504 F.3d at 980.

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Therefore, the initial question is not whether the Abandonment Claim is rent, but whether the Abandonment Claim results from the termination of the Lease. In the decision In re Energy Conversion Devices, Inc., 483 B.R. 119 (Bankr.E.D.Mich.2012), the court denied a trustee's request to disallow a landlord's entire claim for "Additional Damages" assert separate damage claims. Energy Conversion, 483 B.R. at 125 citing El Toro, 504 F.3d at 979–81. However, the Additional Damages claim was based upon claims for:

> [r]emoval of equipment and other personal property in violation of the Lease, ... damage to the roof, damage to the parking lot, damage to HVAC and exhaust units and fire extinguishers, damage to the landscaping, environmental damage and liabilities, cleaning fees, plumbing damages and other costs to be incurred in restoring the property to the condition set forth in the Lease.

Energy Conversion, 483 B.R. at 121. The Energy Conversion Court decided that further development of the record was necessary before it could determine whether particular items (6) cap. Id. at 125–26. In In re Brown, 398 B.R. 215 (Bankr.N.D.Ohio 2008), the lease provided that the tenant was responsible for "refitting costs" (i.e., costs necessary to make the leased property suitable for the needs of a replacement tenant) only when the debtor was in breach of its covenants under the lease. Id. at 219. The Brown Court determined that the debtor's liability for refitting costs was a consequence directly resulting from the termination of the lease.

The El Toro Court determined that the landlord's tort claims for removal of tons of dirt and mining equipment left by the debtor were outside the scope of \$502(b)(6). El Toro, 504 F.3d at 980-81. The El Toro Court suggests a "simple test" to determine whether the claim results from rejection of a lease: assuming all other conditions remain constant, would

the landlord have the same claim against the tenant if the tenant were to assume the lease rather than reject it? In this case, the Landlord would have the same claim for removal of abandoned property, whether the lease terminated upon rejection or, if the lease was assumed, at the end of the lease term. For that matter, the Landlord would also have the same claim due to the natural expiration of the Lease.

Although El Toro focuses on whether the damages arose from rejection of the lease, \$502(b)(6) caps any claims resulting from termination of the lease. I find it significant that Congress chose to use the word "termination," not "rejection," in the introductory phrase of \$\frac{1}{2}\$\\$ 502(b)(6), and conclude that such choice was intentional. In the case before me, the Landlord would remove the Debtors' furniture and fixtures only upon termination of the lease. After review of the facts provided in support of the Abandonment Claim, I conclude that the claim is for damages resulting from termination of the Lease and, therefore, the Abandonment Claim is subject to the limitation imposed by \$\frac{1}{2} \setminus 502(b)(6).

- \*12 Once a court determines that a claim is for lease termination damages, it must decide whether the claim may be included as part of what is "rent reserved" under 502(b)(6)(A). The McSheridan Court used the following test to determine whether a claim falls within the "rent reserved":
  - (1) the charge must: (a) be designated as "rent" or "additional rent" in the lease; or (b) be provided as the tenant's/lessee's obligation in the lease;
  - (2) the charge must be related to the value of the property or the lease thereon; and
  - (3) the charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.

McSheridan, 184 B.R. at 99–100. See In re Crown Books Corp., 291 B.R. 623, 627 (Bankr.D.Del.2003) (relying on the McSheridan test to determine that base rent, CAM charges, insurance premiums and property taxes are subject to the 502(b)(6)(A) cap); In re PPI Enters. (U.S.), Inc., 228 B.R. 339, 348-49 (Bankr.D.Del.1998) (determining that attorney fees and late payments were designated as "additional rent" (6) limitation, but neither attorney fees nor late charges were "rent reserved" under the McSheridan test because neither

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were related to the value of the property or were fixed, regular or periodic charges).

The Lease designated all payments due from the Debtors as "Additional Rent." However, the Abandonment Claim damages are not fixed, regular or periodic charges and do not qualify as "rent reserved." 15

Based on the foregoing, I conclude that the Abandonment Claim is a claim that falls within the scope of \$\frac{1}{2} \\$ 502(b)(6), but is not part of the "rent reserved" under \( \bigsize \) \( \xi and, therefore, cannot be included the calculation of the claim 

#### (2) The Mechanic's Lien Claim

The Mechanic's Lien Claim is based on the Landlord's cost to remove a mechanic's lien on the Leased Premises resulting from the Debtors' nonpayment of a contractor who serviced the elevators and escalators in the Leased Premises. As discussed above, the Court must first determine whether the Mechanic's Lien Claim results from termination of the Lease. Based on the record before me, I conclude that the

Mechanic's Lien Claim exists independent of whether the Lease is terminated. Accordingly, the Mechanic's Lien Claim is not subject to the limitations of \{\bigcircle} \{ 502(b)(6), and the Landlord may assert a separate claim for recovery of those costs.

#### IV. CONCLUSION

Based on the foregoing, I conclude that the text of 502(b)(6)(A) requires application of the 15 percent cap based on the "time" approach. The Landlord's claim must be recalculated accordingly. Further, I conclude that the (6) cap and cannot be asserted as a separate claim; however, the Landlord's Mechanic's Lien Claim does not fall within the § 502(b)(6) cap and may be asserted as a separate claim.

An appropriate Order follows.

#### **All Citations**

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#### **Footnotes**

- 1 The Recognized Debtors in this bankruptcy case are: Filene's Basement, LLC, Syms Corp., Syms Clothing, Inc., and Syms Advertising Inc.
- 2 This Memorandum constitutes the findings of fact and conclusions of law, as required by Fed.R.Bankr.P.
- 3 The parties agree that the facts of this matter are not in dispute.
- 4 Declaration of Gary Binkoski, Interim Chief Financial Officer of Syms Corp., in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings (D.I.3), ¶ 7.
- 5 *Id.*, ¶¶ 8−9.
- 6 The first amendment to the Lease was made by a Memorandum of Understanding dated February 11, 1988; next, by a First Amendment dated April 25, 1988; and then, by a Second Amendment dated December 28, 1989.
- 7 Article 4, § 4.01 of the Lease provides, in part: "In this Lease, the term 'Rent' means collectively, the Minimum Annual Rent, Percentage Rent and Additional Rent and with respect to the payment of Rent and

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the performance by Tenant of all of its other covenants and obligations under this Lease, time is and shall be of the essence."

Additional Rent is defined in Section 4.10 as "all sums of money or charges of whatsoever nature (except Minimum Annual Rent and Percentage Rent) required to be paid by Tenant to Landlord pursuant to this Lease, whether or not the same is designated as additional rent."

Further, Section 4.12 provides: TOTAL RENT. "The rent reserved under this Lease shall be the total of all Minimum Annual Rent, Percentage Rent and Additional Rent, increased and adjusted as elsewhere herein provided, payable during the entire Lease Term...."

- 8 The Attachment to the proof of claim provides that: "The operating expense reimbursements consist of tenant's 22.36% share of the building's expenses due as Additional Rent under the Lease during Remaining Term and payable at the beginning of each month. The separate listing of direct costs for electricity/HVAC are for emergency lights, electric heat for freeze protection, HVAC to prevent mold from heat and humidity and lighting to show the premises to prospective tenants. The separate listing of direct costs for vertical transportation is for quarterly grease and lubrication of the premises' internal elevator and escalators to keep them in working order."
- 9 The "rent" approach is sometimes referred to as the "majority" view, but a review of the case law reveals that courts appear to be evenly split. There is no clear majority of decisions favoring either the "rent" approach or the "time" approach. See Connectix, 372 B.R. at 491.
- 10 The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 suggested in its Final Report and Recommendations that the calculation of rejection damages for real property leases under [78] 502(b)(6) should be clarified consistent with the "time" approach, as follows:

The claim of a lessor for damages resulting from the termination of a lease of real properly shall not exceed: (i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation plus (ii) Any unpaid rent due under the lease on the termination date. For purposes of this section: The "alternative rent calculation" is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date.

AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11, ISBN: 978-1-937651-84-8, Section V.A.6, pp. 129-30 (2014).

Lease Section 26.01, entitled "Delivery At End Of Lease Term," provides, in part: 11

Tenant shall deliver up and surrender to Landlord possession of the demised premises upon the expiration or earlier termination of the Lease Term, broom clean, free of debris and Tenant's personal property, in good order, condition and state of repair (except as may be Landlord's obligation under this Lease and ordinary wear and tear and damage by casualty) and shall deliver the keys to the office of Landlord in the Building or to Landlord at the address to which notices to Landlord are to be sent pursuant to Section 28.01. Any property of Tenant not promptly removed shall be deemed to have been abandoned by Tenant and to have become the property of Landlord and may be retained by Landlord or disposed of at Tenant's expense (Tenant hereby agreeing to remain liable for the cost thereof even though this Lease shall have terminated) as Landlord shall so desire....

12 Lease Section 11.04, entitled "No Liens Permitted; Discharged," provides, in part:

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Tenant will not permit to be created or to remain undischarged any lien, encumbrance or charge (arising out of any work done or materials or supplies furnished, or claimed to have been done or furnished, by any contractor, mechanic, laborer or materialman or otherwise by or for Tenant) or any mortgage, conditional sale, security agreement or chattel mortgage, which might be or become a lien or encumbrance or charge upon the Building or any part thereof or the income therefrom. Tenant will not suffer any other matter or thing whereby the estate, rights and interests of Landlord in the Building or any part thereof might be impaired. If any lien or notice of lien on account of an alleged debt of Tenant or by a party engaged by Tenant or Tenant's contractor to work on the demised premises shall be filed against the Building or any part thereof, Tenant, within ten (10) days after notice of the filing thereof, will cause the same to be discharged of record by payment, deposit, bond, order of a court of competent jurisdiction or otherwise. If Tenant shall fail to cause such lien or notice of lien to be discharged within the period aforesaid, then, in addition to any other right or remedy, Landlord may, but shall not be obligated to, discharge the same either by paying the amounts claimed to be due or by procuring the discharge of such lien by deposit or by by [sic ] bonding proceedings and in any such event Landlord shall be entitled, if Landlord so elects, to compel the prosecution of an action for the foreclosure of such lien by the lienor and to pay the amount of the judgment in favor of the lienor with interest, costs and expenses, including reasonable attorneys' fees, incurred by Landlord in connection therewith, shall constitute additional rent payable by Tenant under this Lease and shall be paid by Tenant to Landlord on demand....

- 13 The Landlord also relies upon Fin re Best Prod. Co., Inc., 229 B.R. 673, 679 (Bankr.E.D.Va.1998) (holding that a claim for prepetition deferred maintenance damages was not subject to the cap of [7] § 502(b)(6)); [7] In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231 -32 (Bankr.D.N.D.1992) (holding that a claim for repairing damages caused by the tenant pre-termination was not a lease termination claim under 502(b)(6)): In re Atlantic Container Corp., 133 B.R. 980, 988 (Bankr.N.D.III.1991) (holding that claims for physical damage to the leased premises and for repair and maintenance expenses are not subject to the \( \frac{1}{2} \) \( 502(b)(6) \) cap).
- 14 The Debtor argues that I should follow McSheridan's broader reading of \( \bigcirc \) \( \xi \) \( \xi \) 502(b)(6), because that decision was adopted by the Third Circuit in First Bank Nat. Ass'n v. F.D.I.C., 79 F.3d 362, 369 n. 7 (3d Cir.1996). First Bank involved a question about under what circumstances, if any, the Federal Deposit Insurance Agency ("FDIC") is required to pay the cost of lease mandated structural repairs to a building when, as receiver for a failed savings bank, it disaffirms its lease under FIRREA. In its analysis, the *First Bank* Court looked, in part, to Bankruptcy Code § 502(b)(6) and the Ninth Circuit Bankruptcy Appellate Panel's decision in McSheridan to inform its interpretation of 12 U.S.C. § 1821(e)(4) concerning the FDIC's obligations when it disaffirms a lease. Since the First Bank Court was considering interpretation of FIRREA, any discussion of [7] § 502(b) (6) is dictum. And, after First Bank was decided, the Ninth Circuit Court of Appeals decided El Toro, which overruled McSheridan, in part. Therefore, First Bank is not controlling.
- To be clear, I do not find it necessary here to apply the three-part McSheridan test, in toto, but I do agree that 15 to be properly classifiable as "rent reserved," a charge must be fixed, regular, or periodic.

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KeyCite Yellow Flag - Negative Treatment Disagreed With by In re Midway Airlines Corp., 4th Cir.(N.C.), May 2,

> 268 F.3d 205 United States Court of Appeals, Third Circuit.

In re MONTGOMERY WARD HOLDING CORP., Debtor.

Centerpoint Properties, Appellant.

Montgomery Ward Holding Corp.

No. 99-6140. Argued April 3, 2001. Filed Oct. 10, 2001.

#### **Synopsis**

Corporate debtor filed Chapter 11 bankruptcy petition seeking relief from its creditors. Bankruptcy court denied motion by landlord, as creditor, to compel performance of its unexpired industrial building lease. Landlord appealed. The United States District Court for the District of Delaware, Joseph J.

Farnan, Jr., J., affirmed, 242 B.R. 142. Landlord appealed. The Court of Appeals, Stapleton, Circuit Judge, held that debtor's lease obligation was required to be fulfilled by bankruptcy trustee, not in part, but in full, at time duty to perform arose under that lease.

Reversed and remanded.

Mansmann, Circuit Judge, filed a dissenting opinion.

**Procedural Posture(s):** On Appeal.

West Headnotes (5)

[1] Federal Courts 📻 Statutes, regulations, and ordinances, questions concerning in general

> The Court of Appeals exercises plenary review over the legal question of the proper interpretation of a statute.

4 Cases that cite this headnote

**Bankruptcy** Debtor's Contracts and Leases [2]

> Corporate debtor's lease obligation was required to be fulfilled by bankruptcy trustee, not in part, but in full at time duty to perform arose under that lease, as part of debtor's Chapter 11 bankruptcy.

Bankr.Code, 11 U.S.C.A. § 365(d)(3).

58 Cases that cite this headnote

**Bankruptcy** Debtor's Contracts and Leases [3]

> In the context of a lease contract in bankruptcy, 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.

62 Cases that cite this headnote

[4] **Bankruptcy** Debtor's Contracts and Leases

> Under bankruptcy law, an obligation arises under a lease when the legally enforceable duty to perform arises under that lease. Bankr.Code,

11 U.S.C.A. § 365(d)(3).

40 Cases that cite this headnote

[5] Constitutional Law P Making, Interpretation, and Application of Statutes

> It is not the role of the courts to make arguably better laws than those fashioned by Congress.

1 Case that cites this headnote

**Attorneys and Law Firms** 

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J. Mark Fisher (Argued), William M. Aguiar, Schiff, Hardin & Waite, Chicago, IL, and Steven K. Kortanek, Klehr, Harrison, Harvey, Branzburg & Ellers, Wilmington, DE, Attorneys for Appellant.

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Before MANSMANN, STAPLETON and GREENBERG, Circuit Judges.

until after the expiration of the Term of this Lease....

#### OPINION OF THE COURT

STAPLETON, Circuit Judge:

This appeal presents us with a narrow question of statutory interpretation. Section 365 of Title 11 requires that a bankruptcy trustee fulfill all the obligations that arise under a non-residential lease subsequent to the entry of the bankruptcy order and prior to the time that the lease is rejected. Under the terms of the non-residential lease entered by the debtor in this case, it was required to reimburse the \*207 landlord for all tax expenses attributable to the leased premises. The obligation to pay that reimbursement did not mature under the terms of the lease until after the order, although the landlord's liability for the taxes accrued in large part prior to the order. We must determine whether in these circumstances section 365 requires the bankruptcy trustee to make the entire payment called for in the lease.

I.

On September 7, 1995, Montgomery Ward Holding Corporation ("Montgomery Ward"), executed a lease on a commercial property in Illinois owned by CenterPoint Properties Trust ("CenterPoint"). Two of the provisions of the lease require Montgomery Ward to reimburse CenterPoint for real estate taxes assessed on the premises. Section 6.1 of the lease states:

> Upon receipt of an invoice from [CenterPoint], [Montgomery Ward] further agrees to pay before any fine, penalty, or interest or cost may be added thereto for the nonpayment thereof, as Additional Rent for the Premises, all Taxes ... levied, assessed or imposed upon the Premises or any part thereof accruing during the Term of this Lease, notwithstanding that such Taxes may not be due and payable

An additional term of the Lease found in Section 6.3, provides for a "security deposit" mechanism which operates as follows:

> As security for [Montgomery Ward's] obligation to pay for Taxes assessed for 1996 and 1997, unless the same were otherwise paid by [Montgomery Ward] prior to the expiration of the Term, [Montgomery Ward] agrees to deposit with [CenterPoint], or such other entity as [CenterPoint] may designate, no later than thirty (30) days prior to the expiration of the Term an amount equal to one hundred percent (100%) of the most recent ascertainable Taxes.... [Montgomery Ward's] payment of the deposit shall be credited against the Taxes due....

Thus, two separate lease provisions obligate Montgomery Ward to reimburse CenterPoint for tax liabilities incurred during the term of the lease.

On July 7, 1997, Montgomery Ward filed for bankruptcy under Chapter 11. Montgomery Ward continued to make use of the premises as a debtor-in-possession pursuant to §§ 1107 and 1108 of the Bankruptcy Code, but it neither assumed nor rejected the lease prior to the lease's expiration on September 1, 1997.

On July 11, 1997, CenterPoint sent three invoices to Montgomery Ward. The first invoice was for a first installment of 1996 taxes (payable in 1997) in the amount of \$320,404.40. The second invoice was for an estimated second installment of 1996 taxes in the amount of \$320,569.70. The third invoice was issued pursuant to Section 6.3 of the lease and covered the 1997 taxes. This was in the amount of \$426,729.87.

Montgomery Ward did not remit payment for either of the first two invoices, but remitted \$96,584.95 as payment for the third invoice. This amount represented the prorated portion

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of taxes attributable to the period subsequent to Montgomery Ward's petition for bankruptcy relief. Montgomery Ward took the position that all taxes attributable to a pre-petition period constituted unsecured claims. 1

\*208 On September 15, 1997, CenterPoint filed a motion pursuant to 11 U.S.C. § 365(d)(3) in the Bankruptcy Court for the District of Delaware seeking payment in full of Montgomery Ward's tax reimbursement obligations pursuant to the lease. Section 365(d)(3) reads, in relevant part:

> 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. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60day period.

CenterPoint argued that all the invoices were payable immediately as "obligations of [Montgomery Ward] ... arising from ... the lease" after the order for relief. 2 Montgomery Ward argued that the statute was ambiguous and that the jurisprudence of the Third Circuit required that it should pay only the taxes attributable to the period after the order.

The Bankruptcy Court decided in favor of Montgomery Ward. CenterPoint appealed this decision to the District Court for the District of Delaware, which affirmed the decision of the Bankruptcy Court. CenterPoint again appeals.

[1] The Bankruptcy Court had subject matter jurisdiction pursuant to 28 U.S.C. § 157 because CenterPoint's claim arose in the Chapter 11 bankruptcy case filed by Montgomery Ward. The District Court had appellate jurisdiction over the Bankruptcy Court's final judgment, order, and decree

pursuant to 28 U.S.C. §§ 158(a) and 1334(a). This Court has appellate jurisdiction to review the final order of the District Court pursuant to 28 U.S.C. §§ 158(d) and 1291. We exercise plenary review over the legal question of the proper interpretation of a statute. In re McDonald. 205 F.3d 606, 609 (3d Cir.2000).

II.

[2] Section 365(d)(3) mandates that "the trustee shall timely perform all the obligations of the debtor ... arising from and after the order for relief under any unexpired lease ..., until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title." 11 U.S.C. § 365(d)(3). There is, of course, a syntactical ambiguity in this text. It is not clear, as a purely formal matter, whether the preposition "from" should be read to modify the most proximate noun, "order," or the more remote, "lease." Nevertheless, we will interpret the preposition, as do both parties here, as modifying "lease," and the requirement as relating to obligations "arising from [,] and after the order of relief under[,] any unexpired lease." To require a trustee to perform all obligations "arising from ... the order of relief" would make little sense and would be entirely inconsistent with the legislative history.

The issue for resolution then is what Congress meant when it referred to "obligations of the debtor arising under a lease after the order of relief." In the factual \*209 context of this case, does it require payment by the trustee of all amounts that first become due and enforceable after the order under the terms of the lease? Or does it require the proration of such amounts based upon whether the landlord's obligation to pay the taxes accrued before or after the order?

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.

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[3] The term "obligation" is not defined in the Code, and it is thus apparently used in its commonly understood sense. Black's Law Dictionary defines it as "[t]hat which a person is bound to do or forebear; any duty imposed by law, promise, contract, relations of society, courtesy, kindness, etc." Black's Law Dictionary 968-69 (5th ed. 1979). 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.

While Montgomery Ward insists that the statutory text is ambiguous, it has not advanced a plausible reading that seems to us consistent with that text. Several courts that have adopted a proration approach have suggested that such an approach can be reconciled with the text by interpreting "obligation" in light of the statutorily defined term "claim." See, e.g., Child World, Inc. v. Campbell/ Massachusetts Trust (In re Child World, Inc.), 161 B.R. 571, 574 (S.D.N.Y.1993). The tenant has an "obligation" when the landlord has a "claim." The Code, of course, defines "claim" as including an "unmatured right to payment." Thus, it is suggested, an "obligation" can arise before the tenant is obliged to perform. There are several difficulties with this suggestion. First, of course, Congress chose "obligation" and not "claim." See In re R.H. Macy & Co., 152 B.R. 869, 873 n. 3 (S.D.N.Y.1993) (suggesting that this makes § 365(d)(3) "somewhat out of synch" with the rest of the code). 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, an obligation that clearly does not arise under the lease. Indeed, any reading that provided an analytical foundation for such proration would be inconsistent with what would appear to be the fundamental tenet of the text-that it is the \*210 terms of the lease that determine the obligation and when it arose.

Finding a straightforward interpretation that produces a rational result and no other reasonable interpretation consistent with the text, we are constrained to hold that \[ \bigcircles \] 365(d)(3) is not ambiguous. We thus have no justification for consulting legislative history. Nevertheless, we believe the limited legislative history of \$\frac{8}{365(d)(3)}\$ is consistent with our reading of the text. The situation existing prior to the adoption of \$\frac{1}{2}\sigma 365(d)(3)\$ has been accurately described in the literature as follows:

> Prior to 1984, landlords who leased premises to a [debtor-in-possession ("DIP") ] sought payment of rent and other postpetition charges as administrative expenses. Several factors, however, made collecting postpetition lease obligations under § 503 an unsatisfactory arrangement. First, a landlord had to comply with the formal and time-consuming procedure of an application, notice, and hearing. Second, a landlord could, upon proper proof, only recover the reasonable value of the DIP's actual use and occupancy of the premises. The "reasonable value-actual use" standard meant that (i) if a DIP physically occupied only a portion of the premises, it would, in turn, only be liable for the pro rata rent corresponding to the percentage of space actually occupied, and (ii) the court could limit a landlord's recovery to a fair market rate where the contract rate in the lease appeared clearly unreasonable. Finally, since bankruptcy courts exercise discretion with respect to the timing of the payment of administrative expenses, the court could delay payment of the amount awarded to the landlord until confirmation of a plan. The resulting loss of income imposed a heavy economic burden on landlords who were forced to provide ongoing services and space to the estate without

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receiving timely payment to satisfy their own cash obligations.

pending the trustee's assumption or rejection of the lease.

See 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; footnotes omitted) [hereinafter "To Bind or Not to Bind"].

In 1984, Congress adopted \( \bigsigma \) \( \bigsigma \) 365(d)(3) as a part of the Bankruptcy Amendments and Federal Judgeship Act of 1984. Virtually all courts have agreed that it was intended to alleviate the above described burdens of landlords by requiring timely compliance with the terms of the lease. As Senator Orrin Hatch, a conferee on the originating act, put it:

> This subtitle contains three major substantive provisions which are intended to remedy serious problems caused shopping centers and their solvent tenants by the administration of the bankruptcy code.... A second and related problem is that during the time the debtor has vacated space but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments under the lease. In this situation, the landlord is forced to provide current services —the use of its property, utilities, security, and other services-without current payment. No other creditor is put in this position. In addition, the other tenants often must increase their common area charge payments to compensate for the trustee's failure to make the required payments for the debtor. The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance requirement \*211 will insure that debtor-tenants pay their rent, common area, and other charges on time

H.R. Rep. No. 882, 95th Cong., 2d Sess., reprinted in 1984 U.S.C.C.A.N. 576 (emphasis added). Senator Hatch's statements seem to us to confirm that Congress intended that the debtor in possession perform "all the obligations ... at the time required in the lease." See In re Krystal Co., 194 B.R. 161, 164 (Bkrtcy.E.D.Tenn.1996) (finding legislative history supports "time required in the lease" theory). 4

[4] We are not alone in holding that an obligation arises under a lease for the purposes of \$\ 365(d)(3)\$ when the legally enforceable duty to perform arises under that lease. See e.g., In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir.2000) (where rent for the coming month was due under the lease on the first of the month and the tenant rejected the lease on the second, "\bigsis \ 365(d)(3) is unambiguous as to the debtor's rent obligation and requires payment of the full month's rent;" proration would be inconsistent with the statute); In re R.H. Macy, 152 B.R. at 873 ("As [the landlord] correctly notes,[the debtor] is not directly liable for the reassessed taxes, but only contractually obligated to pay such amounts to [the landlord.] Accordingly, the reassessed taxes represent an obligation of [the debtor] under the Lease that arose after the order for relief which must be timely performed in accordance with section 365(d)(3)."); In re Duckwall-ALCO Stores, 150 B.R. 965, 976 n. 23 (D.Kan.1993) (stating that "[t]he language of \ \ 365(d) (3) is clear in imposing the duty to comply with all lease obligations arising after the order for relief.... The lease did not provide for payment of taxes to the landlord as they accrued."). See also Joshua Fruchter, To Bind or Not to Bind —Bankruptcy Code § 365(d)(3): Statutory Minefield, 68 Am. Bankr. L.J. 437, 473 (1994).

We reach the conclusion that 365(d)(3) is unambiguous with some reluctance given that one sister court of appeals and a number of other courts have reached the opposite conclusion and have opted for a proration approach. See, e.g., In re Handy Andy, 144 F.3d 1125 (7th Cir.1998); In re Child World, 161 B.R. 571 (S.D.N.Y.1993), reversing 150 B.R. 328 (Bankr.S.D.N.Y.1993). Nevertheless, we

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find ourselves unpersuaded by the contentions that have led them to their conclusion. We acknowledge that there are aspects to a proration approach that Congress might have found desirable. It is not our role, however, to make arguably

better laws than those fashioned by Congress. See Touche Ross & Co. v. Redington, 442 U.S. 560, 578, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979). We also acknowledge that proration was the pre-Code practice and that we had been admonished not to "read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." Pennsylvania Dept. Pub. Welfare v. Davenport, 495 U.S. 552, 563, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990). It seems clear to us, however, that Congress Code practice that had created a problem for landlords of non-residential property and that our task is to determine \*212 the nature of the change based on the text chosen. Finally, we acknowledge that the result we reach may in some cases leave room for strategic behavior on the part of landlords and tenants. Here, we tender only two observations. Tax reimbursement obligations are only a small constellation in the universe of obligations coming within the scope of \( \bigsis \) \( \\ 365(\, \d)(3), \) and there is no basis in the text for distinguishing them from rent and numerous other obligations of tenants. Moreover, strategic behavior even in the area of tax reimbursement can be constrained by forethought and careful drafting.

Contrary to the suggestion of Montgomery Ward, we do not find our decision in In re Columbia Gas Transmission Corp., 37 F.3d 982 (3d Cir.1994), to be helpful in resolving the issue before us. As Montgomery Ward stresses, we there observed that a tax liability is generally "incurred on the date it accrues, not on the date of the assessment or date on which it is payable." *Id.* at 985. *Columbia Gas* did not involve a lease, however, and, accordingly, did not call upon us to interpret § 365(d)(3).

III.

Montgomery Ward's lease obligation to reimburse CenterPoint for tax payments arose post-order and prior to rejection. Under | 365(d)(3), Montgomery Ward's obligation must be fulfilled not in part, but in full.

The judgment of the District Court will be reversed and this case will be remanded for proceedings consistent with this opinion.

MANSMANN, Circuit Judge, dissenting:

I.

This appeal requires us to determine when a leasehold obligation "arises" for purposes of \$\ 365(d)(3) of the Bankruptcy Code. The majority holds, in effect, that an obligation that accrues over time does not arise as it accrues, but instead arises at whatever time the parties specify in their lease. Because I believe that the majority's holding gives an unwarranted preference to landlords for recovery of "prepetition" debts, I respectfully dissent.

II.

Section 365(d)(3) provides, in pertinent part, that:

The trustee shall timely perform all the obligations of the debtor ... 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.

11 U.S.C. § 365(d)(1). The plain import of this provision is that the trustee must fulfill all obligations under the lease which "arise" from the date of the order until the date of assumption or rejection. 1

\*213 In the present case, the lease called for reimbursement of taxes when invoiced by the landlord. Shortly after the tenant filed for bankruptcy protection in July, 1997, the landlord issued invoices for taxes attributable to all of 1996 and 1997, up to the September 1, 1997 expiration date of the lease. The majority today holds that, because the billing took place within the eight-week administrative period between entry of an order for relief and expiration of the lease (before assumption or rejection thereof), the entire

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twenty months' worth of tax obligations "arose" during that eight-week period. In so holding, the majority elevates the accident or artifice of the billing date above 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.

The majority's holding is predicated on its view that the of the lease that determine the obligation and when it arose". Supra at 209. While I agree that the terms of the lease determine the obligation, the statute says nothing about how to determine when the obligation arises. Nothing in the text is inconsistent with the common-sense view that when an obligation arises may be fixed by its intrinsic nature and/or by the extrinsic circumstances of its accrual. An obligation attributable to a particular time may well be said to "arise" at that time, and an obligation that accrues over time may be said to "arise" as it accrues, without doing violence to the statutory language.

I believe that 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. This is in keeping with the policy of the Bankruptcy Code of giving priority to post-petition claims to enable the debtor to keep operating for as long as its current revenues cover current costs (so that the debtor's business is yielding a net economic benefit). See In re Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125, 1127 (7th Cir.1998). Moreover, \$\sum\_{\circ}\$ 365(d)(3) should be read in light of the overarching policy of treating all creditors within a class (such as unsecured pre-petition trade creditors) alike. Both of these policies are disserved by requiring the debtor or trustee to repay back taxes, a pre-petition "sunk cost", as a condition of ongoing operations. See id. at 1128.

Our decision today creates a split of authority among the Courts of Appeals concerning priority of back taxes that are billed post-petition, as it is squarely in conflict with the Seventh Circuit's well-reasoned decision in Handy Andy. As Chief Judge Posner explained:

> The quarrel between the parties is over whether [tenant]'s "obligation" under the lease could arise before

[tenant] was contractually obligated to reimburse [landlord] for the taxes that the latter had paid .... [the] "billing date" approach is a possible reading of section 365(d)(3), but it is neither inevitable nor sensible. It is true that [tenant]'s obligation to [landlord] to pay (or reimburse [landlord] for paying) the real estate taxes did not crystallize until the rental due date after the taxes were paid. But since death and taxes are inevitable and [tenant]'s obligation under the lease to pay the taxes was clear, that obligation could realistically be said to have arisen piecemeal every day of 1994 and to have become fixed irrevocably when, the last day of the year having come and gone, the lease was still in force. Had the lease been terminated for one reason or \*214 another on January 1, 1995, [tenant] would have had a definite obligation to reimburse [landlord] for the 1994 real estate taxes when those taxes were billed to [landlord]. The obligation thus arose, in a perfectly good sense, before the bankruptcy. The obligation to reimburse [landlord] for the first installment of the 1995 taxes likewise arose before the bankruptcy.

Handy Andy, 144 F.3d at 1127. I find this reasoning persuasive, and I would follow it in this case.

The majority finds support for its position in a recent decision by the Sixth Circuit that involved just one month of advance rent rather than a year and a half of back taxes. See In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir.2000). Although I disagree with the statutory analysis in Koenig Sporting Goods, it would seem that parceling a continuing obligation into monthly increments is far less subversive of statutory policies than aggregating a year or more of accrued debt for priority purposes. In any event, the Sixth Circuit itself apparently considers the difference between a short advance payment and a long back payment to be important.

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Compare Vause v. Capital Poly Bag, Inc., 886 F.2d 794 (6th Cir.1989) (rejecting argument that farm rent payable at end of year accrued only on the payment date) with Koenig Sporting Goods, 203 F.3d at 989, nn. 4 & 5 (distinguishing Vause as involving rent payments in arrears rather than in advance).

Although some courts have applied the "billing date" approach adopted by the majority today, most decisions have rejected that approach in favor of proration. See, e.g., In re McCrory Corp., 210 B.R. 934, 940 (S.D.N.Y.1997) (observing that the billing date approach "would result in a windfall either to the landlord or the debtortenant"); In re Victory Markets, Inc., 196 B.R. 6 (Bankr.N.D.N.Y.1996); In re All For A Dollar, Inc., 174 B.R. 358 (Bankr.D.Mass.1994); In re Child World, *Inc.*, 161 B.R. 571 (S.D.N.Y.1993) (observing that allowing landlords to recover for pre-petition services billed postpetition "would grant landlords a windfall payment, to the detriment of other creditors"); In re Ames Department Stores, 150 B.R. 107 (Bankr.S.D.N.Y.1993), Cf. Daugherty v. Kenerco Leasing Co. (In re Swanton Corp.), 58 B.R. 474 (S.D.N.Y.1986) (rent prorated although lease called for yearly rental payments). <sup>2</sup>

established rule. See, e.g., Child World, 161 B.R. at 575-76 (referring to "the long-standing practice under § 503(b)(1) of prorating debtor-tenant's rent to cover only the postpetition, prerejection period, regardless of billing date"). As the majority acknowledges, we should not read legislation to alter established bankruptcy practice "absent a clear indication that Congress intended such a departure." Supra at 211, quoting Pennsylvania Dept. Pub. Welfare v. Davenport, 495 U.S. 552, 563, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990). See also Cohen v. de la Cruz, 523 U.S. 213, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998) (same); Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 501, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) ("The normal

The proration approach is in keeping with what had

been, prior to enactment of \$\frac{1}{2} \cdot \ 365(d)(3), the well-

rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes the intent specific. The court has followed this rule with particular \*215 care in construing the scope of bankruptcy codifications.").

Although, as the majority suggests, Congress clearly intended to change prior practice when it enacted \$365(d)(3), I can find no indication of a specific intent to displace proration with the billing date approach. Rather, it seems clear that the statute was aimed at providing landlords with current pay for current services and relieving them from the "actual and necessary" analysis required under § 503(b)(1). Nothing in the text or legislative history suggests that Congress wished to go beyond putting landlords on the same footing with other trade creditors by allowing them through the timing of their billing to transform pre-petition claims into post-petition claims. See Handy Andy, 144 F.3d at 1128; Child World, 161 B.R. at 575–76.

The majority seeks to marshal support for its interpretation from the remarks of Senator Hatch in the legislative history. However, the Senator's observation that the trustee must perform "all the obligations ... at the time required in the lease" simply has no bearing on the question before us. The quoted passage merely indicates when an obligation must be performed: "at the time required in the lease", which adds nothing to the statute's requirement of "timely" performance. It simply does not address how to determine when the obligation arises.

III.

Because neither the language of the statute nor the legislative history forecloses the District Court's commonsense interpretation—one that preserves prior practice and better serves fundamental bankruptcy policies, I would affirm the decision below. Accordingly, I dissent.

**All Citations** 

268 F.3d 205, 47 Collier Bankr.Cas.2d 135, 38 Bankr.Ct.Dec. 135, Bankr. L. Rep. P 78,515

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## **Footnotes**

- 1 As the Seventh Circuit noted in In re Handy Andy Home Improvement Centers, 144 F.3d 1125, 1126 (7th Cir.1998), recorded decisions often refer to "pre-petition" and "post-petition" periods rather than a "pre-order" and "post-order" periods. The latter terms are technically correct.
- 2 While section 6.3 did not explicitly contemplate an invoice to trigger payment, it did contemplate that the payment obligation would arise at a fixed date no later than thirty days prior to the expiration of the lease. In the absence of an invoice from CenterPoint, the obligation to make payment would have arisen within the post-order, pre-rejection period.
- 3 "Claim" is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A).
- 4 In re Child World, 161 B.R. 571, 575-77 (S.D.N.Y.1993), and a line of similar cases focus on Senator Hatch's "current payment" for "current services" language and conclude that \$\frac{1}{2}\$ \( \frac{365(d)(3)}{3} \) was targeted at the specific inequity of requiring the landlord to provide current services without compensation. Senator Hatch's description of the solution chosen by Congress is not so limited, however.
- I do not perceive a "syntactical ambiguity" in the statute. Unlike the majority, I read the phrase "from and after" as a redundant pair, much like the common phrases "over and above" or "cease and desist". Hence, I believe that "from" is used in the sense of "commencing with", and modifies the order rather than the lease: The statute deals with obligations under the lease, arising "from and after" the date of the order. Although the majority's alteration of the syntax through insertion of commas may resolve the majority's perceived difficulty with the usage of "from", it creates a new usage problem by designating the order for relief (or perhaps the relief itself) to be "under" the lease. In any event, it appears that these disagreements over the parsing of the statutory text are of merely academic concern, as I believe that the majority agrees that the trustee need not perform obligations that arise before the date of the order.
- 2 See generally 2 Norton Bank. L. & Prac.2d § 42:8 Nonresidental Real Property Leases under Code § 365(d) (3) (2000 Supp.); Arnold M. Quittner, Executory Contracts and Leases, 805 PLI/Comm 79, 249-53 (April 2000) Executory Contracts and Leases, 805 PLI/Comm 79, 249-53 (April 2000).

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In re Stone Barn Manhattan LLC, 398 B.R. 359 (2008)

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KeyCite Yellow Flag - Negative Treatment Declined to Follow by In re Imperial Beverage Group, LLC, Bankr.N.D.Tex., July 29, 2011

> 398 B.R. 359 United States Bankruptcy Court, S.D. New York.

In re STONE BARN MANHATTAN LLC, f/k/a Steve & Barry's LLC, et al., Debtors.

> No. 08-12579 (ALG). Dec. 17, 2008.

## **Synopsis**

**Background:** Chapter 11 debtors' landlord sought to compel debtors to pay so-called "stub rent" accruing in interim period between date that order for relief was entered and end of that month. Debtors responded that rent was payable on first of each month, and that any obligation they had for rent relating to month in which petition was filed was prepetition obligation that would give rise only to an unsecured claim if lease was ultimately rejected.

[Holding:] The Bankruptcy Court, Allan L. Gropper, J., held that court had to prorate rent that was owing during first month in which Chapter 11 case was filed, under lease that required debtors to prepay rent on first of each month, to determine debtors' obligation, under Code provision requiring trustee to timely perform all obligations of debtor under any unexpired lease of nonresidential real property, for "stub rent" during interim period between date that order for relief was entered and end of that month.

So ordered.

West Headnotes (5)

[1] **Bankruptcy** Debtor's Contracts and Leases

Bankruptcy Code provision requiring trustee to timely perform all obligations of debtor under any unexpired lease of nonresidential real property, until lease is assumed or rejected, was enacted to ameliorate perceived inequities that lessors of nonresidential real property had faced under administrative expense provisions during the period after a Chapter 11 filing but before assumption or rejection. 11 U.S.C.A. §§ 365(d)(3), 503(b).

6 Cases that cite this headnote

**Bankruptcy** ightharpoonup Administrative expenses in [2]

> Administrative expense claims are construed narrowly. 11 U.S.C.A. § 503(b).

1 Case that cites this headnote

Bankruptcy - Administrative expenses in [3]

> **Bankruptcy** Presumptions and burden of proof

**Bankruptcy** > Notice and hearing

Party seeking an administrative expense has to prove, after notice and hearing, that use of its property is actual and necessary cost of preserving debtor's estate. 11 U.S.C.A. § 503(b)(1)(A).

**Bankruptcy** Administrative expenses in [4] general

> Administrative expenses ordinarily do not have to be paid until end of bankruptcy case. 11 U.S.C.A. § 503(b).

[5] **Bankruptcy >** Debtor's Contracts and Leases

> Bankruptcy court had to prorate rent that was owing during first month in which Chapter 11 case was filed, under lease that required debtors to prepay rent on first of each month, to determine debtors' obligation, under Bankruptcy Code provision requiring trustee to timely perform all obligations of debtor under any unexpired lease of nonresidential real property, for "stub rent" during interim period between

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date that order for relief was entered and end of that month. 11 U.S.C.A. § 365(d)(3).

6 Cases that cite this headnote

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## MEMORANDUM OF DECISION

ALLAN L. GROPPER, Bankruptcy Judge.

In 1984 Congress amended \ 365 of the Bankruptcy Code, 11 U.S.C § 365, to assure commercial landlords timely receipt of post-petition rent from debtors in Chapter 11 proceedings. Since then, courts have differed on the proper application of the provision, 11 U.S.C. § 365(d)(3), where a commercial lease provides for monthly payment of rent in advance (as almost all leases do) and the debtor files its petition or rejects its lease in the middle of a month (as almost all debtors do). As discussed below, in such situations, some courts apply a "proration" approach in calculating the amount of rent due under \$ 365(d)(3), while others use a "performance or billing-date" approach.

The dispute at hand involves the application of \ \ \ \ 365(d) (3) to a filing in the middle of the month and a debtor's liability for the so-called "stub rent"—the rent for the interim period between the day the order for relief was entered in the bankruptcy case and the end of that month. Specifically, the Court has to determine whether \*361

365(d)(3) requires prorating the rent for the first month

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of the bankruptcy case or whether the statute precludes such an approach. The above-named landlords ("Landlords"), holding more than thirty leases, asked the Court to adopt the proration approach. In the alternative, some of these Landlords argued that if the Court did not prorate, it should nonetheless find that stub rent is payable under 11 U.S.C. § 503(b) as a cost of administering the bankruptcy estate. <sup>1</sup>

The Debtors ("Debtors"), on the other hand, urge the Court to reject proration and to find that the rent for the first month of the case was payable on the first day of the month, prior to the filing date, and was a pre-petition obligation that would give rise only to an unsecured claim if the lease is ultimately

rejected. The Debtors did not contest the Landlords' \$503(b) claim in principle but stated it would be premature for the Court to decide the issue. In the first place, the Debtors contended, administrative claims do not have to be paid until the end of a case. Moreover, they argued, administrative expenses are measured by the benefit the estate receives, and an evidentiary hearing would be necessary to determine whether the Debtors had benefited from the lease in question during the post-petition period and, if so, the reasonable amount for "use and occupancy."

There are no issues of fact that bear on the construction of § 365(d)(3) in this case. There is no dispute that the Debtors were, before the Chapter 11 filing, obligated to pay rent and certain other charges, in advance, on the first day of each month, under each of the relevant nonresidential real property leases; that the Debtors had not paid rent for July when they filed their Chapter 11 petitions on July 9, 2008; that the Landlords asked for payment; and that the Debtors refused.

The Court's conclusions of law follow.

## DISCUSSION

I. The Adoption of  $\S 365(d)(3)$ 

Section 365(d)(3) was introduced as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984. The statute, in relevant part, 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."

[2] [3] [4] There is no dispute as to the purpose of \$\)\[ \} \\$ 365(d)(3). Congress enacted the statute to ameliorate the perceived inequities that lessors of nonresidential real property had faced during the period after a Chapter 11 filing but before assumption or rejection. As Senator Orrin Hatch, a conferee to the original act, stated: "In this situation, the landlord is forced to provide current services—the use of its property, utilities, security, and other services-without current payment ... the bill would lessen these problems ..." Cong.Rec. S8894-95 (daily ed. June 29, 1984). Prior to the 1984 amendments, \$\bigcap \{ \bigsigma \} \\$ 503(b)(1) provided landlords with the right to obtain payment for use and occupancy during the post-petition, pre-rejection period. However, administrative expense claims are construed narrowly, and a party seeking prove, after notice and a hearing, that the use of its property is an actual and necessary cost of preserving the debtor's estate. Trustees of the Amalgamated Insurance Fund v. McFarlin's, Inc., 789 F.2d 98, 101 (2d Cir.1986). Moreover, administrative expenses ordinarily do not have to be paid until the end of a case. Debtors in Chapter 11 successfully argued that the Court should adjust lease payments according to the circumstances of the case and the current market, and that payment did not have to be made until the end of the case, and landlords were often forced to make their property available to the debtor during the pre-rejection period without receiving compensation for their services. Cukierman v. Uecker (In re Cukierman), 265 F.3d 846, 851 (9th Cir.2001).

Congress leveled the playing field with \$\\$ 365(d)(3). In re Cukierman, 265 F.3d at 850; In re Pudgie's Development of NY, Inc., 239 B.R. 688, 692 (S.D.N.Y.1999); In re Comdisco, Inc., 272 B.R. 671, 675 (Bankr.N.D.Ill.2002). In effect, \$\\$ 365(d)(3) required timely payment of rent, and it eliminated the discretion that courts had previously exercised to establish a market rent for use and occupancy, fixing the

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amount payable for use and occupancy at the rate provided in the lease. In re Ames Dept. Stores, Inc., 306 B.R. 43, 68 (Bankr.S.D.N.Y.2004). As this Court has observed, many courts "have found 503(b)(1) to be superseded by 365(d) (3); to hold otherwise would flout the intent of Congress in that the landlord would still be forced to provide current services while awaiting an evidentiary hearing to determine the actual amount the debtor owed it." In re P.J. Clarke's Restaurant Corp., 265 B.R. 392, 397 (Bankr.S.D.N.Y.2001), quoting In re Wingspread Corp., 116 B.R. 915, 926 (Bankr.S.D.N.Y.1990).

# II. Past Construction of \$365(d)(3)

Although courts interpreting \$\sime\$ \\$ 365(d)(3) uniformly agree as to the purpose of the statute, there is no agreement on its proper construction with respect to the issue in this case. 3 Collier on Bankruptcy ¶ 365.04[3][g] (15th ed. rev.2005). Four Circuit Court decisions are relevant, keeping in mind, however, that none of them dealt with the precise issue at bar, liability for stub rent during the first month of a debtor's bankruptcy.

The Seventh Circuit Court of Appeals was the first Circuit Court to address \ \bigsim \ \ 365(d)(3), in \ \bigsim In re Handv Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir.1998). Although the case actually involved the proration of taxes payable by the tenant-debtor under a commercial lease, Judge Posner's opinion broadly endorsed the construction of \( \bigsig \) \( \bigsig \) 365(d)(3) as requiring the proration of a lease obligation. The Court reached this result after finding that the term, "obligations of the debtor ... arising from and after the order for relief ..." means obligations arising "after the order for relief" ("We can't figure out what the 'from' adds to the 'after.' "). 144 F.3d at 1127. It continued by noting that "since death and taxes are inevitable and Handy Andy's obligation under the lease to pay the taxes was clear, that obligation could realistically be said to have arisen piecemeal every day of 1994 and to have become fixed irrevocably when, the last day of the year having come and gone, the lease was still in force." Id. at 1128. And it concluded: "There is no indication that Congress meant to go any further than to provide a landlord exception give landlords favored treatment for any class of prepetition

debts ... Statutory language like other language should be read in context ... \*363 When context is disregarded, silliness results." Id. at 1128.

The Sixth Circuit rejected this reasoning, without even

mentioning the Handy Andy decision, in Koenig

Sporting Goods, Inc. v. Morse Road Co. (In re Koenig

Sporting Goods, Inc.), 203 F.3d 986 (6th Cir.2000). There the Court dealt with a debtor that had rejected a commercial lease effective on the second day of a month. The debtor proposed to pay the landlord prorated rent for the final two days of the lease; the landlord countered with the argument that the lease obligated the tenant to pay for the whole month on the first day and that an entire month's rent was payable under 365(d)(3). The Court found with very little statutory analysis that the "obligation" arose before the lease was rejected and that appeals to "equity and common sense" were unavailing, in part because the "debtor alone was in the position to control [the landlord's] entitlement to payment of rent for" the month in question by choosing to reject the lease on the second day of a new month. It found support for the result in the proposition that the statute was designed to "prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-à-vis the estate." 203 F.2d at 989 (internal quotes and citation omitted). And, it noted, another purpose of the statute was "to relieve the burden placed on nonresidential real property lessors ..." Id. (internal quotes and citation omitted).

Nevertheless, the parties to commercial leases continued to be left "in doubt" as to their status, and the issue continued to be litigated. The next Circuit panel to address the question of proration was divided. In re Montgomery Ward Holding Corp., 268 F.3d 205 (3d Cir.2001), like Handy Andy, involved the proration of taxes payable under a lease. There the majority took note of the contrary Handy Andy decision, acknowledged that "there are aspects to a proration approach that Congress might have found desirable," and further acknowledged that "proration was the pre-Code practice and we had been admonished not to 'read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." Montgomery Ward, 268 F.3d at 211, citing Pennsylvania Dept. Pub. Welfare v. Davenport, 495 U.S. 552, 563, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990). The majority, nevertheless, rejected proration because "Congress

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practice that had created a problem for landlords of nonresidential property and our task is to determine the nature of the change based on the text chosen." Id. at 211-12. It found that the word "obligation" could only be read as requiring payment strictly in accordance with the terms of the lease. Circuit Judge Mansmann, dissenting, said that "While I agree that the terms of the lease determine the obligation, the statute says nothing about how to determine when the obligation arises." 268 F.3d at 213. He concluded that "Although, as the majority suggests, Congress clearly intended to change prior practice when it enacted \$\frac{1}{2} \& 365(d) (3), I can find no indication of a specific intent to displace proration with the billing date approach. Rather it seems clear that the statute was aimed at providing landlords with current pay for current services and relieving them from the 'actual and necessary' analysis required under \ \ 503(b) (1)." Fid. at 215.

Finally, in HA-LO Industries v. CenterPoint Properties Trust, 342 F.3d 794 (7th Cir.2003), a different panel of the Seventh Circuit considered the same set of facts as in Koenig—a debtor's obligation for rent where its rejection of the lease took place after the first day of the month. The \*364 Court rejected the Handy Andy approach, limiting that case to the accrual of taxes under a lease. The panel found that the purpose of the statute was to protect landlords by requiring the payment of lease obligations, that the lease in question did not provide for the proration of rent, and that a debtor (having had the power to determine the effective date of rejection) would be liable for an entire month's rent if it did not reject before the first of the month.

The conflict of the Circuit Courts on the question of proration mirrors the conflict on the issue in the lower courts. A significant number of district and bankruptcy courts have held proration to be appropriate. See, e.g., In re Furr's Supermarkets, Inc., 283 B.R. 60, 66 (10th Cir.BAP2002); In re Child World, 161 B.R. 571, 573–574 (S.D.N.Y.1993); In re Ames Dept. Stores, Inc., 306 B.R. 43, 65–68 (Bankr.S.D.N.Y.2004); In re NETtel Corp., Inc., 289 B.R. 486, 489–490 (Bankr.D.Dist.Col.2002). These courts find that landlords are entitled under the statute to post-petition lease payments for the period during which

the debtor enjoys the right to use and occupy the leased property. See, e.g., In re Furr's Supermarkets, Inc., 283 B.R. at 66. These courts stress that (i) proration is simple to apply; (ii) the method produces equitable results as it allows both landlords and tenants to get what they bargained for—current service for current payment—at the rate agreed to in the lease; (iii) proration is consistent with the long-standing, pre-amendment practice of prorating lease obligations pending rejection; (iv) neither the statute nor its legislative history indicates proration is precluded; and (v) proration is consistent with other provisions of the Bankruptcy Code, such as \$\infty\$\\$\\$ 365(g)\$ and \$\infty\$502(g). See

In contrast, other courts construe the statute as mandating strict adherence to the terms of a lease, requiring obligations to be performed in full as they become due. In re R.H. Macy & Co., 152 B.R. 869, 872-73 (Bankr.S.D.N.Y.1993), aff'd, 1994 WL 482948 \*13 (S.D.N.Y.Feb.23,1994); In re Comdisco, Inc., 272 B.R. 671, 675 (Bankr.N.D.III.2002); In re F & M Distributors, Inc., 197 B.R. 829, 831 (Bankr.E.D.Mich.1995). Such an approach entitles lessors to payments under 365(d)(3) for all lease obligations that become due after the order for relief is entered.<sup>2</sup> In re Krystal Co., 194 B.R. 161, 163–164 (Bankr.E.D.Tenn.1996). These courts conclude that proration is an unwarranted exercise of judicial discretion and that the performance date rule is in accord with the plain meaning of the statute. re R.H. Macy, 1994 WL 482948 at \*13; In re Comdisco, 272 B.R. at 675.

This Court approaches the issues with particular care because it has been reversed on a closely-related issue. In an oral decision issued on August 27, 2001, in *In re Loews Cineplex Entertainment, Corp.*, Ch. 11 Case No. 01–40346, this Court opted for proration in a case involving a lease that provided for a large capital expense that accrued over a period of time, mostly pre-petition, but that became payable during the period between the date of the order for relief and the date of lease rejection. The undersigned relied on the *Handy Andy* decision in the Seventh Circuit and rejected the approach of the Sixth Circuit in *Koenig.* By the time of the District Court appeal, the Third Circuit majority had issued its *Montgomery Ward* decision, and the weight

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of authority had \*365 tipped against proration. In any event, the District Court reversed this Court's determination, finding that the wording of the statute precluded proration and that the task would be exceedingly complex when it involved capital expenditures. Urban Retail Properties v. Loews Cineplex Entertainment Corp. (In re Loews), 2002 WL 535479 (S.D.N.Y.Apr.9, 2002). Even though the District Court observed that proration might be applicable in simpler cases, Id. at \*7, it construed the statute in accordance with the reasoning of the *Montgomery Ward* majority.

## III. The Debtors' Liability

[5] After a careful analysis of \$\frac{1}{2}\$\& 365(d)(3), the many conflicting judicial opinions that apply it, and with the greatest respect for the Loews District Court, the Court remains convinced that the proper construction of \ \ \ \ 365(d) (3) in this case is to hold the Debtors responsible for the stub rent measured on a daily basis as it accrued after the date of the orders for relief on July 9, 2008, and until the end of that month. Whether that is called proration or not, it fulfills the mandate of \$\ 365(d)(3).

The Court starts, as it must, with the words of the statute. The statute does not state that the trustee (or, in this case, the debtors in possession) must perform each and every provision of a commercial lease after the date of the order for relief. The statute provides in relevant part that the trustee "shall timely perform all the obligations of the debtor, except those specified in section  $\stackrel{\text{res}}{\triangleright} 365(b)(2)$ , arising from and after the order for relief under any unexpired lease of nonresidential real property ..." (emphasis added). Section 365(b)(2) provides that a trustee need not cure defaults under a lease or executory contract that relate, among other things, to "the commencement of a case" under the Bankruptcy Code. The obligation to make pre-petition payments of rent on a timely basis is one that the debtor need not fulfill as a direct consequence of the bankruptcy filing. No party in this case —or in any of the other authority cited herein—has asserted that \$\frac{1}{2}\$ \\$ 365(d)(3) obligates debtors to make full payment of rent for any part of the pre-petition period (unless, of course, they ultimately assume the lease and become obligated to cure defaults).

Nor can it be disputed that the bankruptcy filing ushers in a new relationship between the parties, with the nonbankrupt party liable to perform under an executory contract or unexpired lease while the debtor decides whether to assume or reject the contract. It is well accepted that during the post-petition, pre-rejection period, the debtor is entitled to performance from the counterparty and need not perform in the interim unless compelled to assume or reject by Court order. As the Supreme Court held in N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 532, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984), during this interim period, the agreement is no longer immediately enforceable, and may never be enforceable again. <sup>3</sup> Section 365(d)(3), as amended in 1984, afforded landlords an enhanced right to timely performance under a commercial lease during this interim period, but it did not disturb the principle that courts should construe \*366 the accrual of obligations during the post-petition, pre-rejection period in a manner that faithfully carries out the purpose of the bankruptcy laws as a whole, as well as provide appropriate protection to landlords.

Proration accomplishes this result. First, it does not eliminate any obligations of tenants to landlords—it merely measures when obligations arise and when they end (if the lease is rejected). In a Chapter 11 case, as the Seventh Circuit found in Handy Andy, since the tenant's "obligation under the lease to pay the taxes was clear, that obligation could realistically be said to have arisen piecemeal every day of 1994 and to have become fixed irrevocably when, the last day of the year having come and gone, the lease was still in force." 144 F.3d at 1127.

Moreover, as many courts have noted, the proration approach is relatively simple to apply, equitable, and consistent with pre-amendment practice. As observed by Judge Goettel in In re Child World, 161 B.R. at 575–576,

> "Nothing in the legislative history indicates that Congress intended § 365(d)(3) to overturn the long-(1) of prorating debtor-tenants' rent to cover only the postpetition, prerejection period, regardless of billing date. Moreover, the logic of requiring debtor-tenants to pay for the 'current services' their

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landlords must provide during the postpetition, prerejection period dictates that to the extent such payments consist of rent, they should be prorated to cover only the postpetition, prerejection period. Allowing landlords to recover for items of rent which are billed during the postpetition, prerejection period, but which represent payment for services rendered by the landlord outside this time period, would grant landlords a windfall payment, to the detriment of other creditors, without any support from the legislative history."

The facts of this case illustrate that failure to prorate leads to an absurd result. Bankruptcy courts in the Third, Sixth and Seventh Circuits, bound by Circuit Court authority, have invariably applied the Montgomery Ward, Koenig and HA-LO cases to preclude proration of the first month's rent when a debtor files its Chapter 11 petition after the first day of a month. They have concluded that proration of rent in the first month would be as inappropriate as prorating rent in the rejection month. However, very few of these courts have been willing to draw the obvious conclusion that rent for the first month is a pre-petition claim only, based on the billing date approach, and that the debtor has the right to use the leased property during the stub period without further liability. Instead, these courts fill "the stub period gap created by \[ \bigsim \{ \} \] 365(d)(3)" by allowing landlords an administrative claim under \$503(b) for rent during the stub period. In re ZB Company, Inc., 302 B.R. 316, 319 (Bankr.D.Del.2003); see also, In re Goody's Family Clothing, Inc., 392 B.R. 604, (Bankr.D.Del.2008); In re UAL Corp., 291 B.R. 121 (Bankr.N.D.Ill.2003). These courts find that "the only issues to be decided are the amount of the claims and when the 503(b)(1)(A) claims of all the landlords should be paid." In re ZB Company, 302 B.R. at 319. Indeed, the Debtors here have accepted the principle that the moving Landlords have an administrative expense claim for prorated rent, although they state that the Landlords will have to demonstrate "benefit

to the estate" and that it is premature to consider payment of \*367 any administrative claims. 4

If there is one point that the proration and billing date courts all accept, it is that Congress intended \$\frac{1}{2} \circ 365(d) prove benefit to the estate before it can obtain administrative expense status for a post-petition rent claim. That is exactly section 503(b)(1) of this title." Under the billing date construction of the statute, as endorsed by the Debtors, landlords would have to provide proof of "benefit to the estate" during the stub period in exchange for a future (instead of current) claim for payment, after the time-consuming and costly process of notice and a hearing. The billing date approach thus contradicts the plain purpose of the statute, a result to be avoided. As the Supreme Court said in United States v. Ron Pair Enterprises, 489 U.S. 235, 242, 109 S.Ct. 1026, 103 L.Ed.2d 290, (1989), quoting Griffin v. Oceanic Contractors, 458 U.S. 564, 571, 102 S.Ct. 3245, 73 L.Ed.2d 973, (1982), when "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters ... the intention of the drafters, rather than the strict language, controls."

It must be noted that it is much easier as a matter of statutory construction to prorate the first month's rent under a rejected lease than to prorate the last month's rent, in light of the assumption or rejection, and timely performance of the first month's rent is explicitly excused by virtue of the bankruptcy filing. In theory, a debtor could be held responsible for payment of the stub rent during the first month of the case on a proration theory but be responsible for payment of a full last month's rent if the lease is rejected on or after the first day of the month. However, such a construction of 365(d)(3) would create a patently unfair result for a debtor, requiring stub rent payments and full payment of the last month's rent. It would directly contradict "the policies of flexibility and equity built into Chapter 11 of the Bankruptcy Code", Bildisco, 465 U.S. at 525, 104 S.Ct. 1188, as well as the "Code's overriding policy favoring debtor reorganization and rehabilitation." In re Penn Traffic Co., 524 F.3d at 383, quoting In re Pub. Serv. Co. of New Hampshire, 884 F.2d

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11, 15 (1st Cir.1989). The proper interpretation of \$365(d) (3) is to construe the provision as a whole to accomplish the plain purpose of the law. Proration is the only principle that accomplishes this result.

Many of the judges who have rejected the proration approach for the last month's \*368 rent have stressed that the billing date principle is not unfair to a debtor because the debtor has control over the date of contract rejection and could plan to avoid an extra month's rent. It is of course bad policy to encourage uneconomic bankruptcy planning on either end of a filing: if proration is not adopted, debtors will be encouraged to file on the second day of a month. In any event, this case illustrates why a debtor does not necessarily have effective control over its liability even for the last month's rent. The Debtors filed on July 9 and immediately sought a court order scheduling a sale of all assets (including leases) on or before July 31, obviously to avoid the accrual of another full month's rent if the billing date approach were determined to be the law of this Circuit. This Court refused to schedule such a hearing on the shortened notice that would have been required, especially as a creditors' committee had not yet been appointed. However, the Debtors' request illustrates another of the discontinuities created by the billing date principle or uncertainty as to whether it must be applied. The intent of Congress can be carried out without harm to the Chapter 11 process only by the adoption of the proration principle.

## **CONCLUSION**

The Court accepts the Landlords' proposition that payment of the stub rent in the month of filing in the amount set forth it is recognized that three Circuit Court opinions have rejected proration, as have several intermediate appellate courts (including the Court that reversed the undersigned). Accordingly, on its own motion, the Court stays its decision so that the parties will have an opportunity to appeal. If the parties desire, the Court will include in an order a certificate supporting an immediate appeal to the Court of Appeals. <sup>6</sup>

The Landlords may settle one, joint order on the Debtors on 10 days' notice, or the Debtors may settle an order if the Landlords cannot agree on one.

**All Citations** 

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## **Footnotes**

- 1 Section 503(b) provides: "After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including(1)(A) the actual, necessary costs and expenses of preserving the estate...." 11 U.S.C. § 503(b)(1)(A).
- 2 In most voluntary bankruptcy filings, the date of the order for relief is the date of the filing.
- 3 The Bankruptcy Amendments and Federal Judgeship Act of 1984 modified the holding of this case as to labor contracts—11 U.S.C. § 1113 was introduced with the 1984 Act. The same statute gave commercial landlords the enhanced lease rights at issue here. However, the Supreme Court's analysis of executory contracts has never been reversed or modified, and courts today still rely on it. See COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.), 524 F.3d 373, 379 (2d Cir.2008); Hayes Lemmerz Int'l, Inc. v. Epilogics Gp., 531 F.Supp.2d 789, 802 (E.D.Mich.2007).
- For this proposition, the Debtors rely on In re DVI, Inc., 308 B.R. 703, 707 (Bankr.Del.2004); In re HQ Global Holdings, Inc., 282 B.R. 169 (Bankr.D.Del.2002); In re UAL, 291 B.R. at 126. (Debtor's Memo of Law, Docket # 1082, ¶ (I)(A)(2)). In their legal memorandum, the Debtors initially argued that under In re

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- Baby N' Kids, 2007 WL 1218768 (E.D.Mich.Apr.24,2007), and In re The 1/2 off Card Shop, 2001 WL for stub rent. (Debtor's Memo of Law, Docket # 1082, ¶ (I)(A)(1)). However, at the hearing on November 18, 2008, the Debtors seemingly abandoned this argument.
- 5 Some of the parties to this dispute argued that the proviso notwithstanding does not preclude reliance on S 503(b)(1), but rather rendered inapplicable the "principles" behind [ \$ 503(b)(1) (notice and a hearing and prove of benefit to the estate) in situations involving \$\frac{1}{2}\$ 365(d)(3). Suffice it to say that the statute does not speak of the "principles" underlying 503(b)(3). It uses the term "notwithstanding", a word that has been properly construed to mean "that irrespective of whether the payments required under the lease meet the usual requirements for administrative status, reasonableness and benefit to the estate, they are unconditionally due." In re Wingspread Corp., 116 B.R. at 926.
- 6 28 U.S.C. § 158(d)(2)(A), as amended in 2005, provides that the bankruptcy court can certify that a final order or judgment should be immediately appealed to the Court of Appeals if it involves a question of law "as to which there is no controlling decision of the court of appeals for the circuit or the Supreme Court of the United States" or there is "a question of law requiring resolution of conflicting decisions." This Court is willing to provide the certification required, as the bar, the clients it represents, and the courts within the Second Circuit would greatly benefit from a binding interpretation of \( \bigcirc\) \( \bigci as important to have this legal issue finally resolved, as it is to have it resolved in a particular way. However, under \textstyle \{ \frac{158(d)(2)(A)}{158(d)(2)(A)}, the Circuit Court retains complete control over the decision whether to accept a case. Moreover, since the Court of Appeals has jurisdiction only over "final" orders of this Court, the parties will presumably have to stipulate or determine the amount of prorated rent for the stub period for each lease before an appeal could be taken.

**End of Document** 

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KeyCite Yellow Flag - Negative Treatment Called into Doubt by In re Leather Factory Inc., Bankr.C.D.Cal., July

> 610 F.3d 812 United States Court of Appeals, Third Circuit.

In re GOODY'S FAMILY CLOTHING INC., et al., Appellants.

> No. 09-2168. Argued Nov. 17, 2009. Opinion filed June 29, 2010.

## **Synopsis**

Background: Commercial landlords that had entered into leases with Chapter 11 debtors that required prepayment of rent on first of every month moved for allowance as administrative expense and immediate payment of "stub rent" relating to that portion of month in which bankruptcy petition was filed which postdated the order for relief. Debtors opposed motion. The United States Bankruptcy Court for the District of Delaware, Christopher S. Sontchi, J.,

392 B.R. 604, allowed administrative expense claim, but denied landlords' request for immediate payment, and debtors appealed. The District Court, Renee M. Bumb, J., 401 B.R. 656, affirmed. Debtors appealed.

Holdings: The Court of Appeals, Ambro, Circuit Judge, held that:

- [1] the section of the Bankruptcy Code requiring trustee to timely perform all obligations of debtor arising under any unexpired lease of nonresidential real property, from and after order for relief, until lease is assumed or rejected does not supplant or preempt the Code's administrative expense provision, and
- [2] debtors' occupancy of the leased premises postpetition was an actual and necessary benefit to the estate and, thus, landlords were entitled to "stub rent" as an administrative expense.

Affirmed.

Procedural Posture(s): On Appeal.

West Headnotes (12)

#### **Bankruptcy** $\longrightarrow$ Use and occupancy claims; [1] administrative rent

"Stub rent" referred to the amount due debtors' landlord for the period of occupancy and use between the petition date and the first postpetition rent payment.

5 Cases that cite this headnote

#### [2] Bankruptcy 📻 Conclusions of law; de novo review

Where the district court sat as an appellate court, reviewing an order of the bankruptcy court, the Court of Appeals would exercise plenary review over the district court's conclusions of law, including matters of statutory interpretation.

34 Cases that cite this headnote

Bankruptcy Pankruptcy Conclusions of law; de novo [3] review

> Bankruptcy - Discretion Bankruptcy 👺 Clear error

Where the district court sat as an appellate court to review the bankruptcy court, the Court of Appeals reviews the bankruptcy court's legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof.

34 Cases that cite this headnote

[4] **Bankruptcy** ightharpoonup Use and occupancy claims; administrative rent

**Bankruptcy** Pebtor's Contracts and Leases

Section of the Bankruptcy Code requiring trustee to timely perform all obligations of debtor arising under any unexpired lease of nonresidential real property, from and after order for relief, until lease is assumed or rejected does not

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supplant or preempt the Code's administrative expense provision. 11 U.S.C.A. §§ 365(d)(3), 503(b)(1).

7 Cases that cite this headnote

#### [5] **Bankruptcy** Fime of accrual; prepetition claims

## **Bankruptcy** > Notice and hearing

Postpetition obligations are ordinarily given payment priority as administrative expenses, though such claims must still go through standard procedures of notice and a hearing to demonstrate that the costs were actual, necessary expenses of preserving the estate.

11 U.S.C.A. § 503(b).

6 Cases that cite this headnote

#### [6] **Bankruptcy** • Use and occupancy claims; administrative rent

**Bankruptcy** Motice and hearing

## **Bankruptcy** Debtor's Contracts and Leases

Section of the Bankruptcy Code requiring trustee to timely perform all obligations of debtor arising under any unexpired lease of nonresidential real property, from and after order for relief, until lease is assumed or rejected operates to dispense with the notice and hearing requirements that otherwise must be satisfied for postpetition obligations under an unexpired lease of nonresidential real property to be given payment priority as administrative expenses.

11 U.S.C.A. §§ 365(d)(3), 503(b).

6 Cases that cite this headnote

#### [7] **Bankruptcy** Debtor's Contracts and Leases

Purpose of the section of the Bankruptcy Code requiring trustee to timely perform all obligations of debtor arising under any unexpired lease of nonresidential real property, from and after order for relief, until lease is assumed or rejected is to protect landlords from the burdensome requirements of the Code's administrative expense provision in securing

payment from non-occupying debtors. U.S.C.A. §§ 365(d)(3), 503(b)(1).

4 Cases that cite this headnote

#### **Bankruptcy** • Use and occupancy claims; [8] administrative rent

Chapter 11 debtors' occupancy of the leased premises postpetition was an actual and necessary benefit to the estate and, thus, commercial landlords were entitled to "stub rent," that is, the amount due landlords for the period of occupancy and use between the petition date and the first postpetition rent payment, as an administrative expense; debtors used the leased premises for their store-closing sales, debtors obtained a better than 105% recovery from the sales, the sales were an integral part of debtors' bankruptcy proceedings, the sales required a physical venue, and debtors charged, and collected from, their liquidation agent "actual occupancy expenses" equal to per diem rent, which was the equivalent of "stub rent," pursuant to their court-approved store closing agreement. 11 U.S.C.A. § 503(b)(1).

4 Cases that cite this headnote

#### [9] **Bankruptcy** • Use and occupancy claims; administrative rent

For a commercial lessor's claim to get administrative expense treatment, the debtor's occupancy of the leased premises must confer an actual and necessary benefit to the debtor in the operation of its business. 11 U.S.C.A. § 503(b)(1).

4 Cases that cite this headnote

# [10]**Bankruptcy** Presumptions and burden of

Proving that a debtor's occupancy of the leased premises conferred an actual and necessary benefit to the debtor in the operation of its business, as required for a commercial lessor's

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claim to get administrative expense treatment, is the lessor's burden. 11 U.S.C.A. § 503(b)(1).

3 Cases that cite this headnote

#### **Bankruptcy** Peorganization cases [11]

When third parties are induced to supply goods or services to the debtor-in-possession pursuant to a contract that has not been rejected, the purposes of administrative claims plainly require that their claims be afforded priority. -11 U.S.C.A. § 503(b)(1).

# **Bankruptcy** Administrative expenses in general

**Bankruptcy** ightharpoonup Executory nature in general

When a debtor's contract has been fully performed prior to the petition date, it is no longer "executory" and thus not entitled to payment priority as an administrative expense.



3 Cases that cite this headnote

## Attorneys and Law Firms

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Before: AMBRO, ALDISERT, and ROTH, Circuit Judges.

## OPINION OF THE COURT

AMBRO, Circuit Judge.

Goody's Family Clothing, Inc. and certain of its direct and indirect subsidiaries (collectively "Goody's" or "Debtors") appeal the judgment of the District Court affirming the Bankruptcy Court's decision to award "stub rent" as an administrative expense under 11 U.S.C. § 503(b) to three of the Debtors' landlords-Mountaineer \*815 Property Co. II, LLC, Stafford Bluffon, LLC, and Eastgate Mall, LLC (collectively the "Landlords"). "Stub rent" here is the amount due a landlord for the period of occupancy and use between the petition date and the first post-petition rent payment. 1 In deciding this issue, we construe further the meaning of 11 U.S.C. § 365(d)(3), first addressed in CenterPoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.), 268 F.3d 205 (3d Cir.2001). We hold that \$\frac{1}{2}\$ 365(d)(3) does not supplant \ \bigsim \ \ 503(b) and the Landlords are entitled to "stub rent" as an administrative expense. We thus affirm the judgment of the District Court, and do so for essentially the reasons given by Judge Bumb in her excellent opinion.

## I. Facts and Procedural Background

The relevant facts are undisputed. Goody's and the Landlords entered into leases for nonresidential real property in various shopping venues around the country. Each provided that rent would be paid in advance on the first day of every month during the term of the lease. Goody's was current on its rent obligations until June 1, 2008, when it did not pay rent due under the leases.

On June 9, 2008, the Debtors filed voluntary petitions for bankruptcy relief under the Bankruptcy Code. They simultaneously filed a motion with the Bankruptcy Court asking for permission to engage in various activities related to the closing of certain stores, including those leased from the Landlords, and the liquidation of the products in those stores. The store-closing sales were to be handled by an agent specifically hired to perform that task.

The Bankruptcy Court granted the motion, and a store-closing agent was hired soon thereafter. Goody's continued to occupy the properties owned by the Landlords, and the sales occurred

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on premises. The agent sold the merchandise in the designated stores, taking a portion for itself and turning over the balance of the proceeds to the estate. By Goody's own admission, the sale was "pretty successful" and brought in 105.4% of costs. Additionally, Goody's received from the agent an amount equal to per diem rent associated with use of the Landlords' property to conduct the closing sales, including the entire "stub rent" period.

Goody's, however, has not paid the Landlords for the postpetition occupancy of the stores from June 9 through June 30, 2008. In line with 11 U.S.C. § 365(d)(3), Goody's did pay, and the Landlords accepted, the rent due for the month of July on July 1, 2008. The "stub rent" for June remains in dispute.

The Landlords filed administrative expense claims under 503(b)(1) for the "stub rent," characterizing it as unpaid, postpetition rent that was an actual, necessary cost and expense of preserving the estate. Goody's objected, arguing the "stub rent" was due under the Leases prior to the petition date, making it a general, unsecured pre-petition claim entitled to no special priority. Goody's further argued that \$\bigcap\_{\quad \text{\gentle}} \quad 365\$ was the exclusive source of obligations and remedies under unexpired leases, making any reference to \$503(b)(1) contrary to statutory text and controlling precedent.

The Bankruptcy Court heard argument on the Landlords' motions and granted them all as administrative expenses, but refused to require immediate payment. 392 B.R. 604 (Bankr, D.Del. 2008). An appeal was taken to the District Court, which \*816 affirmed. 2 401 B.R. 656 (D.Del.2009). Debtors then appealed to our Court. The District Court had jurisdiction under 28 U.S.C. § 158(a)(1) over the appeal from the Bankruptcy Court, which had jurisdiction under 28 U.S.C. § 157(b). We have jurisdiction under 28 U.S.C. §§ 1291 and 158(d).

[3] We exercise plenary review over the District Court's conclusions of law, including matters of statutory interpretation. In re Tower Air, Inc., 397 F.3d 191, 195 (3d Cir.2005). Because the District Court sat as an appellate court to review the Bankruptcy Court, we review the Bankruptcy Court's legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof. Id.

## II. Analysis

The threshold question is simple: does the existence of [8] 365(d)(3) preclude the attempted use of 8503(b)(1) for the "stub rent"? If so, the inquiry ends there. If not, we must then determine whether the "stub rent" may be considered an administrative expense under \$503(b)(1). We answer "no" to the first question and "yes" to the second.

A. Section 365(d)(3) does not preempt \$503(b) **(1)** 

[4] Section 365(d)(3) of the Bankruptcy Code imposes a special duty with respect to unexpired leases of nonresidential real property:

> 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. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

11 U.S.C. § 365(d)(3). In Montgomery Ward, we interpreted what Congress meant when it referred to "obligations of the debtor ... arising ... after the order for relief

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under any unexpired lease of nonresidential real property." 268 F.3d at 208. We determined that the "clear and express the lease in accordance with its terms." Id. at 209. We thus held that "an obligation arises under a lease for the purposes of § 365(d)(3) when the legally enforceable duty to perform arises under that lease." Id. at 211.

Goody's argues that this completes the inquiry—the rent was due on June 1, 2008, prior to the petition date, so it did not need to pay for the occupancy from June 9 to June Montgomery Ward \*817 considered only the debtor's petition obligation, but Montgomery Ward did not address arising from actual occupancy independent of the lease. We turn to this question.

Section 503(b)(1) is specifically mentioned in \[ \bigsim\] 365(d)(3). The provision imposes the duties discussed in Montgomery Ward "notwithstanding section 503(b)(1) of [the Bankruptcy Code]." 11 U.S.C. § 365(d)(3). The key word here is "notwithstanding." It means "in spite of" or "without prevention or obstruction from or by." Webster's Third New Int'l Dictionary 1545 (1971). In this context, [7] § 365(d)(3) is best understood as an exception to the general procedures of \$503(b)(1) that ordinarily apply.

Post-petition obligations are ordinarily given payment priority as administrative expenses, though such claims must still go through standard procedures of notice and a hearing to demonstrate that the costs were actual, necessary expenses of preserving the estate. See 11 U.S.C. § 503(b) ("After notice and a hearing, there shall be allowed administrative expenses, ... including ... the actual, necessary costs and expenses of preserving the estate."). Section 365(d)(3) operates to dispense with these requirements for post-petition obligations under an unexpired lease of

nonresidential real property, meaning it functions "without prevention or obstruction from or by"  $\stackrel{\triangleright}{\triangleright}$  \$ 503(b)(1). This is essentially our holding in Montgomery Ward.

Relieving a landlord under \( \bigcip\_{\bigsi} \) 365(d)(3) of burdensome administrative procedures, however, does not foreclose that landlord's ability to use the more burdensome procedures to recover in situations outside the scope of \$\ 365(d)\$ (3). Put simply, \$\frac{1}{2} \setminus 365(d)(3) does not supplant or preempt  $\S$  503(b)(1). The last sentence of  $\S$  365(d)(3) makes 365(d)(3)] does not constitute waiver or relinquishment of the lessor's rights under such lease or under [the Bankruptcy Codel." 11 U.S.C. § 365(d)(3). By accepting the July 1. 2008, payment from Goody's, the Landlords did not give up any other rights under the Bankruptcy Code, including those awkward place if, while debtors were required to pay them served also to deprive lessors of the balance of their rights under the Code.

[7] The text of  $\stackrel{\triangleright}{\sim}$  § 365(d)(3) is consistent with the Conference Report explaining the provision, which we referenced in Montgomery Ward. See 268 F.3d at 210–11. We specifically referred to the statements of Senator Orrin Hatch, a conferee on the originating act:

> This subtitle contains three major substantive provisions which are intended to remedy serious problems caused shopping centers and their solvent tenants by the administration of the bankruptcy code.... A second and related problem is that during the time the debtor has \*818 vacated space but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments due under the lease.... In this situation, the landlord is forced to provide current services—the use of its property, utilities, security, and other

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services—without current payment. No other creditor is put in this position. In addition, the other tenants often must increase their common area charge payments to compensate for the trustee's failure to make the required payments for the debtor. The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance requirement will [e]nsure that debtor-tenants pay their rent, common area, and other charges on time pending the trustee's assumption or rejection of the lease.

H.R. Conf. Rep. No. 98-882 (1984), 98th Cong., 2d Sess., reprinted in 1984 U.S.C.C.A.N. 576, 598-99 (emphasis added). The statement supports our conclusion that 365(d)(3) does not cover the situation in our case. Goody's never vacated the space. On the contrary, it continued to occupy the Landlords' properties to conduct store-closing sales. The purpose of \( \frac{1}{2} \) \( \frac{365(d)(3)}{3} \) is to protect landlords from the burdensome requirements of \$\frac{1}{2}\$ 503(b)(1) in securing payment from non-occupying debtors; it would be perverse indeed to conclude that it then precluded the use of § 503(b)(1) to secure "stub rent" from a debtor actually occupying the premises.

When a debtor occupies post-petition non-residential space it leases, that \(\frac{1}{2}\) \( \) \( \) \( \) 365(d)(3) provides when the rent obligation arises does not erase when lessors may make \$\frac{1}{2}\$ 503(b) (1) claims for the value conferred post-petition by that occupancy. We thus conclude that the Landlords may assert a \$ 503(b)(1) claim for "stub rent."

# B. Debtors' occupancy of the leased premises was an actual and necessary benefit to the estate

turn to whether the "stub rent" is an administrative expense 4 

[9] For a commercial lessor's claim to get debtor's occupancy of the leased premises must confer an actual and necessary benefit to the debtor in the operation of its business. See Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.), 181 F.3d 527, 532-33 (3d Cir.1999) (citing Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart, Inc.), 536 F.2d 950, 954 (1st Cir.1976)). Proving this is the lessor's burden. Id. at 533. Thus, the Landlords "must ... carry the heavy burden of demonstrating that the ['stub rent'] for which [they] seek[ ] payment provided an actual benefit to the estate and that [incurring 'stub rent' was] necessary to preserve the value of the estate assets." Id. (citation omitted).

[12] We look to the Mammoth Mart test we [11] adopted in O'Brien, and note that "[w]hen third parties are induced to supply goods or services to the debtor-inpossession pursuant to a contract that has not been rejected, the purposes of [administrative claims] plainly require that their claims be afforded priority." In re Mammoth Mart, 536 F.2d at 954. In contrast, \*819 when the contract has been fully performed prior to the petition date, it is no longer executory and thus not entitled to payment priority as an administrative expense. In our case, Goody's has continued to occupy the premises post-petition, and it is attempting to do so without providing any post-petition consideration to the Landlords who were still providing services for the premises in the time prior to rejection.

This is similar, though not directly analogous, to the situation in Zagata, where we held that "[a]t a minimum, [a creditor] is ... entitled to a reasonable value for the use and occupancy of its land as an administrative cost under section 503 of the Bankruptcy Code." Zagata Fabricators v. Superior Air Prods., 893 F.2d 624, 627-28 (3d Cir.1990). Although it addressed an expired lease, Zagata supports that the Debtors' retaining possession of the premises, thereby inducing post-petition services from the Landlords, is sufficient under the O'Brien and Mammoth Mart inquiries to be a transaction justifying administrative priority. This accords with the application of

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Zagata in the Bankruptcy Courts of our Circuit. See In re DVI, Inc., 308 B.R. 703, 707-08 (Bankr.D.Del.2004) ("A landlord is entitled to an administrative claim in the amount of the fair market value of the premises when a debtor occupies and uses them post-petition." (emphasis added)); In re ZB Co., 302 B.R. 316, 319 (Bankr.D.Del.2003) ("It is beyond dispute that all of the Debtors' landlords whose properties are occupied and used post-petition have valid administrative claims." (emphasis added)); In re HQ Global Holdings, Inc., 282 B.R. 169, 173 (Bankr.D.Del.2002) ("A lessor is generally entitled to an administrative claim under section 503(b) for the fair rental value of the lessor's property actually used by the debtor." (emphasis added)); cf. In re Unidigital, Inc., 262 B.R. 283, 288 (Bankr.D.Del.2001) (unexpired lease of equipment sought to be abandoned with no continuing use thereof denied administrative priority); In re Pinnacle Brands, Inc., 259 B.R. 46, 51–52 (Bankr.D.Del.2001) (denying administrative priority because indemnification, though under a pre-petition contract, is not an ongoing actual use of services); In re Mid-Am. Waste Sys., Inc., 228 B.R. 816, 821 (Bankr.D.Del.1999) (same).

Although mere occupancy is not always an actual and necessary expense that benefits an estate, there can be no reasonable dispute that the occupation of the leased premises here conferred a benefit. Goody's obtained a better than 105% recovery from the store-closing sales, and these sales were an integral part of the bankruptcy proceedings. The sales

required a physical venue, and remaining in existing premises was just as necessary and beneficial to the estate as leasing new premises specifically for store-closing sales. Indeed, Goody's own conduct indicates that it saw the occupation of the Landlords' premises as a necessary expense when it charged (and collected from) its liquidation agent "actual [o]ccupancy [e]xpenses" equal to *per diem* rent pursuant to the store closing agreement approved by the Bankruptcy Court. *See* App. 937, 977–78. It would be illogical to allow Goody's to collect the equivalent of "stub rent" from its liquidation agent, but not to require payment to the Landlords of "stub rent" as "necessary expenses." Thus, the Landlords are entitled to a reasonable "stub rent" as an actual and necessary expense for the benefit of the estate.

\* \* \* \* \*

The Landlords are entitled to receive payment under Bankruptcy Code § 503(b)(1) for use of their nonresidential real property during the stub period of \*820 June 9—June 30, 2008. Section 365(d) does not preempt § 503 in this regard. The judgment of the District Court is affirmed.

## **All Citations**

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# **Footnotes**

- Though called "rent," it is not necessarily tied to the rent amounts in the underlying lease agreements. Here, the parties have stipulated to the "stub rent" amounts.
- 2 The issue of immediate payment was not appealed and it is not before us.
- Goody's also argues that \$\sim\_{\}\$ 365 provides the exclusive avenue through which a debtor can be made to pay lease rent. We reject this argument for numerous reasons. First, we are not confronted with lease rent; we are confronted with "stub rent" under \$\sim\_{\}\$ 503(b)(1), which may or may not be tied to the actual lease rate. Second, other provisions in the Code address leases, dispelling any notion that \$\sim\_{\}\$ 365 is exclusive here. See, e.g., \$\sim\_{\}\$11 U.S.C. \$\sim\_{\}\$ 503(b)(7) (addressing leases that are assumed and then rejected). Third, because \$\sim\_{\}\$ 365(d)(3) does not address residential leases, Goody's interpretation would imply that a debtor

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- could occupy residential real property prior to assumption or rejection, leaving no \$\frac{1}{100}\$\, 503(b)(1) remedy for a landlord. Finally, Goody's attempt to invoke expressio unius est exclusio alterius (to express one thing is to exclude the others) fails to support the exclusivity of \$\frac{1}{2}\$ 365(d)(3)—here, Congress expressly preserved other rights under the Code in the text of \$\frac{1}{2}\$ 365(d)(3).
- Administrative expenses, including the "actual, necessary costs and expenses of preserving the estate," may be allowed after notice and a hearing. 11 U.S.C. § 503(b)(1). There is no dispute that notice and a hearing occurred here.

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# **Faculty**

Marc E. Albert is a partner with Stinson LLP in Washington, D.C., and chairs its Bankruptcy and Creditors' Rights Group. He has concentrated over the past 35 years in the areas of financial restructuring, insolvency and creditors' rights. Mr. Albert has represented debtors, creditor committees, lenders and other creditors. He has been appointed by the Office of the U.S. Trustee as operating trustee in chapter 11 and 7 cases, and he has been on the Chapter 7 Trustee Panel in the District of Columbia for over 30 years. Mr. Albert has served as receiver in numerous federal and state court cases. He also serves as counsel in a variety of bankruptcy and nonbankruptcy matters, including representing numerous clients who have tax problems with the Internal Revenue Service or state tax authorities. Prior to joining the firm, Mr. Albert was litigation counsel with the Tax Division of the Department of Justice. With three other attorneys, he started a boutique bankruptcy law firm that grew to become one of the leading bankruptcy firms in Northern Virginia. Mr. Albert maintains an AV rating from Martindale-Hubbell and is admitted to practice in Pennsylvania, the District of Columbia, Maryland and Virginia, and before the U.S. Supreme Court. He is a member of the District of Columbia, American and Virginia Bar Associations, and the Walter Chandler Inn of Court, National Association of Bankruptcy Trustees, ABI, World Affairs Council – Washington, D.C., and the George Washington University Law School Mentoring and Recruitment Program. He was recognized in 2015 with the Founders Award from World Affairs Council and is listed in The Best Lawyers in America from 2011-17 for Bankruptcy and Creditor/Debtor Rights/ Insolvency and Reorganization Law and Litigation-Bankruptcy, Washington D.C. Super Lawyers from 2012-17 for Bankruptcy & Creditor/ Debtor Rights, and the 2015 edition of Chambers USA: America's Leading Lawyers for Business in Bankruptcy/Restructuring. Mr. Albert received his B.A. in 1970 and his J.D. in 1973 from George Washington University, and his M.L.T. in 1984 from Georgetown University.

Hon. Melanie L. Cyganowski is a partner with Otterbourg P.C. in New York and chairs its Bankruptcy practice. She joined the firm in 2008 after serving a full 14-year term as a U.S. Bankruptcy Judge for the Eastern District of New York and as its Chief Judge from 2005-08, and she now is a commercial and bankruptcy law litigator, mediator, arbitrator and expert witness. She also serves as a fiduciary (examiner, trustee, receiver, referee, monitor or special master) in bankruptcy and civil litigation. Judge Cyganowski is currently co-counsel to the Ad Hoc Committee in *Purdue Pharma*, and was appointed as a member of a blue-ribbon committee by the Rockville Center Diocese with former Chief Bankruptcy Judge Arthur Gonzalez and former Comptroller of the City of New York Harrison J. Goldin. Judge Cyganowski's fiduciary appointments include receiver in SEC v. Platinum Partners; CRO and temporary operator of Brooklyn's Interfaith Medical Center; patient care ombudsman in Randolph Hospital Inc., Promise Healthcare, Orianna Health Systems, 21st Century Oncology and California Proton; auditor of Capital One; and various trusteeships. She also served as special master in Vivendi and Neogenix Oncology, a court-appointed expert in Orion HealthCorp, and an arbitrator/mediator in cases including Madoff and Lehman. Judge Cyganowski has testified as an expert in international cases involving U.S. bankruptcy laws. She is a Fellow in the American College of Bankruptcy, sits on the editorial advisory board of the Norton Journal of Bankruptcy Practice & Law, and is an adjunct professor at St. John's University School of Law in the Bankruptcy LL.M. Program. She also is active in philanthropic organizations, including Tina's Wish. Judge Cyganowski received her J.D. magna cum laude from the State University of New York at Buffalo School of Law in 1981.

Hon. Heather Z. Cooper is the Chief U.S. Bankruptcy Judge for the District of Vermont in Burlington. Prior to her appointment on March 14, 2022, she began her legal career as a briefing attorney to Justice David L. Richards of the Texas Court of Appeals, Second District. She then entered private practice with the firm of Dunn, Kacal, Adams, Pappas & Law, P.C. in Houston, followed by the firm of Murphy & King, P.C. in Boston. In 2004, Judge Cooper moved to Vermont and clerked for former Bankruptcy Judge Collen A. Brown (her predecessor). In 2006, Judge Cooper joined the firm of Facey Goss & McPhee P.C., a Vermont-based law firm, as an associate and then as a partner. Judge Cooper's practice focused on litigation with extensive and diverse bankruptcy law experience, with more than 20 years of experience in the financial and restructuring industry, representing individual and corporate debtors and creditors in loan workouts and restructurings, liquidations, foreclosures, litigation seizures and receiverships. During her partnership at Facey Goss & McPhee P.C., Judge Cooper served as managing partner and became certified in Consumer Bankruptcy Law by the American Board of Certification. She also served as the Bankruptcy Law Section Chair of the Vermont Bar Association from 2014-18 and on various task forces for the U.S. Bankruptcy Court for the District of Vermont since 2011. Judge Cooper is a member of the Texas, Massachusetts and Vermont Bar Associations, the Federal Bar Council, the National Conference of Bankruptcy Judges, ABI and the National Association of Bankruptcy Trustees. She serves as a member of the Human Resources Advisory Council of the Administrative Office of the U.S. Courts and various Second Circuit committees. Judge Cooper is a frequent lecturer at national conferences on bankruptcy-related issues. She received her B.A. from the University of Houston in 1993 and her J.D. magna cum laude from South Texas College of Law in 1998.

Hon. Elizabeth L. Gunn is a U.S. Bankruptcy Judge for the District of Columbia in Washington, D.C., appointed on Sept. 4, 2020. A COVID-era selection and appointment, she was sworn in by Zoom from her living room. Prior to her appointment, Judge Gunn served as an Assistant Attorney General for the Commonwealth of Virginia as the bankruptcy specialist for the Division of Child Support Enforcement. She also practiced law in Richmond, Va., at Sands Anderson PC and McGuire-Woods LLP. In 2017, Judge Gunn was honored as a member of ABI's inaugural class of "40 Under 40." In 2022, she was recognized by the Bar Association of the District of Columbia as its Judicial Honoree and recipient of the BADC's Suzanne V. Richards Foundation Grant. Judge Gunn serves on the advisory board of the American Bankruptcy Law Journal and is a coordinating and associate editor of the ABI Journal. In addition, she sits on the boards of the Federal Bar Association Bankruptcy Section, International Women's Insolvency & Restructuring Confederation, American Bar Association, National Conference of Federal Trial Judges and the Chesapeake Chapter of the Turnaround Management Association, and she hosts the popular American Bar Association Business Law Section Podcast "Bad Boys of Bankruptcy." She also is a member of the Walter Chandler Bankruptcy Inn of Court and is Board Certified in Consumer Bankruptcy Law by the American Board of Certification. Judge Gunn received her B.A. cum laude from Willamette University and her J.D. cum laude from Boston College Law School.

**Hon. Brendan Linehan Shannon** is a U.S. Bankruptcy Judge for the U.S. Bankruptcy Court for the District of Delaware in Wilmington, appointed in 2006. He manages a full chapter 11 docket and also handles all chapter 13 consumer bankruptcy cases filed in Delaware. He served as Chief Judge from 2014-18. Prior to his appointment to the bench, Judge Shannon was a partner with Young Conaway Stargatt & Taylor, LLP in Wilmington, Del., where he primarily represented corporate debtors and official committees in chapter 11 cases. He is an adjunct professor in the Bankruptcy LL.M. Program

at St. John's University School of Law in New York, and at Widener School of Law in Delaware. He also serves on the board of editors of *Collier on Bankruptcy* (16th ed.) and is a contributing author for *Collier Forms* and for several chapters covering the Federal Rules of Bankruptcy Procedure. In addition, he serves on the editorial board of the *American Bankruptcy Institute Law Review*. In 2011, Judge Shannon was appointed to serve as a member of the National Bankruptcy Conference. In 2020, he was inducted as a member of the American College of Bankruptcy. Judge Shannon is a member of the Delaware State Bar Association, the American Bar Association, ABI and the Rodney Inns of Court in Wilmington, Del. He is also a member of the board of directors of the Delaware Council on Economic Education. Judge Shannon received his undergraduate degree from Princeton University and his J.D. from the Marshall-Wythe School of Law at the College of William and Mary.