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1 Collier Real Estate Trans & Bankruptcy Code Author(s)

Author(s)

Collier Real Estate
Transactions and the
Bankruptcy Code

LAURENCE D. CHERKIS
Member, New York Bar

STEVEN M. ABRAMOWITZ
Member, New York and New Jersey Bars

Alan N. Resnick & Henry J. Sommer
Collier Editors-In-Chief

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Editorial Questions?

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Kent K. B. Hanson, J.D. kent.hanson@lexisnexis.com at 1-800-252-9257 (ext. 2247)
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MATTHEW BENDER & Co., INC.

Editorial Offices

121 Chanlon Rd., New Providence, NJ 07974 (908) 464-6800

201 Mission Street, San Francisco, CA 94105-1831 (415)908-3200



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Finally, to my wife and to the other members of my family, whose patience, understanding and support made this book possible, my gratitude and my love.



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1 Collier Real Estate Trans & Bankruptcy Code Foreword

Foreword

Foreword

The Bankruptcy Reform Act of 1978, which includes the Bankruptcy Code, contains numerous provisions affecting real estate transactions, including provisions invalidating certain "standard" clauses in real estate documents, altering the rights of co-owners of real property, and substantially affecting the remedies of landlords and mortgagees. Accordingly, as members of the real estate bar we have found that certain traditional transaction structures and documentation may no longer have the effects which obtained under the former Bankruptcy Act. It has therefore become increasingly necessary to focus upon bankruptcy issues in the structuring and documentation of real estate transactions, and to generally become more conversant with the Bankruptcy Code in order to better advise our clients of the potential consequences of a "downside" situation. This book is intended to assist the real estate practitioner in fulfilling these needs, and has been prepared as an adjunct to the comprehensive 15th Edition Revised of *Collier on Bankruptcy*, the Third Edition Revised of the *Collier Bankruptcy Manual* and the *Collier Bankruptcy Practice Guide*.

This book contains suggested provisions for real estate documents which address certain concerns created by provisions of the Bankruptcy Code. The suggested provisions are submitted in the belief that there is a reasonable prospect for their acceptance by the courts. However, many of the suggested provisions remain untested, and should be viewed as starting points for evaluation of the issues to which they relate.



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1 Collier Real Estate Trans & Bankruptcy Code About the Authors

About the Authors

LAURENCE D. CHERKIS

Laurence D. Cherkis has practiced in the areas of real estate and creditors' rights law since 1969. He has lectured before bar associations and other groups on various subjects relating to the Bankruptcy Code, and is a contributing author to the *Collier Bankruptcy Practice Guide*.

A graduate of Brown University, Mr. Cherkis received his law degree in 1966 from New York University, where he was research editor of the law review and was awarded a John Norton Pomeroy Scholarship. Mr. Cherkis was a member of the firm of Wachtell, Lipton, Rosen & Katz in New York City, until 1996. He is now Of Counsel in the New York City office of Vinson & Elkins LLP. Mr. Cherkis was a Distinguished Visiting Practitioner at the St. John's University School of Law from 1996 to 2002.

STEVEN M. ABRAMOWITZ

Steven M. Abramowitz is a member of Vinson & Elkins LLP in New York City, specializing in Bankruptcy Reorganization, Commercial Law, Finance, Debtor and Creditor, and Mergers, Acquisitions & Divestiture law. He is a member of the New York and New Jersey bars, as well as the U.S. District Court, Southern and Eastern Districts of New York, and the U.S. District Court, District of New Jersey.

Mr. Abramowitz was graduated from the University of Pennsylvania, Wharton School, and he earned his J.D. at Columbia University, where he was a James Kent Scholar and Senior Editor of the *Columbia Law Review*. He was Law Clerk to Hon. Michael B. Mukasey, U.S. District Judge, Southern District of New York, 1990-1991.



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1 Collier Real Estate Trans & Bankruptcy Code About the Collier Editors-in-Chief

About the Collier Editors-in-Chief

ALAN N. RESNICK

Alan N. Resnick is the Benjamin Weintraub Distinguished Professor of Bankruptcy Law at Hofstra University School of Law in Hempstead, New York. Professor Resnick, who has taught for more than 25 years, is a nationally recognized authority on bankruptcy law.

Professor Resnick is also Of Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson llp in New York City, where he regularly consults on bankruptcy, insolvency and restructuring matters.

Professor Resnick was appointed by Chief Justice William H. Rehnquist to serve as Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States, a position he held from 1987 to 1999, and was a member of the Advisory Committee from 1999 to 2005. Professor Resnick also testified before congressional and National Bankruptcy Review Commission committees on various issues relating to bankruptcy legislation.

Professor Resnick's writings have been cited in more than 150 judicial opinions, including opinions of the U.S. Supreme Court. He was the author of *Bankruptcy Law Manual* (5th ed. West) and was the co-editor of *Bankruptcy Reform Act of 1978: A Legislative History* (Wm. Hein). He has written numerous articles on bankruptcy and commercial law, including articles that have appeared in the *American Bankruptcy Law Journal*, *Banking Law Journal*, *Uniform Commercial Code Law Journal*, *University of Pennsylvania Law Review*, *Boston College Law Review*, *Rutgers Law Review* and *William & Mary Law Review*. He also is a frequent speaker at professional seminars and educational programs. He has lectured at Federal Judicial Center seminars for bankruptcy judges, at the National Conference of Bankruptcy Judges and at various bar association programs. Professor Resnick has been on the faculty of the annual New York University Workshop on Bankruptcy and the faculty of the Uniform Commercial Code Institute in Washington, D.C.

Professor Resnick is an elected member of the National Bankruptcy Conference and the American Law Institute, and is a Fellow of the American Bar Foundation. He is also an elected Fellow of the American College of Bankruptcy and has

served as that organization's Scholar-in-Residence. He received his legal education at Georgetown University Law Center (J.D.) and Harvard Law School (LL.M.).

HENRY J. SOMMER

Henry J. Sommer is a leading authority on consumer bankruptcy law and has litigated many major cases involving bankruptcy, consumer law, civil rights and other issues. He is the Supervising Attorney at the *pro bono* Consumer Bankruptcy Assistance Project in Philadelphia and formerly served as the head of the Consumer Law Project at Community Legal Services in Philadelphia. Mr. Sommer has also served as a Lecturer-in-Law at the University of Pennsylvania Law School.

Mr. Sommer is the author of *Collier Consumer Bankruptcy Practice Guide* (Matthew Bender), *Consumer Bankruptcy Law and Practice* (Nat'l Consumer Law Center), *Consumer Bankruptcy* (Wiley) and numerous articles on bankruptcy law. He is co-author of *Collier Family Law and the Bankruptcy Code* (Matthew Bender), Editor of *Collier Bankruptcy Manual* (Matthew Bender 3d ed. rev.) and a contributing author to *Debtor-Creditor Law* (Matthew Bender).

From 1991 to 1998, Mr. Sommer was a member of the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States. He has testified on many occasions before the House and Senate Judiciary Committees, as well as the National Bankruptcy Review Commission, on bankruptcy and consumer law issues and has appeared as a bankruptcy expert on national and local television and radio shows. He has served on the faculty of numerous continuing legal education programs, including those presented by the Federal Judicial Center, NYU Law School, the National Conference of Bankruptcy Judges, the Southeastern Bankruptcy Law Institute, the Executive Office of U.S. Trustees, ALI-ABA, the National Association of Chapter 13 Trustees, the National Association of Consumer Bankruptcy Attorneys and the ABA Family Law Section.

Mr. Sommer is an elected member of the American Law Institute and the National Bankruptcy Conference, for which he served as Reporter for the Bankruptcy Code Review Project's Working Group on Individual Debtors. In addition, he is an elected Fellow of the American College of Bankruptcy. He is a former president of the National Association of Consumer Bankruptcy Attorneys, former Chair of the Eastern District of Pennsylvania Bankruptcy Conference and a former member of the Federal Reserve Board Consumer Advisory Council.

Mr. Sommer was the first recipient of the National Consumer Law Center's Vern Countryman Consumer Law Award. He received his legal education from Harvard Law School (J.D., *cum laude*).



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What's New

1 Collier Real Estate Trans & Bankruptcy Code Scope

Scope

HIGHLIGHTS

Release 24 December 2009

Mortgages and Leases

Chapters 2 and 3 have been revised and updated, and include added discussion of the recharacterization of leases.

Time-Computation Changes

This release reflects changes, effective December 1, 2009, to the computation of time under certain Code provisions and in numerous Federal Rules of Bankruptcy Procedure.

Survey of Bankruptcy Code Provisions. Revised Chapter 1 has been updated throughout to provide a current and concise explanation of those Bankruptcy Code provisions most relevant in real estate transactions. In *In re MMH Automotive Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008), the court allowed for a sale to be completed "free and clear of all interests" by requiring an interest holder to accept the cash-out option in a billboard lease on the property that was sold (P 1.08).

Mortgages. Revised Chapter 2 now highlights the circuit split over whether "substantially contemporaneous" requires a case-by-case analysis or instead is tied to the 30-day relation-back period of section 547(e)(2)(A). The Eleventh Circuit has joined the Sixth, Eighth and Ninth Circuits, holding that unlike the bright-line rule of section 547(e)(2)(A), the "substantially contemporaneous" rule of section 547(c)(1)(B) requires an examination of all the facts and circumstances. *Gordon v. Novastar Mortgage, Inc. (In re Hedrick)*, 524 F.3d 1175 (11th Cir.), *cert. denied*, 29 S. Ct. 631, 172 L. Ed. 2d 610 (2008) (P 2.02[2]). Among other recent cases references in the revised chapter are *Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee)*, 530 F.3d 458 (6th Cir. 2008), in which a court held a new mortgage to be a preferential transfer because the trustee met its burden on all elements under section 547(b) and found that the earmarking doctrine did not apply (P 2.02[2][a]).

Leases. Case highlights in Chapter 3 include *Midwest Holding #7, LLC v. Anderson*, 59 C.B.C.2d 1191, 387 B.R. 892 (N.D. Ga. 2008), *aff'd*, 556 F.3d 1194, 61 C.B.C.2d 127 (11th Cir. 2009), where the court held that a fee paid

prepetition for early termination of a lease was not avoidable because the debt had arisen at the time when the nonresidential real estate lease was signed (P 3.01).

Miscellaneous Real Estate Transactions. Revised Chapter 4 references, among other significant cases, *COR Route 5 Company, LLC. v. The Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373 (2d Cir. 2008) (holding that whether a contract is executory is determined on the date of the petition).

Time-Computation Changes. The Federal Rules of Bankruptcy Procedure, as well as the Federal Rules of Appellate, Civil Procedure and Criminal Procedure, are amended effective December 1, 2009, to adopt a new method of computing time under the rules. Bankruptcy Rule 9006(a) implements that change in the Bankruptcy Rules. Most notably, the rule will no longer exclude intermediate Saturdays, Sundays or holidays for periods that are less than eight days. If a period ends on a Saturday, Sunday or holiday, the period is extended to the next day that is not a Saturday, Sunday or holiday. In addition to the amendments to Rule 9006(a) establishing a new method for computing time, the rules were amended to make the deadlines under the rules multiples of seven days for most periods that are fewer than 30 days. Thus, 5-day periods have become 7-day periods; 10-day periods have become 14-day periods; 15-day periods have become 14-day periods; 20-day periods have become 21-day periods; and 25-day periods have become 28-day periods.

Also effective December 1, 2009, are amendments to the Bankruptcy Code substituting seven-day deadlines for five-day deadlines. Pursuant to the Statutory Time-Periods Technical Amendments Act of 2009, Pub. L. No. 111-16 (2009), the following Code sections were affected: 109(h)(3)(A)(ii), 322(a), 332(a), 342(e)(2), 521(e)(3)(B), 521(i)(2), 704(b)(1)(B), 749(b), 764(b).

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

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§ 1.syn Synopsis to Chapter 1: Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.01

P 1.01 Scope and Use of Chapter

This chapter surveys the provisions of the Bankruptcy Code that affect real estate transactions. Many provisions of the Code, affecting both real estate and other types of property, have been included in the survey to provide a complete presentation. Case law is referenced when a significant decision has been rendered or an important line of cases has developed. In addition, extensive references are included in this chapter to the significant changes made to the Bankruptcy Code in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Most of the 2005 provisions became effective 180 days after enactment, on October 17, 2005.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.02

P 1.02 Organization and Enactment History of the Bankruptcy Reform Act of 1978

The Bankruptcy Code was enacted as part of the Bankruptcy Reform Act of 1978.ⁿ¹ The Bankruptcy Reform Act of 1978 comprised four titles: Title I was the Bankruptcy Code and was enacted as title 11 of the United States Code. Title II established the United States bankruptcy courts and their attendant administrative system, and was included in title 28 of the United States Code. Title III amended other federal legislation relating to bankruptcy, and Title IV provided for the judicial and administrative transition from the system that administered the former Bankruptcy Act to the system which was to administer the Bankruptcy Code. The Bankruptcy Code became effective on October 1, 1979, and was administered by the United States bankruptcy courts made up of bankruptcy judges (and their replacements) who were appointed under the former Bankruptcy Act. On June 28, 1982, the United States Supreme Court, in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*,ⁿ² held that the broad grant of jurisdiction to bankruptcy judges set forth in the Bankruptcy Reform Act of 1978 violated Article III of the Constitution. The Supreme Court stayed the effectiveness of its judgment in *Marathon*, first, until October 4, 1982, and then until December 24, 1982.ⁿ³ In the absence of any congressional action to amend the Bankruptcy Code, and in view of the Supreme Court's refusal to further stay its judgment,ⁿ⁴ the bankruptcy courts began hearing cases under a so-called "emergency rule," promulgated by the Judicial Conference. The emergency rule authorized the bankruptcy courts to hear and determine "core issues" (matters directly arising under the Code) but to function only as referees with respect to "related issues." On June 27, 1984, the emergency rule, and, indeed, the terms of all United States bankruptcy judges, expired.ⁿ⁵ On July 10, 1984, President Reagan signed into law the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments"), which amended title 28 of the United States Code to establish the bankruptcy judges as a unit of the United States District Court to be known as the bankruptcy court, and which amended title 11 of the United States Code in many substantive respects.ⁿ⁶ The structure and jurisdiction of the bankruptcy court, which are described later in this chapter, have remained substantively the same since being established by the 1984 Amendments.ⁿ⁷

On October 27, 1986, President Reagan signed into law the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 (the "1986 Amendments").ⁿ⁸ The 1986 Amendments provided for, among other things, the appointment of additional bankruptcy judges, the establishment of a nationwide United States trustee system for bankruptcy cases, and the addition to the Bankruptcy Code of a new chapter 12 to provide special treatment for family farmers.ⁿ⁹ Chapter 12 became effective on November 26, 1986, and, as originally enacted, was to be repealed on October 1, 1993.ⁿ¹⁰ Congress subsequently extended the effectiveness of chapter 12 on several occasions. On August 6, 1993, Congress enacted Public Law No. 103-65, which extended the effectiveness of chapter 12 until October 1, 1998.ⁿ¹¹ On October 21, 1998, Congress enacted Public Law No. 105-277, which extended the effectiveness of chapter

12 until April 1, 1999.ⁿ¹² On March 30, 1999, October 9, 1999, October 31, 2000, and June 26, 2001, Congress enacted, respectively, Public Law Nos. 106-5, 106-70, 107-8 and 107-17, which together extended the effectiveness of chapter 12 until October 1, 2001.ⁿ¹³ Congress subsequently enacted Public Law Nos. 107-170, 107-171 and 107-377, which extended the former bankruptcy provisions of chapter 12 through July 1, 2003.ⁿ¹⁴ Chapter 12 was again extended by Congress through January 1, 2004.ⁿ¹⁵ Finally, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which is discussed in greater detail in this chapter and throughout this volume, Congress eliminated the sunset provision and permanently enacted chapter 12, while at the same time extending its benefits to "family fisherman" and making other important changes to chapter 12.ⁿ¹⁶

On October 22, 1994, President Clinton signed into law the Bankruptcy Reform Act of 1994 (the "1994 Amendments"), which made several substantial changes to the Bankruptcy Code, including several major changes affecting real estate transactions.ⁿ¹⁷

On April 20, 2005, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"). Most of the provisions of the 2005 Act become effective 180 days after enactment, or October 17, 2005.ⁿ¹⁸ Several provisions became effective upon enactment, while other provisions have individualized effective dates. Although the publicized focus of the 2005 Act related to consumer bankruptcies, including the implementation of means testing for the filing of chapter 7 cases by individuals, the legislation included significant provisions relating to commercial and business matters, including several major changes to existing law affecting real estate transactions. These changes will be addressed later in this chapter and throughout this volume.

Under the former Bankruptcy Act, there were myriad possible proceedings available, with differing rights and powers of the debtor or trustee and effects on creditors. These included the so-called "straight bankruptcy," or liquidation, corporate reorganization (Chapter X) arrangements (Chapter XI) and real property arrangements by a noncorporate debtor (Chapter XII).

Under the Bankruptcy Code, the available forms of relief are the following:

Chapter 7--Liquidation, including Stockbroker Liquidation (Subchapter III) and Commodity Broker Liquidation (Subchapter IV)

Chapter 9--Adjustment of Debts of a Municipality

Chapter 11--Reorganization, including Railroad Reorganization (Subchapter IV)

Chapter 12--Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income

Chapter 13--Adjustment of Debts of an Individual with Regular Income

Chapter 15--Ancillary and Other Cross-Border Cases.ⁿ¹⁹

Under the Code, cases are filed under one of the five main operative chapters, although there is provision for conversion from one chapter to another.ⁿ²⁰ In the case of a chapter 15 proceeding, the case is commenced by the filing of a petition for recognition of a preexisting foreign proceeding.ⁿ²¹ Chapters 7, 11, 12 and 13 may be employed by individuals, although the 2005 Act imposed stringent limitations on the ability of individuals to utilize chapter 7 for cases commenced on and after October 17, 2005.ⁿ²² Chapters 7 and 11 may also be utilized by businesses that are otherwise eligible to be debtors under the Bankruptcy Code, whether such businesses are large or small, publicly or privately owned, or in corporate or partnership form.ⁿ²³ In addition, it should be noted that as part of the Bankruptcy Reform Act of 1994 and the 2005 Act various sections of chapter 11 were amended to have different applications in the case of a debtor that is a "small business debtor."ⁿ²⁴

Chapter 12 may be employed by a "family farmer" or "family fisherman," as defined in *subsections 101(18) and (19A) of the Code*, including individuals and spouses, corporations and partnerships.ⁿ²⁵

Chapter 13, relating to adjustment of debts of an individual with regular income, is limited to individuals, but the individuals need not be wage earners; chapter 13 is available only to an individual who alone or with his spouse has noncontingent and liquidated unsecured debts of less than \$336,900 and noncontingent and liquidated secured debts of less than \$1,010,650.ⁿ²⁶

Chapters 1, 3 and 5 apply generally to cases under any of the operative chapters of the Code unless otherwise provided in *section 103 of the Code*.ⁿ²⁷

The definitions of many uncapitalized terms employed in the Code are set forth in chapter 1 *of the Code*, as are certain principal rules of statutory construction. Many seemingly self-explanatory terms, such as "creditor," "claim," "lien," "person," "purchaser" and "security interest," which are used throughout the Code, are defined in *section 101 of the Code* and may materially qualify or otherwise affect the provision in which such term is employed.ⁿ²⁸ Similarly, the rules of construction of the Code, set forth in *section 102*, deal with certain words and phrases that have significant procedural or substantive effects throughout the Code. For example, the term "after notice and a hearing" means "such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances," and authorizes an action without a hearing if there is insufficient time or if a hearing is not timely requested by a party in interest.ⁿ²⁹ Therefore, under emergency circumstances, a trustee who may take an action and affect the rights of a creditor only after notice and a hearing may take such action without actual notice or a hearing.ⁿ³⁰ Also, the term "claim against the debtor" includes "claim against property of the debtor."ⁿ³¹ This provision is of particular importance to holders of nonrecourse secured debt.

Chapter 1 also includes section 104, providing for the triennial adjustment of certain dollar amounts used throughout the code to reflect changes in the Consumer Price Index;ⁿ³² section 105, empowering the bankruptcy court to issue all orders "necessary or appropriate to carry out the provisions" of title 11;ⁿ³³ section 106, dealing with waivers of sovereign immunity; as to governmental units;ⁿ³⁴ and section 107, providing, generally, for public access to all papers filed in title 11 cases.ⁿ³⁵ Section 109 establishes the requirements for qualifying as a debtor under the Code.ⁿ³⁶

Of particular significance is section 108, which provides for extensions of any time periods set forth in any otherwise applicable nonbankruptcy laws, court orders or agreements for actions to be taken by or against the debtor or the trustee. In particular, *section 108(a)* extends any unexpired statute of limitations on debtor commenced actions to the latter of the otherwise applicable period or two years after the order for relief in the case, *section 108(b)* extends any unexpired period in which a debtor may cure a default, file a proof of claim or loss (such as an insurance claim) or perform any other similar act to the later of the otherwise applicable period or 60 days after the order for relief in the case and *section 108(c)* extends any unexpired statute of limitations for claims against the debtor to the latter of the otherwise applicable period or 30 days after notice of the termination or expiration of any bankruptcy code stay with respect to such claim.ⁿ³⁷ Of particular significance in real estate matters, it has been held that section 108(b) also applies to extend any statutory period of redemption following a mortgage foreclosureⁿ³⁸ or a tax sale.ⁿ³⁹ Thus, if applicable nonbankruptcy law fixes a period within which a debtor may redeem property, and such period has not expired before the date of the filing of the petition, then debtor may redeem the property before the end of such period or 60 days after the order for relief, whichever is later.

On a related issue, the United States Supreme Court has held that in certain circumstances, the doctrine of equitable tolling of limitations periods will apply in bankruptcy cases.ⁿ⁴⁰

Sections 301 through 303 set forth the standards and procedure for the commencement of voluntary and involuntary cases under the Code.ⁿ⁴¹ Some of the details of these standards and procedures are described later in this chapter.ⁿ⁴² In particular, section 301 provides that the filing with the bankruptcy court of a voluntary bankruptcy case by an eligible

debtor constitutes an order for relief.ⁿ⁴³ Section 303 sets forth the requirements for the commencement of an involuntary case.ⁿ⁴⁴ Sections 305 and 306 address certain jurisdictional and similar matters, such as the bankruptcy court's power to abstain by dismissing a case or suspending all proceedings in a case and the right of a foreign representative to make a limited appearance without submitting to general jurisdiction of a United States court.ⁿ⁴⁵ Section 307 deals with the standing of the United States trustee,ⁿ⁴⁶ while section 308, added by the 2005 Act, provides for periodic reporting requirements by small business debtors.ⁿ⁴⁷

The eligibility, appointment, functioning and compensation of trustees and professionals in a Bankruptcy Code case, including examiners, attorneys and other professionals, is governed by sections 321 through 331.ⁿ⁴⁸ The administration of a Bankruptcy Code case is governed by *sections 341 through 350 of the Code*, including provisions for the meeting of creditors (*section 341*), notice to appropriate parties of the entry of an order for relief (*section 342*), examination of the debtor (*section 343*), the granting of immunity from self incrimination (*section 344*), investment of money of the estate (*section 345*) and special tax provisions dealing with treatments under state or local (but not federal) tax law (*section 346*).ⁿ⁴⁹ The so-called "administrative powers" subchapter of the Code, set forth in sections 361 through 366, provides the operating machinery for a Bankruptcy Code case, including the automatic stay (*section 362*), the trustee's authority to use, sell and lease property and to obtain unsecured and secured credit (*sections 363 and 364*) and the trustee's powers to reject, assume and assign executory contracts and unexpired leases (*section 365*).ⁿ⁵⁰

Chapter 5 of the Code, which is also generally applicable to all Bankruptcy Code cases, deals with creditors and claims, including allowance of claims or interests, administrative claims, tax liabilities, secured claims, priorities, claims of codebtors and subordination (*sections 501 through 510*), debtors' duties and benefits, including exemptions and discharge (*sections 521 through 525*) and formation and protection of the estate, including turnover of the property to the estate, avoidance of prepetition transfers constituting preferences or fraudulent conveyances, setoffs and the authority of a trustee to abandon property of the estate that is burdensome or that is of inconsequential value and benefit to the estate (*sections 541 through 554*).ⁿ⁵¹ Chapter 5 also contains provisions intended to address the rights of debtors and nondebtors with respect to securities contracts (*section 555*), commodities contracts and forward contracts (*section 556*), grain storage facilities (*section 557*), repurchase agreements (*section 559*), swap agreements (*section 560*) and master netting agreements (*section 561*).ⁿ⁵² Section 562, added by the 2005 Act, provides for the timing of damage measurement in connection with swap agreements, securities contracts, forward contracts, commodity contracts, repurchase agreements and master netting agreements.ⁿ⁵³

The Bankruptcy Code should be read in conjunction with the Federal Rules of Bankruptcy Procedure, also known as the Bankruptcy Rules, prescribed by the United States Supreme Court and effective initially as of August 1, 1983.ⁿ⁵⁴ On March 30, 1987, April 30, 1991, and April 22, 1993, the United States Supreme Court announced amended Bankruptcy Rules, reflecting, *inter alia*, amendments to the Bankruptcy Code.ⁿ⁵⁵ The amended rules, which took effect on August 1, 1987, August 1, 1991, and August 1, 1993, govern all proceedings in bankruptcy commenced after those respective dates and "insofar as just and practicable, all proceedings in bankruptcy cases then pending." Additionally, less extensive amendments have been made to the rules at other times; for example, amended versions of two rules--*Rules 8002 and 8006*--became effective on August 1, 1994. Also, in 2002, *Rule 1004* was amended to remove the implication that the Bankruptcy Code or Bankruptcy Rules required that all general partners consent to the filing of a voluntary petition by a partnership.ⁿ⁵⁶ Extensive amendments were made to the Official Bankruptcy Forms, effective in cases filed on or after October 17, 2005, to take into account the 2005 Act. In addition, the Advisory Committee on Bankruptcy Rules approved Interim Bankruptcy Rules, suggested for adoption by courts as local rules, to guide practice under the 2005 Act pending the adoption of amendments to the Federal Rules of Bankruptcy Procedure.ⁿ⁵⁷ Additional amendments became effective in December 2007, including, significantly, new *Rule 6003*, which prohibits certain types of relief during the first 21 days of a case, such as the assumption or assignment of an executory contract or unexpired lease or a motion to use, sell or lease property.ⁿ⁵⁸ Effective December 1, 2008, over 30 rules were amended and seven new rules promulgated. The 2008 amendments supersede on a permanent basis the Interim Bankruptcy Rules. Effective December 1, 2009, more than 40 additional rules were amended and one new rule promulgated.

In addition to the Bankruptcy Rules, practice and procedure are governed by local rules adopted in each district. The local rules of each bankruptcy court and United States district court should be consulted for particular practice requirements of those courts.ⁿ⁵⁹ *Rule 9029* provides that a nonwillful failure to comply with a local rule imposing a requirement of form will not result in a loss of rights.ⁿ⁶⁰

As noted, the 1986 Amendments provided for, among other things, the establishment of a nationwide United States trustee system for Bankruptcy Code cases. In particular, the 1986 Amendments require the Attorney General to appoint one United States trustee in each of 21 regions generally composed of more than one judicial district, for a term of five years, but subject to removal by the Attorney General without cause.ⁿ⁶¹ Only the judicial districts in Alabama and North Carolina remain outside the United States trustee system.ⁿ⁶²

The primary purpose of the United States trustee system is to divorce bankruptcy judges from the performance of administrative tasks required in bankruptcy cases. Section 586 of title 28, as amended in 1986, specifies the duties of the United States trustee, which include establishing, maintaining and supervising a panel of private trustees who are eligible and available to serve as chapter 7 and chapter 11 trustees, reviewing and monitoring fee applications and, if appropriate, filing comments or objections with respect to such applications, monitoring disclosure statements in chapter 11 cases and monitoring plans in chapter 11, 12 and 13 cases, monitoring appointed creditors' committees in chapter 11 cases and notifying the United States Attorney of criminal acts and assisting in prosecution when requested by the United States Attorney. In addition, the 1986 Amendments made important additions to and changes in the Bankruptcy Code to reflect the establishment of the nationwide United States trustee system, and move into substantive sections of the Bankruptcy Code certain provisions previously contained in chapter 15 of the Code (subsequently repealed).ⁿ⁶³

The other significant provisions of the 1986 Amendments included the following:

Section 105 of the Code was amended to permit the bankruptcy court to act *sua sponte* notwithstanding any provision in the Code providing for a party in interest to raise an issue (thus, the United States trustee can, *inter alia*, bring certain matters to the court's attention).ⁿ⁶⁴

The 1986 Amendments also added section 307 to the Code, which permits the United States trustee to "raise and appear and be heard on any issue in any case or proceeding" under the Code, but the United States trustee may not file a chapter 11 plan.ⁿ⁶⁵

Section 341 was amended to require the United States trustee to convene and preside at the meeting of creditors and may convene an equity security holders' meeting. Section 341(c) was further amended to bar a judge's attendance at a final meeting.ⁿ⁶⁶

Section 701 was amended to require the United States trustee to appoint an interim trustee in a chapter 7 case, and section 1102 to require the United States trustee to appoint the unsecured creditors' committee in a chapter 11 case.ⁿ⁶⁷

Section 707(a) was amended to add, as a ground for dismissal of a chapter 7 case, only on motion of the United States trustee, the failure of the debtor to file the schedules of assets and liabilities, and current income and expenditures, and the statement of financial affairs required by *section 521(1)* within 15 days after the filing of a voluntary petition or any extended time permitted by the court.ⁿ⁶⁸

Section 707(b) was also amended to permit the United States trustee to move for dismissal based on abuse of chapter 7 provision.ⁿ⁶⁹

Section 1102(a)(1) was amended to allow the United States trustee to appoint additional committees as the United States trustee deems appropriate (the court may still order such committees) and section 1102(c) was repealed. (The

effect of the repealer was not clear. Presumably, unfettered discretion to appoint committees includes the authority to change membership on the committee.ⁿ⁷⁰ The 2005 Act further amended section 1102 to provide that the court may order the United States trustee to change the membership of a committee if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders. The amendments also provided that the court could order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern if the court determines that the creditor holds claims of the kind represented by the committee the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.ⁿ⁷¹

Section 1112 was amended by the 1986 Amendments with the addition of subsection (e) to permit the United States trustee (only) to request conversion or dismissal of a chapter 11 case if the debtor fails to file the schedules and statements required by *section 521(1)*, including the list of the holders of the 20 largest unsecured claims, within 15 days after the petition or such time as allowed by the court.ⁿ⁷²

Section 1307 was amended by the 1986 Amendments to permit conversion or dismissal of a chapter 13 case on motion of the United States trustee for failure to file the documents required by *section 521(1)* within 15 days of the petition or as it may be extended by the court.ⁿ⁷³

FOOTNOTES:

(n1)Footnote 1. References herein to the Bankruptcy Code are to Title 11 of the United States Code, enacted as part of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598 (1978), *reprinted*, with amendments, in Vol. A Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th Ed. Revised), as amended by Pub. L. No. 97-35 (1981), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(c) (Matthew Bender 15th Ed. Revised); Pub. L. No. 97-222 (1982), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(d); Pub. L. No. 98-353 (1984), *reprinted* in Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a); Pub. L. No. 99-554 (1986), *reprinted* in Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a); Pub. L. No. 100-334 (1988), *reprinted* in Vol. E-1 Collier on Bankruptcy, App. Pt. 8(a); Pub. L. No. 100-506 (1988), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(g)(i); Pub. L. No. 100-597 (1988), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(g)(ii); Pub. L. No. 101-311 (1990), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(h)(i); Pub. L. No. 101-508 (1990), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(h)(ii); Pub. L. No. 101-581 (1990), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(h)(iii); Pub. L. No. 101-647 (1990), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(h)(iv); Pub. L. No. 101-650 (1990), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 42(b)(i)(D); Pub. L. No. 102-486 (1992), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(j)(ii); Pub. L. No. 103-65 (1993), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i); Pub. L. No. 103-394 (1994), *reprinted* in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a); and Pub. L. No. 105-183 (1998), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(o)(ii); Pub. L. No. 105-244, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(o)(iii); Pub. L. No. 105-277, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(o)(iv); Pub. L. No. 106-5, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(p)(i); Pub. L. No. 106-270, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(p)(ii); Pub. L. No. 106-181, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(q)(i); Pub. L. No. 106-518, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(q)(ii); Pub. L. No. 106-554, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(q)(iii); Pub. L. No. 107-170, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(s)(i); Pub. L. No. 107-171, *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(s)(ii); Pub. L. No. 107-204, *reprinted* in Vol. F ; Pub. L. No. 107-377, *reprinted* in Vol. F Collier on Bankruptcy, App. P. 41(s)(iv); Pub. L. No. 108-73, *reprinted* in Vol. F Collier on Bankruptcy, App. P. 41(t)(i); Pub. L. No. 109-8 (2005), *reprinted* in Vol. E-2, Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Pub. L. No. 109-390 (2006), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(v) (Matthew Bender 15th Ed. Revised); Pub. L. No. 109-439 (2006), *reprinted* in Vol. F Collier on Bankruptcy, App. Pt. 41(v) (Matthew Bender 15th Ed. Revised).

References to the Bankruptcy Act, and to the "former Act," are to the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938. References to the House Report are to H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977), *reprinted* in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i), and to the Senate Report are to S. Rep. No. 95-989, 95th

Cong., 2d Sess. (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i). References to the Bankruptcy Rules are to the Federal Rules of Bankruptcy Procedure. References to a trustee, or a trustee of the debtor, also constitute references to a debtor in possession in a case under chapter 11 of the Code in which no trustee has been appointed. Under section 1107(a) of the Code, a debtor in possession has substantially all of the rights and powers of a chapter 11 trustee.

(n2)Footnote 2. 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598, 6 C.B.C.2d 785 (1982) .

(n3)Footnote 3. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 459 U.S. 813, 103 S. Ct. 199, 74 L. Ed. 2d 160 (1982) .

(n4)Footnote 4. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 459 U.S. 1094, 103 S. Ct. 662, 74 L. Ed. 2d 942 (1982) .

(n5)Footnote 5. S. 2776 (1984).

(n6)Footnote 6. Pub. L. No. 98-353 (1984), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised). For a description of the administrative chaos which occurred after June 27, 1984, and of the legal questions raised by the "retroactive" appointment of the bankruptcy judges to June 27, 1984, see Miller & Bienenstock, *A Summary and Assessment of the Major Components of the Bankruptcy Amendments and Federal Judgeship Act of 1984*, Legal Times, July 30, 1984, at 30, col. 1.

(n7)Footnote 7. *See P 1.02 infra.*

(n8)Footnote 8. Pub. L. No. 99-554 (1986), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n9)Footnote 9. *See P 1.12 infra.*

(n10)Footnote 10. Pub. L. No. 99-554, § 302(f) (1986), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. Pub. L. No. 103-65 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. Pub. L. No. 105-277, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(o)(iv) (Matthew Bender 15th Ed. Revised).

(n13)Footnote 13. Pub. L. No. 106-5, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(p)(i) (Matthew Bender 15th Ed. Revised); Pub. L. No. 106-70, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(p)(ii) (Matthew Bender 15th Ed. Revised).

(n14)Footnote 14. Pub. L. 107-170, *reprinted in* Vol. F. Collier on Bankruptcy, App. P. 41(s)(i) (Matthew Bender 15th Ed. Revised); Pub. L. No. 107-171, *reprinted in* Vol. F. Collier on Bankruptcy, App. P. 41(s)(ii) (Matthew Bender 15th Ed. Revised); Pub. L. No. 107-377, *reprinted in* Vol. F. Collier on Bankruptcy, App. P. 41(s)(iv) (Matthew Bender 15th Ed. Revised).

(n15)Footnote 15. Pub. L. No. 108-73, *reprinted in* Vol. F Collier on Bankruptcy, App. P. 41(t)(i) (Matthew Bender 15th Ed. Revised).

(n16)Footnote 16. Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The provisions relating to chapter 12 were included in Title X (§§ 1001-1007) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

(n17)Footnote 17. Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. Chapter 15 was added to the Bankruptcy Code by the 2005 Act and was intended to replace former section 304, which was repealed. According to the legislative history, the new chapter 15, which was included in title VIII of the 2005 Act, "incorporates the Model Law on Cross-Border Insolvency to encourage cooperation between the United States and foreign countries with respect to transnational insolvency cases. Title VIII is intended to provide greater legal certainty for trade and investment as well as to provide for the fair and efficient administration of cross-border insolvencies, which protects the interests of creditors and other interested parties, including the debtor. In addition, it serves to protect and maximize the value of the debtor's assets." *See* H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) at p. 10-376 (Matthew Bender 15th Ed. Revised).

(n20)Footnote 20. 11 U.S.C. §§ 706, 1112, 1208 and 1307. Under *Bankruptcy Code* section 1307(f), 11 U.S.C. § 1307(e), the court may not convert a chapter 13 case to a case under chapter 7 or 11 if the debtor is a farmer unless the debtor requests conversion. Section 1208 provides for conversion of a chapter 12 case only to a case under chapter 7. No provision in the Code authorizes conversion of a chapter 12 case to a case under chapter 11. *In re Sinclair*, 870 F.2d 1340 (7th Cir. 1989) .

(n21)Footnote 21. 11 U.S.C. § 1504.

(n22)Footnote 22. *See* 11 U.S.C. § 109. Among the limitations under the 2005 Act is a presumption that the granting of chapter 7 relief would be an abuse of such chapter if current monthly income (as defined) less certain allowed expenses and deductions, over the next 60 months exceeds the lesser of \$10,000 or 25% of general unsecured claims, but not less than \$6,000. 11 U.S.C. § 707(b).

(n23)Footnote 23. *See id.*

(n24)Footnote 24. The statute, as amended by the 2005 Act, defines "small business debtor" as a

(A) ... person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title *and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto*) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than \$2,190,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under *section 1102(a)(1)* a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,190,000 (excluding debt owed to 1 or more affiliates or insiders).

11 U.S.C. § 101(51D) (emphasis added), as amended by Pub. L. No. 109-8, § 432(a) (2005). As noted, the statute specifically excludes persons whose primary activity is the business of owning or operating real property or activities incidental thereto from application of the small business debtor provisions of chapter 11.

(n25)Footnote 25. *See* P 1.12 *infra*.

(n26)Footnote 26. 11 U.S.C. § 109(e). Pursuant to the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), these limits were raised from \$100,000 and \$350,000, respectively, to, initially, \$250,000 and \$750,000. Section 108 of the Bankruptcy Reform Act of 1994 also provided for increases in these limits commencing April 1, 1998, and at each three-year interval ending on April 1 thereafter, to reflect the change in the Consumer Price Index for All Urban Consumers, published by the Department of Labor, for the most recent three-year period ending immediately before January 1 preceding such April 1. This adjustment mechanism is codified in new *section 104 of the Bankruptcy Code*. 11 U.S.C. § 104. The current chapter 13 eligibility limits have been in effect since April 1, 2007, *see* 72 Fed. Reg. 7082-83 (Feb 14, 2007) , and will change again on April 1, 2010.

(n27)Footnote 27. 11 U.S.C. § 103.

(n28)Footnote 28. 11 U.S.C. § 101(10), (5), (37), (41), (43), (51).

(n29)Footnote 29. 11 U.S.C. § 102(1).

(n30)Footnote 30. *See* P 1.06 *infra*.

(n31)Footnote 31. 11 U.S.C. § 102(2).

(n32)Footnote 32. 11 U.S.C. § 104.

(n33)Footnote 33. 11 U.S.C. § 105. The potentially broad reach of section 105 has been limited in scope by the holding in *Marathon*. 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598 (1982) .

(n34)Footnote 34. 11 U.S.C. § 106. The term "governmental units" is defined as the United States; any state, commonwealth, district, territory, municipality, or foreign state; any department, agency or instrumentality of the United States, a state, a commonwealth, a district, a territory, a municipality or a foreign state; or any other foreign or domestic government. 11 U.S.C. § 101(27).

(n35)Footnote 35. 11 U.S.C. § 107. It should be noted that the general public record status of bankruptcy case papers and the bankruptcy court docket is qualified by section 107(b), which contains provisions for the bankruptcy court, on its own motion or on request of a party in interest, to issue protective orders with respect to a trade secret or confidential research, development, or commercial information and with respect to scandalous or defamatory matters contained in any paper filed in a bankruptcy case. 11 U.S.C. § 107(b).

(n36)Footnote 36. 11 U.S.C. § 109; *see* P 1.04 *infra*.

(n37)Footnote 37. 11 U.S.C. § 108.

(n38)Footnote 38. *Canney v. Merchants Bank (In re Frazer)*, 284 F.3d 362 (2d Cir. 2002) ; *see also In re 210 Roebling, LLC*, 336 B.R. 172, 174 (Bankr. S.D.N.Y. 2005) (discussing cases addressing issue of whether redemption period can be further extended pursuant to section 105).

(n39)Footnote 39. *In re Davenport*, 268 B.R. 159, 165 (Bank. N.D. Ill. 2001) ; *see also In re Isom*, 342 B.R. 743 (Bankr. N.D. Miss. 2006) .

(n40)Footnote 40. *Young v. United States*, 122 S. Ct. 1036, 152 L. Ed. 2d 79 (2002) (holding that three-year lookback period for which income taxes were nondischargeable was equitably tolled during debtor's prior bankruptcy proceeding).

(n41)Footnote 41. 11 U.S.C. §§ 301-303.

(n42)Footnote 42. *See* P 1.05 *infra*.

(n43)Footnote 43. *11 U.S.C. § 301.*

(n44)Footnote 44. *11 U.S.C. § 303.*

(n45)Footnote 45. *11 U.S.C. §§ 304-306.*

(n46)Footnote 46. *11 U.S.C. § 307.* However, the United States trustee is not permitted to file a chapter 11 plan.

(n47)Footnote 47. *11 U.S.C. § 308.*

(n48)Footnote 48. *11 U.S.C. §§ 321-331.*

(n49)Footnote 49. *11 U.S.C. §§ 341-350.*

(n50)Footnote 50. *11 U.S.C. §§ 361-66.*

(n51)Footnote 51. *11 U.S.C. §§ 501-510, 521-525, 541-554.*

(n52)Footnote 52. *11 U.S.C. §§ 555-561.*

(n53)Footnote 53. *11 U.S.C. § 562.*

(n54)Footnote 54. The Bankruptcy Rules were prescribed pursuant to *28 U.S.C. § 2075*. The 1991 amendments to the Bankruptcy Rules and Official Forms amended *Fed. R. Bankr. P. 1001* by changing the citation form of the Bankruptcy Rules to the "Federal Rules of Bankruptcy Procedure." Subsequent references to the "Bankruptcy Rules" or the "Rules" in this chapter refer to the Federal Rules of Bankruptcy Procedure.

(n55)Footnote 55. *See P 1.14 infra.*

(n56)Footnote 56. *See 2002 Advisory Committee Note to Fed. R. Bankr. P. 1004.*

(n57)Footnote 57. The Interim Rules were effective only in cases commenced on or after October 17, 2005, and only in the judicial districts that adopted them by local rule or court order.

(n58)Footnote 58. *Fed. R. Bankr. P. 6003*. The Advisory Committee Note states that the purpose of the rule was to alleviate some of the time pressures present at the start of the case so that full and close consideration could be given to matters that may have a fundamental impact on the case. *See 2007 Advisory Committee Note to Fed. R. Bankr. P. 6003.*

(n59)Footnote 59. *See Collier Bankruptcy Practice Guide Local Rules Pamphlets (Matthew Bender).*

(n60)Footnote 60. *Fed. R. Bankr. P. 9029(a)(2).*

(n61)Footnote 61. *28 U.S.C. § 581*. On the expiration of the five-year term, an appointed United States trustee shall continue to perform her duties until a successor is appointed and qualifies. *28 U.S.C. § 581(b).*

(n62)Footnote 62. This system replaced the pilot program enacted under the Bankruptcy Reform Act of 1978, which provided for the appointment of a United States trustee for each of 10 areas of the country. *28 U.S.C. § 581(a)* (amended 1986).

Bankruptcy administrator offices oversee the administration of bankruptcy cases in the six judicial districts of Alabama and North Carolina. Those offices also maintain a panel of private trustees, as well as monitor all transactions and the conduct of the parties in a bankruptcy case.

(n63)Footnote 63. Pub. L. No. 99-554, § 231 (1986), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a)

(Matthew Bender 15th Ed. Revised). The 2005 Act added a new chapter 15 to the Code, "Ancillary and Other Cross-Border Cases." Pub. L. No. 109-8, § 801 (2005).

(n64)Footnote 64. This amendment abrogated the rule of *In re Gusam Rest. Corp.*, 737 F.2d 274, 10 C.B.C.2d 1203 (2d Cir. 1984) .

(n65)Footnote 65. 11 U.S.C. § 307.

(n66)Footnote 66. 11 U.S.C. § 341(c).

(n67)Footnote 67. 11 U.S.C. §§ 701 and 1102.

(n68)Footnote 68. 11 U.S.C. § 707(a).

(n69)Footnote 69. 11 U.S.C. § 707(b).

(n70)Footnote 70. 11 U.S.C. § 1102(a)(1); Pub. L. No. 99-554, § 221 (1986), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n71)Footnote 71. 11 U.S.C. § 1102(a)(4), added by Pub. L. No. 109-8, § 405(a) (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n72)Footnote 72. 11 U.S.C. § 1112(e).

(n73)Footnote 73. 11 U.S.C. § 1307. For a discussion of the changes to the Bankruptcy Rules accommodating the adoption of a national United States trustee system, *see* P 1.14[12] *infra*.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.03

P 1.03 The Structure and Jurisdiction of the Bankruptcy Court

The principal thrust of the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*ⁿ¹ was that the grant of jurisdiction to non-Article III bankruptcy judges to adjudicate common and state law claims of the trustee against third parties is unconstitutional. Under the amendments to title 28 set forth in the Bankruptcy Reform Act of 1978 prior to enactment of the 1984 Amendments, bankruptcy judges were to be appointed by the President for 14-year terms, and were granted all of the powers and courts of equity, law and admiralty.ⁿ² They could not enjoin another court, or punish a criminal contempt not committed in the presence of the judge or warranting a punishment of imprisonment.ⁿ³ Thus, under the jurisdictional statutes in effect before the 1984 Amendments, the bankruptcy judges could take jurisdiction of matters ranging from state law tort claims to federal antitrust cases.

In order to rectify the crisis caused by the *Northern Pipeline* decision, Congress, in the 1984 Amendments, amended section 1334 and section 157 of title 28 to set forth the division of jurisdiction, power and responsibility as between the United States district court, on the one hand, and the bankruptcy court, on the other hand. The 1984 Amendments also provide that the bankruptcy judges are to be appointed to 14-year terms by the United States court of appeals and are judicial officers of the United States district court.ⁿ⁴ Pursuant to section 1334 of title 28, the United States district courts are granted original and exclusive jurisdiction of all bankruptcy cases, and original but not exclusive jurisdiction of all civil proceedings "arising under" a Bankruptcy Code case, or "arising in or related to" bankruptcy cases.ⁿ⁵ In turn, section 157 of title 28 provides that each United States district court may provide that any or all cases and any and all proceedings arising in or related to a case may be "referred" initially to the bankruptcy judges for the district.ⁿ⁶ This reference from the district court may be revoked for "cause," and shall be revoked on timely motion if a proceeding requires consideration of both title 11 matters and other laws of the United States regulating organizations or activities affecting interstate commerce.ⁿ⁷

The district court may abstain, in the interest of justice, or in the interest of comity with state courts or respect for state law, from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11.ⁿ⁸ Upon timely motion of a party in a proceeding based on a state law claim or cause of action "related to a case under title 11 but not arising under title 11 or arising in a case under title 11" which could not have been otherwise commenced in federal court, the district court must abstain if the "action is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction."ⁿ⁹ However, the liquidation or estimation of contingent or unliquidated personal injury tort and wrongful death claims are not subject to this mandatory abstention provision and such claims are to be tried in the district court in the district where the bankruptcy case is pending or where the claim arose.ⁿ¹⁰ Any decision to abstain

or not abstain under the above-mentioned provisions (other than a decision not to abstain in connection with a proceeding based on a state law claim or cause of action) is not reviewable by appeal or otherwise by the court of appeals or the United States Supreme Court.ⁿ¹¹

The bankruptcy courts are empowered to issue final judgments and orders only in cases under the Bankruptcy Code and all "core proceedings" arising under the Bankruptcy Code or arising in a case under the Bankruptcy Code, to the extent such case or proceeding, as the case may be, was referred by the district court.ⁿ¹² In non-core proceedings that are related to bankruptcy cases, the bankruptcy courts may issue final judgments and orders only with the consent of the parties, and otherwise may hear non-core proceedings and submit proposed findings of fact and conclusions of law to the district court.ⁿ¹³ The district court shall enter a final judgment or order in the proceeding after considering the bankruptcy court's findings and conclusions and after reviewing *de novo* any matters timely and specifically objected to by a party.ⁿ¹⁴

"Core proceedings" include, but are not limited to, the following:

- (1) administrative matters;
- (2) claims estimation, allowance and disallowance, other than estimation and liquidation of personal injury tort or wrongful death claims for purposes of a distribution in a chapter 11 case;
- (3) counterclaims by the estate against persons filing claims against the estate;
- (4) financing orders;
- (5) turnover orders;
- (6) preference matters;
- (7) motions to terminate, annul or modify the automatic stay;
- (8) fraudulent conveyance matters;
- (9) dischargeability matters;
- (10) determinations of the validity, extent or priority of liens;
- (11) plan confirmation;
- (12) orders approving sale, use or leasing of property, including use of cash collateral, but excluding orders for the sale of property resulting from claims brought by the estate against persons who have not filed claims against the estate;
- (13) "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims";
- (14) recognition of foreign proceedings and other matters under the new chapter 15 (added by the 2005 Act).ⁿ¹⁵

The Supreme Court has held that a defendant who has not filed a claim in the chapter 11 case in a fraudulent

conveyance action brought by a trustee to recover a monetary transfer has a constitutional right to a jury trial.ⁿ¹⁶ The opinion implies that the ruling extends to preference actions as well.ⁿ¹⁷ The effect of this ruling is to convert fraudulent conveyance actions to non-core proceedings in cases in which the defendant has not filed a claim.

The district court for the district in which a bankruptcy is sitting has jurisdiction to hear appeals from final judgments, orders and decrees of the bankruptcy judge entered in core proceedings or consented to in non-core proceedings.ⁿ¹⁸ The judicial council of a circuit may establish a bankruptcy appellate panel, comprised of bankruptcy judges from the districts within the circuit, to hear appeals from bankruptcy court judgments and orders, upon consent of the parties. The Bankruptcy Reform Act of 1994ⁿ¹⁹ included provisions designed to encourage the use of bankruptcy appellate panels by mandating the establishment of such panels unless the judicial council finds that (1) "there are insufficient judicial resources available in the circuit" or (2) "establishment of such a panel would result in undue delay or increased cost to parties in cases under title 11."ⁿ²⁰

The 2005 Act amended the appellate provisions to give the court of appeals jurisdiction to hear directly an appeal from a judgment or order of the bankruptcy court if certain conditions are satisfied, including certifications by the bankruptcy court, district court or bankruptcy appellate panels, or by all appellants and appellees acting jointly.ⁿ²¹

Title 28 of the United States Code also contains a number of other provisions related to the jurisdiction of the bankruptcy courts, including provisions relating to original venue (sections 1408-1410 of title 28), change of venue (section 1412 of title 28) and removal of claims related to bankruptcy cases (sections 1441 and 1452 of title 28).ⁿ²² Under the original venue provision in section 1408 of title 28, a Bankruptcy Code case may be commenced in the district court for the district (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the 180 days immediately preceding such commencement, or for a longer portion of such 180-day period than the domicile, residence or principal place of business in the United States, or principal assets in the United States, of such person were located in any other district; or (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner or partnership.ⁿ²³ Thus, a single asset real estate debtor that is registered as a limited partnership or limited liability company in one district (domicile) but has its principal assets in another district will have more than one choice as to where to commence the Bankruptcy Code case. In practice, venue decisions by debtors are often guided by matters such as convenience of the parties and, in certain instances, the existence of particularly favorable law in one of the jurisdictions. Although original venue may be proper, a party in interest or the court on its own motion can transfer a case to another district court in the interest of justice or for the convenience of the parties.ⁿ²⁴

FOOTNOTES:

(n1)Footnote 1. *458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598, 6 C.B.C.2d 785 (1982)* .

(n2)Footnote 2. *28 U.S.C. §§ 153(a), 1481 (repealed)*.

(n3)Footnote 3. *28 U.S.C. § 1481 (repealed)*.

(n4)Footnote 4. *28 U.S.C. § 152(a)*.

(n5)Footnote 5. *28 U.S.C. § 1334*.

(n6)Footnote 6. *11 U.S.C. § 157(a)*.

(n7)Footnote 7. *28 U.S.C. § 157(d)*.

(n8)Footnote 8. *28 U.S.C. § 1334(c)(1)*.

(n9)Footnote 9. *28 U.S.C. § 1334(c)(2)*.

(n10)Footnote 10. 28 U.S.C. § 157(b)(5).

(n11)Footnote 11. 28 U.S.C. § 1334(c)(2).

(n12)Footnote 12. 28 U.S.C. § 157(b).

(n13)Footnote 13. 28 U.S.C. § 157(c).

(n14)Footnote 14. 28 U.S.C. § 157(c)(1).

(n15)Footnote 15. 28 U.S.C. § 157(b)(2). It may be extremely difficult to apply the distinction between "core proceedings" and "related to" proceedings in specific instances. For example, a proceeding to determine the nondischargeability of debts incurred for willful and malicious injury may represent a hybrid situation in which the determination of nondischargeability is a core proceeding under section 157(b)(2)(I) and the determination of underlying liability is the exclusive province of the district court. *Baranski v. Lagrotteria (In re Lagrotteria)*, 12 B.C.D. 467 (Bankr. N.D. Ill. 1984) . A real property foreclosure proceeding conducted by the bankrupt-holder of a note and mortgage is a core proceeding in the nature of a turnover action, but a foreclosure proceeding against a mortgage debtor is not a core proceeding. *In re Cassidy Land & Cattle Co.*, 836 F.2d 1130, 18 C.B.C.2d 291 (8th Cir.) , cert. denied, 486 U.S. 1033 (1988) . For a review of cases evidencing divergent views of core and related proceedings involving contract breach disputes, see *Bernheim v. Chubb Ins. Co. of Canada*, 160 B.R. 42 (Bankr. D.N.J. 1996) ; see also *In re G-I Holdings, Inc.*, 48 C.B.C.2d 314, 278 B.R. 376 (Bankr. D.N.J. 2002) . See generally King, *Jurisdiction and Bankruptcy Powers of United States Bankruptcy Courts, District Courts and Courts of Appeals*, N.Y.U. School of Law, Workshop on Bankruptcy and Business Reorganization (1998); King, *Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984*, 38 Vand. L. Rev. 675 (1985).

(n16)Footnote 16. *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 2d 26, 20 C.B.C.2d 1216 (1989) . However, the Supreme Court has also clearly held that a creditor who files a proof of claim in a bankruptcy case waives its right to a jury trial on any preference action brought by the trustee. *Langenkamp v. Culp*, 498 U.S. 42, 111 S. Ct. 330, 112 L. Ed. 2d 343, 23 C.B.C.2d 973 (1990) . The filing of a claim against a bankruptcy estate triggers the process of claims allowance and disallowance which is subject to the bankruptcy court's equitable power and any ensuing preference action is an integral part of the court's equity jurisdiction. *Id.*

(n17)Footnote 17. 492 U.S. 33, 48, 109 S. Ct. 2782, 2794, 106 L. Ed. 2d 26, 45, 20 C.B.C.2d 1216, 1227 .

(n18)Footnote 18. 28 U.S.C. § 158(a).

(n19)Footnote 19. Pub. L. No. 103-394. *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised)

(n20)Footnote 20. 28 U.S.C. § 158(b). As of this writing, the First, Sixth, Eighth, Ninth and Tenth Circuits have established bankruptcy appellate panels.

(n21)Footnote 21. 28 U.S.C. § 158(d)(2), added by Pub. L. No. 109-8, § 1233 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n22)Footnote 22. 28 U.S.C. §§ 1408-1410, 1412, 1441 and 1452.

(n23)Footnote 23. 28 U.S.C. § 1408.

(n24)Footnote 24. 28 U.S.C. § 1412. A leading bankruptcy court decision discussing the standards for transferring venue under section 1412 of title 28 was rendered in the Enron chapter 11 proceedings. *In re Enron*, 274 B.R. 327 (Bankr. S.D.N.Y. 2002) .

For a discussion of the correct procedure when original venue was improper, see *Thompson v Greenwood*, 507 F.3d 416 (6th Cir.2007) , cert. denied, 129 S. Ct. 193, 172 L. Ed. 2d 139 (2008) .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.04

P 1.04 Who May Be a Debtor

Section 109(a) of the Bankruptcy Code provides that only a person that resides or has a domicile, place of business or property in the United States, or a municipality, may be a debtor under the Code.ⁿ¹ This test is measured on the petition date.ⁿ² Notably, there is no minimum threshold in the statute regarding domicile, place of business or property in the United States; thus, under section 109(a), a person with most of its operations in a foreign country but with a small bank account located in the United States would satisfy the jurisdictional requirements of the Bankruptcy Code.ⁿ³ A "person" is defined in section 101(41) to include an individual, a partnership and a corporation, but not a governmental unit.ⁿ⁴ Under section 101(9), a corporation includes an association having the powers and privileges of a private corporation, a partnership association organized under a law that makes only the capital subscribed responsible for the debts of the corporation, a joint-stock company, an unincorporated company or association, and a business trust.ⁿ⁵ Limited partnerships are expressly excluded from the definition of "corporation" and, according to the legislative history, general partnerships likewise fall outside the definition.ⁿ⁶ It is nevertheless clear under sections 101(41) and 109(a) that both general and limited partnerships may be debtors under the Code.ⁿ⁷ However, the United States Court of Appeals for the Second Circuit has ruled that under New York law a partnership in dissolution was not a person eligible for relief under the Bankruptcy Code.ⁿ⁸

However, an issue exists as to whether certain land trusts, such as Illinois and Florida land trusts, are considered "persons" under sections 101(41) and 109(a) for purposes of eligibility as debtors under the Code.ⁿ⁹ Although the section 101(41) definition of "person" provides that such term "includes" the enumerated types of entities, and although section 102(3) provides that the terms "includes" and "including" are not limiting,ⁿ¹⁰ the legislative history relating to section 101(41) states that the definition of "person" "does not include an estate or a trust, which are included only in the definition of 'entity' in proposed 11 U.S.C. § 101(15)."ⁿ¹¹ The principal issue, therefore, appears to be whether such land trusts constitute "business trusts," and are therefore "corporations" under *section 101(9)* and "persons" under *sections 101(41) and 109(a)*, or constitute nonbusiness trusts and are therefore to be considered ineligible trusts in accordance with the House Report. In general, land trusts will be found to be business trusts when they have a development, financing, leasing or other business purpose as distinguished from mere preservation of the *res*.ⁿ¹² It has been held that a Florida land trust is not eligible to be a debtor under the Bankruptcy Code under a finding that such trusts are not business trusts under Florida law.ⁿ¹³ Both Nevada and West Virginia have found that land trusts created under those States' laws are not "business trusts," and therefore are not eligible for relief.ⁿ¹⁴

Courts have held that the basic distinction between a "business trust" and other trusts is that business trusts are created

for the purpose of carrying on some kind of business, typically (though not dispositively) with an objective of generating a profit to the trust beneficiaries, whereas the purpose of a nonbusiness trust is to protect and preserve the res.ⁿ¹⁵ Thus, it has been held that a trust created effectively to hold collateral for the benefit of multiple lenders--and thereby facilitate a secured financing transaction--was not a business trust and was not eligible for bankruptcy relief.ⁿ¹⁶

Any person eligible for relief under chapter 7 of the Code is eligible for relief under chapter 11 unless such person is a stockbroker or a commodity broker;ⁿ¹⁷ moreover, a railroad may be a chapter 11 debtor but is not eligible for relief under chapter 7.ⁿ¹⁸ With respect to chapter 13, section 109(e) provides that only an individual with regular income and noncontingent, liquidated, unsecured debts as of the date of filing of the petition of less than \$336,900, and noncontingent, liquidated, secured debts of less than \$1,010,650 as of such date, or such an individual and spouse, may be a debtor under chapter 13.ⁿ¹⁹

Under *section 109(g) of the Code*, no individual may be a debtor under the Code if within the preceding 180 days a case of the debtor under the Code was dismissed for willful failure to abide by the orders of the court, "or to appear before the court in the proper prosecution of the case," or if the debtor obtained a voluntary dismissal of its Bankruptcy Code case following a request for relief from the automatic stay.ⁿ²⁰

The 2005 Act added a further restriction on individuals by restricting an individual from being a debtor unless such individual has, during the 180-day period preceding the petition date, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.ⁿ²¹

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 109(a)*.

(n2)Footnote 2. *In re Axona Int'l Credit & Commerce*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988) ; *see also In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000) (\$10,000 in bank accounts as of petition date and retainers paid to debtor's attorney and unapplied as of petition date sufficient under *section 109(a)*).

(n3)Footnote 3. *See In re Globo Comunicacoes e Participacoes S.A.*, 317 B.R. 235 (S.D.N.Y. 2004) . Of course, although jurisdiction may be technically proper in such a situation, the bankruptcy court may choose to dismiss the case of a debtor having minimal contacts pursuant to section 305(a)(1), which permits dismissal of a case if "the interests of creditors and the debtor would be better served by such dismissal." *11 U.S.C. § 305(a)(1)*. For a good discussion of *11 U.S.C. § 305(a)(1)*'s authority, *see In re Aerovias Nacionales de Colombia S.A.*, 303 B.R. 1 (Bankr. S.D.N.Y. 2003) . But, where the debtor's overwhelming contacts are in a foreign jurisdiction and a bank account in the United States was created for the sole purpose of conferring jurisdiction, a bankruptcy court may dismiss the filing for cause under section 1112(b). *See In re Yukos Oil Co.*, 321 B.R. 396, 411 (Bankr. S.D. Tex. 2005) .

(n4)Footnote 4. *11 U.S.C. § 101(41)*. Section 101(41) excepts from this exclusion a governmental unit that acquires an asset through the operation of a loan guarantee agreement or as a receiver or liquidating agent or that is a guarantor of a pension benefit payable by or on behalf of the debtor or an affiliate of the debtor for the purpose of eligibility as a member of a creditors' or equity security holders' committee. These exceptions are intended to permit the Federal Deposit Insurance Corporation and the Pension Benefit Guaranty Corporation to serve on a creditors' or equity securities holders' committee.

(n5)Footnote 5. *11 U.S.C. § 101(9)*.

(n6)Footnote 6. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 309 (1977) ("House Report"), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *See also 11 U.S.C. §§ 548(d) and 723*.

(n8)Footnote 8. *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304 (2d Cir. 1997) ; see also *In re Hagerstown Fiber Ltd. P'ship*, 226 B.R. 353 (Bankr.S.D.N.Y. 1998) . But see *In re StatePark Building Group, Ltd.*, 316 B.R. 466 (Bankr. N.D. Tex. 2004) (where court chose not to follow either of the above Second Circuit cases when applying Texas law to a partnership in dissolution).

(n9)Footnote 9. 11 U.S.C. §§ 101(41) and 109(a).

(n10)Footnote 10. 11 U.S.C. § 102(3).

(n11)Footnote 11. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 309 (1977) at 313.

(n12)Footnote 12. *Eastern Airlines, Inc. v. First Fid. Bank (In re Secured Equip. Trust of E. Airlines, Inc.)*, 38 F.3d 86, 32 C.B.C.2d 1069 (2d Cir. 1994) ; see also *Brady-Morris v. Schilling (In re Kenneth Allen Knight Trust)*, 303 F.3d 671 (6th Cir. 2002) ; *In re Mosby*, 791 F.2d 628 (8th Cir. 1986) ; *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009); *In re Medallion Realty Trust*, 103 B.R. 8 (Bankr. D. Mass. 1989) , *aff'd*, 120 B.R. 245 (1990) .

(n13)Footnote 13. *In re Cohen*, 2 C.B.C.2d 4, 4 B.R. 201 (Bankr. S.D. Fla. 1980) ; *In re Treasure Island Land Trust*, 1 C.B.C.2d 407, 2 B.R. 332 (Bankr. M.D. Fla. 1980) .

(n14)Footnote 14. *In re McCarthy*, 312 B.R. 413 (Bankr. D. Nev. 2004) ; *In re Morgantown Trust No. 1*, 155 B.R. 137 (Bankr. N.D. W. Va. 1993) .

(n15)Footnote 15. *In re Secured Equip. Trust of E. Air Lines, Inc.*, 38 F.3d 86, 32 C.B.C.2d 1069 (2d Cir. 1994) ; see also *In re Gurney's Inn Corp. Liquidating Trust*, 215 B.R. 659 (Bankr. E.D.N.Y. 1997) (holding that whether entity is a "business trust" is a question of Federal law); *In re Star Trust*, 237 B.R. 827 (Bankr. M.D. Fla. 1999) (trusts that were established and maintained to hold and manage two business properties qualified as business trusts of the kind eligible to be chapter 11 debtors).

(n16)Footnote 16. 38 F.3d 86, 32 C.B.C.2d 1069 (2d Cir. 1994) .

(n17)Footnote 17. 11 U.S.C. § 109(d).

(n18)Footnote 18. 11 U.S.C. § 109(b).

(n19)Footnote 19. 11 U.S.C. § 109(e). This limit is subject to triennial adjustment pursuant to *section 104 of the Bankruptcy Code*, enacted in 1994. The chapter 13 eligibility limits currently in effect reflect the first such adjustment on April 1, 1998, the third such adjustment on April 1, 2004, and the fourth such adjustment on April 1, 2007. For the current adjustment, see 72 Fed. Reg. 7082-83 (Feb. 14, 2007) .

(n20)Footnote 20. 11 U.S.C. § 109(g).

(n21)Footnote 21. 11 U.S.C. § 109(h), added by Pub. L. No. 109-8, § 106(a) (2005), effective in cases commenced on or after October 17, 2005.

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.05

P 1.05 Voluntary and Involuntary Petitions

A voluntary case under the Code is commenced by the filing of a petition by an entity that is qualified to be a debtor.ⁿ¹ The United States Supreme Court long ago held that the authority of a nonnatural person to file a bankruptcy petition is governed by applicable nonbankruptcy law.ⁿ² Thus, under general principals of corporate law, the authority of a corporation to file for bankruptcy vests with the board of directors and not with an individual officer unless the officer's action is authorized by the board of directors in the first instance or later ratified by the board, and a petition that is not properly authorized should be dismissed.ⁿ³ The result is similar under partnership and limited liability company law.ⁿ⁴ Therefore, under these holdings, provisions in corporate charters or partnership agreements that require specific approvals for the filing of a voluntary bankruptcy petition, such as the common provision contained in the charter of a special purpose entity for the approval of an "independent" director for certain acts, including the commencement of a voluntary bankruptcy case, should be respected.

The commencement of a voluntary case constitutes an "order for relief."ⁿ⁵ The Code has eliminated the acts of bankruptcy enumerated in the former Bankruptcy Act, and no allegation of bankruptcy or insolvency is required for a valid petition. Indeed, the terms "bankruptcy" and "adjudication," which were a part of the lexicon of the former Bankruptcy Act, have been eliminated. Thus a "debtor" (not a "bankrupt") need not be insolvent to qualify for relief.

An involuntary case under the Code may be commenced only under chapters 7 and 11 against a person otherwise qualified to be a debtor thereunder, except that an involuntary petition may not be filed against a farmer or a corporation that is not "a moneyed, business, or commercial corporation."ⁿ⁶ If a debtor has 12 or more creditors holding claims that are not contingent as to liability (an indenture trustee is such a creditor), or subject to a bona fide dispute as to liability or amount,ⁿ⁷ an involuntary petition may be filed by three or more of such creditors having such claims aggregating at least \$13,475, including claims representing the deficiency portion of any secured claims.ⁿ⁸ If there are fewer than 12 such creditors, excluding creditors who are employees, "insiders" and holders of certain avoidable transfers, then any one of such creditors may file the involuntary petition.ⁿ⁹ Courts have held that the statutory requirements for petitioning creditors can be waived if not contested by the debtor.ⁿ¹⁰

In the case of a partnership, an involuntary petition may be filed by fewer than all of the general partners.ⁿ¹¹ A petition against a partnership that does not meet the requirements for a voluntary petition under substantive law will be treated under the Code as an involuntary petition.ⁿ¹² A limited partner of a limited partnership may not in its capacity as a limited partner force the partnership into a proceeding under the Code;ⁿ¹³ however, nothing in the Code disqualifies a

limited partner that is also a creditor of a limited partnership and that is not otherwise deemed an "insider" from joining in an otherwise proper involuntary petition commenced by creditors against the partnership. If all of the general partners of a partnership have themselves become debtors in proceedings under the Code, any such general partner or his trustee, or the holder of any claim against the partnership, may file an involuntary petition against that partnership.ⁿ¹⁴ The right of fewer than all general partners to file a petition against a partnership conferred by the Code supersedes any contrary provisions of the partnership agreement or of state law.

Bankruptcy Rule 1010 provides that the clerk of the court shall forthwith issue a summons for service on the debtor of an involuntary petition. If service cannot be effected in accordance with *Bankruptcy Rule 7004(a)* or *(b)*, the court may order the summons and petition to be served by mailing copies to the debtor's last known address and by at least one publication in the manner and form directed by the court. *Bankruptcy Rule 1004* requires the partners that have filed an involuntary petition to "promptly send to or serve on each general partner who is not a petitioner a copy of the petition" The clerk of the court is also required under *Bankruptcy Rule 1004* to promptly issue a summons for each general partner that is not a petitioner.ⁿ¹⁵

Section 303(d) of the Code provides that the debtor, or any general partner in a partnership debtor that did not join in the petition, may file an answer to the petition.ⁿ¹⁶ Similarly, *Bankruptcy Rule 1011(a)* provides that an involuntary petition may be contested by the debtor named therein and, if the debtor is a partnership, by a nonpetitioning general partner or "alleged" general partner. *Bankruptcy Rule 1011* does not permit a response by creditors to an involuntary petition, and any such creditor should seek to intervene under *Bankruptcy Rule 2018(a)* providing for permissive intervention. *Bankruptcy Rule 1018* governs the procedure to be employed in contesting involuntary petitions and in vacating orders for relief.

If the involuntary petition is not timely controverted, the court shall order relief against the debtor under the chapter under which the petition was filed.ⁿ¹⁷ However, if an involuntary petition is controverted, the court may under *section 303(h) of the Code* enter an order for relief only if (1) the debtor is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute as to liability or amount; or (2) within 120 days before the date of filing of the petition, a "custodian," other than a trustee, receiver or agent appointed or authorized to take charge of less than substantially all of the debtor's property for the purpose of lien enforcement, "was appointed or took possession."ⁿ¹⁸ *Section 101* defines a "custodian" as a:

(A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;

(B) assignee under a general assignment for the benefit of the debtor's creditors; or

(C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.ⁿ¹⁹

Thus, if controverted, a party filing an involuntary petition must demonstrate the occurrence of one of the events specified in *section 303(h)* or the petition will be dismissed.

In view of the potential for abuse by creditors and others of the involuntary petition procedure, the court is empowered under *section 303(i)* to impose substantial costs and damages upon a petitioner.ⁿ²⁰ Under *section 303(i)*, the court may, if an involuntary petition is dismissed, enter a judgment against the petitioners for costs and reasonable attorney's fees.ⁿ²¹ If the court finds the petition to have been filed in bad faith it may enter judgment for damages proximately caused by the filing of the involuntary petition and for punitive damages.ⁿ²² The court may in addition under *section 303(e)* order the petitioners to file an indemnity bond for such amounts as the court may later allow against the

petitioners.n23

The costs, attorney's fees, damages and punitive damages authorized by *section 303(i)* may be imposed upon partners who file an involuntary chapter 11 petition against the partnership that is ultimately dismissed as a bad faith filing.n24 Thus, the penalties provided for under *section 303(i)* may be assessed against "insiders" as well as unaffiliated creditors that file involuntary petitions. It has been held that only the debtor or a representative acting on behalf of the debtor has standing to recover damages under 303(i).n25

Under section 303(g), the court may, on request of a party in interest in a chapter 7 case, appoint an interim trustee before the entry of the order for relief if necessary to preserve the property of the estate or to prevent loss to the estate. The debtor may regain possession of such property before the entry of the order for relief if the debtor files a bond conditioned on the debtor's accounting for and delivering to the trustee if there is an order for relief in the case, such property, or the value, as of the date the debtor regains possession, of such property.n26

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 301*.

(n2)Footnote 2. *Price v. Gurney*, 324 U.S. 100, 65 S. Ct. 513, 89 L. Ed. 776 (1945) .

(n3)Footnote 3. *AMG Res., Inc. v. Industrial Concerns, Inc. (In re Industrial Concerns, Inc.)*, 289 B.R. 609 (Bankr. W.D. Pa. 2003) .

(n4)Footnote 4. *Jolly v. Pittore*, 170 B.R. 793 (S.D.N.Y 1994) ; *In re Orchards Village Investments, LLC*, 405 B.R. 341 (Bankr. D. Or. 2009) ; *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006) ; *In re J&J Prop. Holdings, LLC*, 2004 Bankr. LEXIS 2543 (Bankr. W.D.N.C. Jan. 20, 2004) (limited liability company); *In re SWG Assocs.*, 199 B.R. 557, 559 (Bankr. W.D. Pa 1996) (partnerships).

(n5)Footnote 5. *11 U.S.C. § 301*. The deemed entry of an "order for relief" is significant because that event constitutes the starting point for certain time limits set forth in the Bankruptcy Code. *See, e.g., 11 U.S.C. §§ 108* (providing for extensions of statutes of limitation), 546 (providing time limit for trustee to commence avoidance actions).

(n6)Footnote 6. *11 U.S.C. § 303(a)*.

(n7)Footnote 7. The language requiring that the bona fide dispute relate to "liability or amount" was added to the statute by the 2005 Act. Pub. L. No. 109-8, § 1234 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *11 U.S.C. § 303(b)(1)*. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), increased this amount from \$5,000. This threshold is subject to triennial adjustment pursuant to *section 104 of the Bankruptcy Code*, enacted in 1994. The minimum aggregate claims to commence an involuntary petition, as currently in effect, reflect the first such adjustment on April 1, 1998, the second such adjustment on April 1, 2001, the third such adjustment on April 1, 2004, and the fourth such adjustment on April 1, 2007. For the current adjustment, *see 72 Fed. Reg. 7082-83 (Feb 14, 2007)* .

(n9)Footnote 9. *11 U.S.C. § 303(b)(2)*. The term "insider" is defined in *section 101(31) of the Code*.

(n10)Footnote 10. *E.g., Trusted Net Media Holdings, LLC v. Morrison Agency, Inc. (In re Trusted Net Media Holdings, LLC)*, 550 F.3d 1035, 61 C.B.C.2d 292 (11th Cir.2008) . *But see* Key Mechanical Inc. v. BDC 56 LLC (*In re BDC 56 LLC*), 330 F.3d 111, 50 C.B.C.2d 161 (2d Cir. 2003) , where the Second Circuit said that the requirements of section 303(b) must be met for the court to have subject matter jurisdiction, which is inconsistent with the reasoning of the Eleventh Circuit in *Trusted Net Media*.

(n11)Footnote 11. *11 U.S.C. § 303(b)(3)(A)*.

(n12)Footnote 12. *See P 1.14[2] infra*.

(n13)Footnote 13. *In re Royal Gate Assocs., Ltd., (Bankr. M.D. Ga. 1988), 81 B.R. 165 .*

(n14)Footnote 14. *11 U.S.C. § 303(b)(3)(B)*.

(n15)Footnote 15. Formerly *Fed. R. Bankr. P. 1004(b)*. The 2002 amendment to *Fed. R. Bankr. P. 1004* deleted subdivision (a) (concerning voluntary petitions) of the rule, retitled the rule to reflect that it applies only to involuntary petitions filed against partnerships and changed the wording of the "Involuntary Petition" portion slightly.

(n16)Footnote 16. *11 U.S.C. § 303(d)*.

(n17)Footnote 17. *11 U.S.C. § 303(h)*.

(n18)Footnote 18. *11 U.S.C. § 303(h)*.

(n19)Footnote 19. *11 U.S.C. § 101(11)*.

(n20)Footnote 20. *11 U.S.C. § 303(i)*.

(n21)Footnote 21. *11 U.S.C. § 303(i)(1)*.

(n22)Footnote 22. *11 U.S.C. § 303(i)(2)*.

(n23)Footnote 23. *11 U.S.C. § 303(e)*.

(n24)Footnote 24. *In re Fox Island Square P'ship, 106 B.R. 962 (Bankr. N.D. Ill. 1989) .*

(n25)Footnote 25. *Franklin v. Four Media Co. (In re Mike Hammer Prods., Inc.), 294 B.R. 752 (B.A.P. 9th Cir. 2003) ; see also Miles v. Okun (In re Miles), 50 C.B.C.2d 235, 294 B.R. 756 (B.A.P. 9th Cir. 2003) , aff'd, 430 F.3d 1083 (9th Cir. 2005) ; In re VII Holdings Co., 362 B.R. 663 (Bankr. D. Del. 2007) .*

(n26)Footnote 26. *11 U.S.C. § 303(g)*.

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.06

P 1.06 Creation of the Estate

[1] Property of the Estate

The commencement of a case under the Code creates an estate.ⁿ¹ The estate is the property that the trustee and the court will administer for the benefit of the creditors of the debtor. However, not all property of the estate will be available for distribution to creditors, or for conversion into other types of property to be distributed to creditors, or for the implementation of a plan. Certain property may be subject to exemption for the benefit of the debtor,ⁿ² may be abandoned during the course of the case,ⁿ³ may be surrendered to secured creditors,ⁿ⁴ or, in the case of executory contracts and unexpired leases, may be rejected by the trustee.ⁿ⁵

Section 541(a) provides in substance that subject to exceptions specified therein all legal and equitable interests of the debtor in property as of the commencement of the case are included in the estate. The term "legal and equitable interests of the debtor" includes security interests held by the debtor, life estates, any equity of redemption, rights of dower, curtesy or derivatives thereof, and co-ownership interests in real property.ⁿ⁶ Under section 541(a)(3), property of the estate includes any interest in property that the trustee recovers under its avoidance power,ⁿ⁷ and under section 541(a)(7), property acquired by the estate after the commencement of the case is likewise included in the estate.ⁿ⁸ In addition, section 541(a)(5) provides that any interest in property acquired by the debtor within 180 days after the filing of the petition passes to the estate (as opposed to being retained by the debtor), if such interest was obtained by bequest, devise or inheritance, as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree, or as a beneficiary of a life insurance policy or death benefit plan.ⁿ⁹

Section 541(a)(6) provides for inclusion in the estate of proceeds, product, offspring, rents or profits of or from property of the estate other than earnings from services performed by an individual debtor after the commencement of the case.ⁿ¹⁰ This is of considerable importance to mortgagees holding assignments of rent on income producing property, inasmuch as section 552(b)(1), dealing with the postpetition effect of security interests, provides that a prepetition security interest which by its terms attaches to property of the debtor acquired before the case and to proceeds, product, offspring, or profits of such property and amounts paid as rents of such property will attach to such proceeds, product, offspring, rents and profits acquired by the estate after the commencement of the case to the extent provided by the governing security agreement and applicable law.ⁿ¹¹ Thus, subject to the matters discussed below,ⁿ¹² mortgagees holding rent assignments may treat postpetition rents and profits as loan collateral and seek to apply postpetition rents and profits to the mortgage debt.

Section 541(b)(2), added by the 1984 Amendments, provides that property of the estate does not include any interest of the debtor under a nonresidential lease of real property that has terminated on its stated expiration date before the commencement of the debtor's Bankruptcy Code case, and ceases to include any such interest under a nonresidential lease of real property that has terminated on its stated expiration date during the pendency of the case. These provisions appear to be merely declarative of existing law.ⁿ¹³

Section 541(d) is of fundamental importance to secondary mortgage market transactions and is set out herein in full:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.ⁿ¹⁴

There is substantial legislative history underlying *section 541(d)*. The Senate Report states (the reference therein to section 541(e) is to section 541(d) as enacted):

Section 541(e) confirms the current status under the Bankruptcy Act of bona fide secondary mortgage market transactions as the purchase and sale of assets. Mortgages or interests in mortgages sold in the secondary market should not be considered as part of the debtor's estate. To permit the efficient servicing of mortgages or interests in mortgages the seller often retains the original mortgage notes and related documents, and the purchaser records under State recording statutes the purchaser's ownership of the mortgages or interests in mortgages purchased. Section 541(e) makes clear that the seller's retention of the mortgage documents and the purchaser's decision not to record do not impair the asset sale character of secondary mortgage market transactions. The committee notes that in secondary mortgage market transactions the parties may characterize their relationship as one of trust, agency, or independent contractor. The characterization adopted by the parties should not affect the statutes [sic] in bankruptcy of bona fide secondary mortgage market purchases and sales.ⁿ¹⁵

The statement of Representative Edwards on the floor of the House was:

Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. Examples of this are mortgages sold for which legal title has been retained for servicing.ⁿ¹⁶

Senator DeConcini also rendered the following statement in his presentation of the Code on the Senate floor:

Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. The purpose of section 541(d) as applied to the secondary mortgage market is identical to the purpose of section 541(e) of the Senate amendment and section 541(d) will accomplish the same result as would have been accomplished by section 541(e). Even if a mortgage seller retains for purposes of servicing legal title to mortgages or interests in mortgages [sic] sold in the secondary mortgage market, the trustee would be required by section 541(d) to turn over the mortgages or interests in mortgages to the purchaser of those mortgages.

The seller of mortgages in the secondary mortgage market will often retain the original mortgage

notes and related documents and the seller will not endorse the notes to reflect the sale to the purchaser. Similarly, the purchaser will often not record the purchaser's ownership of the mortgages or interests in mortgages under State recording statutes. These facts are irrelevant and the seller's retention of the mortgage documents and the purchaser's decision not to record do not change the trustee's obligation to turn the mortgages or interests in mortgages over to the purchaser. The application of section 541(d) to secondary mortgage market transactions will not be affected by the terms of the servicing agreement between the mortgage servicer and the purchaser of the mortgages. Under section 541(d), the trustee is required to recognize the purchaser's title to the mortgages or interests in mortgages and to turn this property over to the purchaser. It makes no difference whether the servicer and the purchaser characterize their relationship as one of trust, agency, or independent contractor.

The purpose of section 541(d) as applied to the secondary mortgage market is therefore to make certain that secondary mortgage market sales as they are currently structured are not subject to challenge by bankruptcy trustees and that purchasers of mortgages will be able to obtain the mortgages or interests in mortgages which they have purchased from trustees without the trustees asserting that a sale of mortgages is a loan from the purchaser to the seller.ⁿ¹⁷

In sum, when an entity retains legal title to one or more mortgages for the purpose of servicing such mortgages for the benefit of the purchaser of the mortgages, the mortgages will not be considered property of the estate of the servicer. This rule appears applicable notwithstanding that the servicer may not be the originator of the mortgages, and regardless of whether the transfer of the mortgages to the purchaser has been recorded. In connection with litigation arising from the failure of several mortgage originators in 2007, section 541(d) has been cited by bankruptcy courts to hold that a trustee could not use its strong-arm avoidance powers to assert an interest in sold mortgages for which the mortgage assignment in favor of the lender was not recorded.ⁿ¹⁸ The section has also been cited to hold that foreclosed properties that came into the name of the debtor-servicer as a result of its foreclosure services was property of the purchaser of the mortgages.ⁿ¹⁹ However, because the statutory text distinguishes between "servicing" and an underlying mortgage or mortgage interest, the rights to service the mortgages remains property of the estate and such rights are severable from the transferred mortgages notwithstanding the inclusion of servicing rights in the same contracts providing for transfer.ⁿ²⁰

It should be noted, however, that under section 109(b), a domestic bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association or credit union may not be a debtor under chapter 7 or 11 of the Code nor may a foreign banking institution of like kind be a debtor under the Code if it is engaged in business in the United States.ⁿ²¹ Therefore, the protections of section 541(d) will not apply to purchases of mortgages from servicers of the kind included within section 109(b).ⁿ²²

Section 541(c)(1) provides that an interest in property that becomes property of the estate under section 541(a) will be transferred to the estate notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law that: (a) restricts or conditions transfer of such interest by the debtor; (b) is conditioned on (1) the insolvency or financial condition of the debtor, (2) the commencement of a Bankruptcy Code case, or (3) the appointment of or taking possession by a trustee in a Bankruptcy Code case or by a custodian before the commencement of a case; or (c) would effect or create an option to effect a forfeiture, modification or termination of the debtor's interest in property.ⁿ²³ Section 541(c)(1) is intended to overcome any barriers to the creation of an estate that may be imposed by anti-assignment clauses, clauses that invalidate transfers of contractual or leasehold rights "by operation of law" and clauses that create contractual or leasehold defaults and rights of termination upon a transfer by operation of law or a filing under the Code. Having effected a transfer of all contractual and leasehold rights from the debtor to the estate through section 541, the Code then provides for the preservation and right of assumption and assignment of those rights in section 365.ⁿ²⁴

The recognition in section 541(c)(2) of restrictions on transfer of the debtor's beneficial interest in a trust appears to be

applicable solely to spendthrift trusts.ⁿ²⁵ Thus, a debtor that is a beneficiary under a deed of trust, trust indenture or similar instrument passes such interest to the estate upon the commencement of the case.

Section 70a of the former Bankruptcy Act vested in the trustee title to all nonexempt property of the "bankrupt" as of the date of filing of the petition. Accordingly, the trustee or the debtor in possession in cases in which there was no trustee could execute in its name and capacity deeds, bills of sale, contracts and all other instruments and agreements disposing of an interest in the estate's property. No provision in the Code corresponds to former section 70a. However, section 323(a) makes the trustee the representative of the estate,ⁿ²⁶ section 1107 confers upon a debtor in possession in a chapter 11 case all of the rights and powers of a trustee serving in a chapter 11 case,ⁿ²⁷ section 363(b)(1) empowers the trustee after notice and a hearing to sell or lease property of the estate outside of the ordinary course of business,ⁿ²⁸ and section 363(c) empowers the trustee in a case in which the business of the debtor is authorized to be operated under *section 721, 1108 or 1304* to enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business and without notice and a hearing.ⁿ²⁹ Moreover, section 364 permits a trustee, after notice and hearing, to obtain credit secured by a lien on property of the estate.ⁿ³⁰ Thus, a trustee or debtor in possession may, as the representative of the estate, execute and deliver deeds, other instruments of sale and leases after notice and a hearing with respect to extraordinary transactions, and without notice and a hearing with respect to ordinary course transactions. The difference between Bankruptcy Code and former Bankruptcy Act practice in conveyancing and other dispositions is, therefore, that under the former Act the party effecting the disposition was the trustee or debtor in possession, whereas under the Code the conveying party is the estate of the debtor and the trustee or debtor in possession is signing the transfer document as the estate's representative.

[2] Turnover of Property to the Estate and Avoidance Powers of Trustee

The trustee is given an array of powers to recapture for the estate certain property that has been transferred by the debtor to third parties prior to the entry of the order for relief. Under section 542(a) an entity other than a custodian is required to deliver to the trustee and account for property in such entity's possession, custody or control, which the trustee may use, sell or lease under *section 363* or which may be exempt under section 522.ⁿ³¹ Section 542(c) includes exceptions for transfers by third parties of property of an estate to entities other than the trustee in good faith and without actual notice of the debtor's Bankruptcy Code case, and under section 542(d) with respect to automatic premium payment provisions in life insurance policies entered into prior to the filing of the debtor's bankruptcy petition.ⁿ³² Under section 543, a custodian is subject to specific turnover obligations and related liabilities with respect to property of an estate.ⁿ³³

Section 544 contains the so-called "strong arm" provisions of the Bankruptcy Code and empowers the trustee, without regard to any knowledge of the trustee or any creditor, to avoid certain transfers of property of the debtor and provides the trustee with the rights and powers of certain hypothetical creditors that are favored under applicable nonbankruptcy state law. For example, section 544(a)(1) provides the trustee with the rights and power of a creditor that extends credit to the debtors at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor actually exists.ⁿ³⁴ The importance of this provision is evident when read in conjunction with Revised Article 9 of the Uniform Commercial Code. Specifically, section 9-317 of Revised Article 9 provides that an unperfected security interest is subordinate to the rights of a person that becomes a lien creditor before the security interest is perfected.ⁿ³⁵ Thus, when read in conjunction with Revised Article 9 of the Uniform Commercial Code, section 544(a)(1) has the effect of empowering the trustee to avoid all unperfected security interests covered by Article 9. Similarly, with respect to real property, *section 544(a)(3) of the Bankruptcy Code* empowers the trustee to avoid any transfer that is voidable by a hypothetical bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the bankruptcy case, whether or not such a purchaser actually exists.ⁿ³⁶ For example, a trustee may avoid a leasing transaction under which the debtor was lessor and the lease was unrecorded or not evidenced by the lessee's possession.ⁿ³⁷ Also, under section 544(a)(3), a trustee can avoid a recorded mortgage that was nonetheless defectively acknowledged under state law.ⁿ³⁸

Section 544(b)(1) empowers a trustee to avoid any transfer or obligation avoidable under applicable law by an actual unsecured creditor of the debtor (except a transfer of a charitable contribution). This section accordingly incorporates into the avoidance provisions of the Bankruptcy Code the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act in the form adopted by the respective states including the applicable state statute of limitations.ⁿ³⁹ Because the statute of limitations under the state fraudulent conveyance statutes are typically longer than the two-year provision contained in the federal Bankruptcy Code fraudulent conveyance statute, *section 548*, *section 544(b)(1)* significantly enhances the power of the trustee to avoid prepetition transfers. The legislative history of the section indicates that it is intended to follow the holding of the seminal United States Supreme Court case of *Moore v. Bay* ⁿ⁴⁰ that permits the trustee to avoid an entire fraudulent transfer for the benefit of the estate even if the actual creditor from whom the trustee derives its rights has a smaller claim.ⁿ⁴¹

Under *section 545 of the Code*, the trustee may avoid certain statutory liens, including liens for rent and of distress for rent.ⁿ⁴² *Section 546(a)* prescribes the time limits within which an avoiding action under the Code must be commenced.ⁿ⁴³ *Section 546(b)* provides that the rights and power of the trustee are subject to generally applicable laws that permit a party to perfect or continue the perfection of an interest in property to an effective date that is earlier than the date of perfection,ⁿ⁴⁴ while *section 546(c)* preserves certain State law reclamation rights of sellers of goods.ⁿ⁴⁵ The legislative history to the 1994 Amendments to *section 546(b)* indicates that the provision is intended, among other things, to confirm that certain actions taken during the bankruptcy case pursuant to the Uniform Commercial Code to maintain a secured creditor's position as it was at the commencement of the case, such as the filing of a continuation statement, will not violate the automatic stay.ⁿ⁴⁶ However, the legislative history is clear that the section only is intended to permit the secured creditor to maintain the status quo and not to improve its position.ⁿ⁴⁷ A detailed discussion of *section 546(b)* and its impact on assignments of rent is set forth later in this volume.ⁿ⁴⁸

Section 547 is the preferential transfer provision of the Code.ⁿ⁴⁹ In a nutshell, *section 547* permits the trustee to avoid any transfer of an interest of the debtor in property, to or for the benefit of a creditor, for or on account of an antecedent debt, made while the debtor was insolvent and made on or within 90 days before the date of the filing of the petition (or one year in the case of an insider), which transfer enables the creditor to receive more than such creditor would receive in a chapter 7 proceeding.ⁿ⁵⁰ The debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.ⁿ⁵¹ The preference provision applies to any transfers of interests in property within the applicable time period prior to the petition date, including payments of money and transfers of security interests. In determining the timing of a transfer for purposes of the preference statute, *Section 547(e)(2)* provides that a transfer is made

(A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 30 days after, such time ... ;

(B) at the time such transfer is perfected, if such transfer is perfected after such 30 days; or

(C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of--

(i) the commencement of the case; or

(ii) 30 days after such transfer takes effect between the transferor and transferee.

In turn, *section 547(e)(1)(A)* provides that a transfer of real property (other than fixtures), including the transfer by the debtor of an interest in a contract of sale of real property, is perfected when a bona fide purchaser, against whom applicable law permits such perfection, cannot acquire an interest in the property superior to the interest of the transferee. For fixtures (as well as personal property), *section 547(e)(1)(B)* provides that a transfer is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee. As noted, the

period within which a transfer must be made in order to be subject to preference avoidance is 90 days before the filing of the petition, except that if the transferee is an "insider" (as defined in *section 101(31)*), the period is one year. The preference statute also contains several affirmative defenses, including that the subject transfer was the payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee and the transfer was made either in the ordinary course of business and financial affairs of the debtor and the transferee or according to ordinary business terms. The statute further provides that the trustee has the burden of proving the basic elements of avoidance (except for insolvency, which the statute presumes for the 90-day period) and the creditor has the burden of proving the elements of the affirmative defenses.

Section 548 is the Bankruptcy Code fraudulent conveyance provision, which deals with, among other things, transfers made and obligations incurred for less than reasonably equivalent value occurring within two years before the date of filing of the debtor's petition.ⁿ⁵² As noted above, *section 544(b)(1)*, through incorporation of state fraudulent conveyance statutes, may result in the avoidance of a fraudulent transfer that occurred more than two years before the filing of the petition to the extent that the applicable state statute of limitations is longer than two years. Section 548(b) is a special fraudulent conveyance provision for partnerships that permits avoidance of transfers of partnership property, or the incurrence of partnership obligations, to a general partner, in each case within two years of the petition date, to a general partner when the partnership was (or would be rendered) insolvent without any requirement that the transfer be for less than reasonably equivalent value.ⁿ⁵³ Section 548(c) protects certain good faith transferees and good faith obligees by providing that such persons shall have a lien on or retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that the transferee or obligee gave value to the debtor in exchange for such transfer or obligation.ⁿ⁵⁴ For purposes of the fraudulent transfer provision of the Bankruptcy Code, a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee.ⁿ⁵⁵

Section 549 authorizes a trustee to avoid postpetition transfers of property of the estate, but contains an important exception in *section 549(c)* for a postpetition transfer of an interest in real property to a good faith purchaser without knowledge of the Bankruptcy Code case of the debtor and for present fair equivalent value, if a copy or notice of the Bankruptcy Code petition was not filed in the appropriate real estate recording office before the transfer was perfected.ⁿ⁵⁶ If the good faith purchaser has paid less than present fair equivalent value, *section 549(c)* grants to such purchaser a lien on the property to the extent of the present value given, unless a copy or notice of the petition was so filed before the transfer was perfected. *Bankruptcy Rule 6001* provides that the entity asserting the validity of a transfer under *section 549* shall have the burden of proof. The time limit for a trustee to commence an action to avoid a postpetition transfer is the earlier of two years after the date of the transfer or the time that the case is closed or dismissed.ⁿ⁵⁷ Section 550 provides for the liability of a transferee of an avoided transfer and empowers the trustee to recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property from the initial transferee of such transfer or any immediate or mediate transferee of an initial transferee.ⁿ⁵⁸ However, the trustee may not recover from any immediate or mediate transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the avoided transfer.ⁿ⁵⁹ In addition, any good faith transferee from whom the trustee recovers (whether an initial transferee or an immediate or mediate transferee) in respect an avoided transfer will receive a lien on the property recovered to secure the lesser of the cost to such transferee of any improvement made after the transfer, less the amount of any profit realized by or accruing to the transferee from such property and any increase in the value of such property as a result of such improvement.ⁿ⁶⁰ The statute specifically provides that "improvements" include physical additions or changes to the property transferred, repairs, tax payments, payments of certain secured debts and costs incurred in connection with the preservation of the property.ⁿ⁶¹

Section 551 provides that any avoided transfer or any lien that is void under *section 506(d)* is preserved for the benefit of the estate, but only with respect to property of the estate.ⁿ⁶² The legislative history indicates that the requirement of benefit to the estate is intended to prevent junior lien holders from improving their position at the expense of the estate

when a senior lien is avoided and the limitation with respect to property of the estate is intended to prevent the trustee from asserting an avoided tax lien against after acquired property of the debtor.ⁿ⁶³

Section 554 authorizes the trustee to abandon any property of the estate that is burdensome or that is of inconsequential value and benefit to the estate.ⁿ⁶⁴ The doctrine of abandonment is discussed extensively in Chapter 6 of this volume in the context of the trustee's right to abandon real property having environmental concerns.ⁿ⁶⁵

Section 558 specifically provides that the estate shall have the benefit of any defense available to the debtor as against any entity other than the estate, including statutes of limitation, statutes of frauds, usury, and other personal defenses.ⁿ⁶⁶

[3] Postpetition Effect of Security Interest

One of the most critical issues to secured lenders is the effect that a bankruptcy filing will have on its security interest in after-acquired property and in the proceeds of collateral in existence as of the filing date.

Section 552 addresses the postpetition effect of a security interest and provides generally that property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.ⁿ⁶⁷ The major exception to this general rule is set forth in subsection (b), which provides generally that if a security interest created by a prepetition security agreement extends to property acquired before the commencement of the case and to proceeds, products, offspring or profits of such property, such security interest shall also extend "to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by the security agreement and by applicable nonbankruptcy law, except to the extent that the court, based on the equities of the case, orders otherwise."ⁿ⁶⁸ Moreover, of particular significance to real estate lenders and lenders to lodging properties, the 1994 Amendments clarified that if a prepetition security agreement creates a security interest that extends to property acquired before the commencement of the case and to amounts paid as rents for such property or the fees, charges, accounts or other payments for the use or occupancy of rooms and other facilities in hotels, motels or other lodging properties, such security interest shall also extend to such rents and such fees, charges, accounts or other payments acquired by the estate after the commencement of the bankruptcy case to the extent provided in such security agreement, except to the extent that the court, based on the equities of the case, orders otherwise.ⁿ⁶⁹ There is substantial legislative history to the 1994 Amendments to section 552. The Floor Statements accompanying the 1994 Amendments state, with respect to these amendments (references to "Section 214" are to Section 214 of Public Law No. 103-394, which included such Act):

Under current *section 552 of the Bankruptcy Code*, real estate lenders are deemed to have a security interest in postpetition rents only to the extent their security interest has been "perfected" under applicable State law procedures, *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979). Inclusion under section 552, in turn, allows such proceeds to be treated as "cash collateral" under *section 363(a) of the Bankruptcy Code*, which prohibits a trustee or debtor-in-possession from using such proceeds without the consent of the lender or authorization by the court. In a number of States, however, it is not feasible for real estate lenders to perfect their security interest prior to a bankruptcy filing; and, as a result, courts have denied lenders having interests in postpetition rents the protection offered under *sections 552 and 363 of the Bankruptcy Code*. See, e.g., *In re Multi-Group III Ltd. P'ship*, 99 B.R. 5 (Bankr. D. Ariz. 1989); *In re Association Center Ltd. P'ship*, 87 B.R. 142 (Bankr. W.D. Wash. 1988); *In re TM Carlton House Partners, Ltd.*, 91 B.R. 349 (Bankr. E.D. Pa. 1988); *In re Metro Square*, 93 B.R. 990 (Bankr. D. Minn. 1988). Section 214 provides that lenders may have valid security interests in postpetition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable State law. This is accomplished by adding a new provision to *section 552 of the Bankruptcy Code*, applicable to lenders having a valid security interest which extends to the underlying property and the postpetition rents. Section 214 also clarifies the bankruptcy treatment of

hotel revenues which have been used to secure loans to hotels and other lodging accommodations. These revenue streams, while critical to a hotel's continued operations, are also the most liquid and most valuable collateral the hotel can provide to its financiers. When the hotel experiences financial distress, the interests of the hotel operations, including employment for clerks, maids, and other workers can collide with the interests of persons to whom the revenues are pledged. Section 214 recognizes the importance of this revenue stream for the two competing interests and attempts to strike a fair balance between them. Thus, subsection (a) expressly includes hotel revenues in the category of collateral in which postpetition revenues are subject to prepetition security interests, and subsection (b) includes such revenues in "cash collateral" as defined in *section 363*. These clarifications of the rights of hotel financiers are, however, circumscribed. A critical limit is the "equities of the case" provision in subsection (a) which is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally. Further circumscription is supplied by the list of exceptions at the beginning of subsection (a). Thus, among other things, the reference to *section 363* permits use of pledged revenues if adequate protection is provided; the reference to *section 506(c)* permits broad categories of operating expenses-such as the cost of cleaning and repair services, utilities, employee payroll and the like-to be charged against pledged revenues; the reference to *section 522* protects individual debtors' rights; and the reference to *sections 544, 545, 547 and 548* protect the debtor's right to use all its avoiding powers against the lienholder. These rights, preserved by the list of sections, would not be waivable by the debtor, either pre- or postpetition.ⁿ⁷⁰

A detailed discussion and analysis of the 1994 Amendments and their impact on the postpetition "perfection" on assignments of rent is set forth later in this volume.ⁿ⁷¹

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 541(a)*.

(n2)Footnote 2. *11 U.S.C. § 522*.

(n3)Footnote 3. *11 U.S.C. § 554*.

(n4)Footnote 4. *11 U.S.C. § 1129(b)(2)(iii)*.

(n5)Footnote 5. *11 U.S.C. § 365(a)*.

(n6)Footnote 6. *5 Collier on Bankruptcy, P 541.05* (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *11 U.S.C. § 541(a)(3)*.

(n8)Footnote 8. *11 U.S.C. § 541(a)(7)*.

(n9)Footnote 9. *11 U.S.C. § 541(a)(5)*.

(n10)Footnote 10. *11 U.S.C. § 541(a)(6)*.

(n11)Footnote 11. *11 U.S.C. § 552(b)(1); section 552(b)(2)*, added by the Bankruptcy Reform Act of 1994, deals with the postpetition effect of a prepetition security interest in specified revenues of hotels, motels and other lodging properties. See *P 2.03[1] infra*.

(n12)Footnote 12. See *P 2.03 infra*.

(n13)Footnote 13. See cases cited in P 3.01[3][a] note 52 *infra* .

(n14)Footnote 14. 11 U.S.C. § 541(d).

(n15)Footnote 15. S. Rep. No. 95-989, 95th Cong., 2d Sess. 83-84 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n16)Footnote 16. 124 Cong. Rec. H11,096 (Sept. 28, 1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(i) (Matthew Bender 15th Ed. Revised).

(n17)Footnote 17. 124 Cong. Rec. S17,413 (Oct. 6, 1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(iii) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. *Stalford v. Lion Financial, LLC (In re Lancaster Mortg. Bankers, LLC)*, 388 B.R. 106, 59 C.B.C.2d 1696 (Bankr. D.N.J. 2008) .

(n19)Footnote 19. *Mortgage Lenders Network USA, Inc. v. Wells Fargo Bank, N.A. (In re Mortgage Lenders Network, USA, Inc.)*, 380 B.R. 131, 140 (Bankr. D. Del. 2007) .

(n20)Footnote 20. *Calyon N.Y. Branch v. Am. Home Mortg. Corp. (In re Am. Home Mortg., Inc.)*, 379 B.R. 503, 522 (Bankr. D. Del. 2008) .

(n21)Footnote 21. 11 U.S.C. § 109(b).

(n22)Footnote 22. See P 4.05 *infra*.

(n23)Footnote 23. 11 U.S.C. § 541(c)(1).

(n24)Footnote 24. 11 U.S.C. § 365.

(n25)Footnote 25. 11 U.S.C. § 541(c)(2); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 369 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n26)Footnote 26. 11 U.S.C. § 323(a).

(n27)Footnote 27. 11 U.S.C. § 1107.

(n28)Footnote 28. 11 U.S.C. § 363(b)(1).

(n29)Footnote 29. 11 U.S.C. § 363(c).

(n30)Footnote 30. 11 U.S.C. § 364c, (d).

(n31)Footnote 31. 11 U.S.C. § 542(a); section 542(a) is analyzed extensively in *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n32)Footnote 32. 11 U.S.C. § 542(c), (d).

(n33)Footnote 33. 11 U.S.C. § 543; see P 4.08 *infra*.

(n34)Footnote 34. 11 U.S.C. § 544(a)(1).

(n35)Footnote 35. This is identical to the rule under the former (pre-revision) Article 9 of the Uniform Commercial Code, section 301(1)(b).

(n36)Footnote 36. 11 U.S.C. § 544(a)(3); see *Hamilton v. Washington Mutual Bank (In re Colon)*, 563 F.3d 1171 (10th Cir. 2009) ; *In re Project Homestead, Inc.*, 374 B.R. 193 (Bankr. M.D.N.C. 2007) .

(n37)Footnote 37. *Watts Contrs., Inc. v. Watts (In re Watts Contrs., Inc.)*, 360 B.R. 489, 492 (Bankr. E.D. Va. 2007) .

(n38)Footnote 38. *Argent Mortgage Co. v. Drown (In re Bunn)*, 578 F.3d 487 (6th Cir. 2009) ; *Gordon v Terrace Mortgage Co. (In re Kim)*, 571 F.3d 1342 (11th Cir. 2009) ; *Countrywide Home Loans, Inc. v. Gardner (In re Henson)*, 391 B.R. 210 (B.A.P. 6th Cir. 2008) .

(n39)Footnote 39. See 4 *Collier Bankruptcy Practice Guide*, P 65.08 (Matthew Bender).

(n40)Footnote 40. 284 U.S. 4, 52 S. Ct. 3, 76 L. Ed. 133 (1931) .

(n41)Footnote 41. H.R. Rep. No 95-595, 95th Cong., 1st Sess. 370 (1977), *reprinted in* Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n42)Footnote 42. 11 U.S.C. § 545.

(n43)Footnote 43. 11 U.S.C. § 546(a). The section was amended in 1994 to require any action to be commenced before the earlier of either (i) the later of two years after the entry of the order for relief or one year after the appointment or election of the first trustee in the case or (ii) the time the case is closed or dismissed.

(n44)Footnote 44. 11 U.S.C. § 546(b).

(n45)Footnote 45. 11 U.S.C. § 546(c). Section 546(c) was amended by the 2005 Act to limit such reclamation rights to goods received within 45 days before the commencement of the bankruptcy case, to delete the court's option to give the seller an administrative expense claim instead of reclamation, and to provide that the reclamation rights were subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof. Pub. L. No. 109-8, § 1227 (2005), *reprinted in* Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n46)Footnote 46. 140 Cong. Rec. H10,767 (Oct. 4, 1994), *reprinted in* Vol. E-1 *Collier on Bankruptcy*, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n47)Footnote 47. *Id.*

(n48)Footnote 48. See P 2.03[1][v] *infra*.

(n49)Footnote 49. 11 U.S.C. § 547.

(n50)Footnote 50. *Id.* For an application of 11 U.S.C. § 547, see *Gordon v Novastar Mortgage, Inc. (In re Hedrick)*, 524 F.3d 1175 (11th Cir.) , *cert. denied*, 29 S. Ct. 631, 172 L. Ed. 2d 610 (2008) .

(n51)Footnote 51. 11 U.S.C. § 547(f).

(n52)Footnote 52. 11 U.S.C. § 548. The reachback period under section 548 was extended from one year to two years by the 2005 Act. Pub. L. No. 109-8, § 1402(1) (2005), *reprinted in* Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Note, however, that this change applies only to cases commenced on or after April 21, 2006. *Id.* § 1406.

(n53)Footnote 53. 11 U.S.C. § 548(b).

(n54)Footnote 54. 11 U.S.C. § 548(c). For these purposes, "value" is defined as property, or the satisfaction or

securing of a present or antecedent debt. 11 U.S.C. § 548(d)(2)(A).

(n55)Footnote 55. 11 U.S.C. § 548(d)(1).

(n56)Footnote 56. 11 U.S.C. § 549. *In re Konowitz*, 905 F.2d 55, 23 C.B.C.2d 433 (6th Cir. 1990) , and *Federal Nat'l Mortgage Ass'n v. McGowan (In re McGowan)*, 6 C.B.C.2d 829, 19 B.R. 952 (Bankr. E.D. Pa. 1982) , are examples of the application of section 549(c).

(n57)Footnote 57. 11 U.S.C. § 549(d).

(n58)Footnote 58. 11 U.S.C. § 550.

(n59)Footnote 59. 11 U.S.C. § 550(b).

(n60)Footnote 60. 11 U.S.C. § 550(e)(1).

(n61)Footnote 61. 11 U.S.C. § 550(e)(2).

(n62)Footnote 62. 11 U.S.C. § 551.

(n63)Footnote 63. 11 H.R. Rep. No 95-595, 95th Cong., 1st Sess. 376 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d) (Matthew Bender 15th Ed. Revised); 124 Cong. Rec. H11,097 (September 28, 1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f) (Matthew Bender 15th Ed. Revised).

(n64)Footnote 64. 11 U.S.C. § 554.

(n65)Footnote 65. *See P 6.04 infra*.

(n66)Footnote 66. 11 U.S.C. § 558.

(n67)Footnote 67. 11 U.S.C. § 552.

(n68)Footnote 68. 11 U.S.C. § 552(b)(1).

(n69)Footnote 69. 11 U.S.C. § 552(b)(2).

(n70)Footnote 70. 140 Cong. Rec. H10,768 (Oct. 4, 1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n71)Footnote 71. *See P 2.03[1][v] infra*.

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.07

P 1.07 The Automatic Stay and Adequate Protection

[1] Introduction

One of the most fundamental principles of the Bankruptcy Code is the creation of the automatic stay immediately upon the filing of a bankruptcy petition. The automatic stay is a statutory injunction that takes effect upon the commencement of a case under the Code.ⁿ¹ Acts taken in violation of the automatic stay are void, and an individual injured by any willful violation of the stay is entitled to recover damages, including costs and attorney's fees, and in appropriate circumstances, punitive damages.ⁿ²

The stay prohibits, among other things, the commencement or continuation of lawsuits or other judicial proceedings against the debtor, the enforcement of judgments against the debtor, acts to obtain possession of property of the estate or to exercise control over property of the estate, acts to create, perfect or enforce liens, to collect on a claim or to take a setoff on a prepetition claim. *Section 362(b)* sets forth certain exceptions to the scope of the stay. Section 362(b)(3) provides that the stay does not apply to an act to perfect, or to maintain or the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b), discussed *supra*,ⁿ³ or to the extent such act is accomplished within the periods provided under *section 547(e)(2)(A)*.ⁿ⁴ Section 362(b)(10) provides that the stay does not apply to an act by the lessor of nonresidential real property to obtain possession of the property from the debtor-lessee if the lease has terminated at its scheduled expiration date prior to or during the pendency of the debtor's Bankruptcy Code case.ⁿ⁵ Section 362(b)(18), as added by the Bankruptcy Reform Act of 1994, and as further amended by the 2005 Act, provides that the stay does not apply to prevent "the creation or perfection of a statutory lien for an ad valorem property tax, or a special tax or special assessment on real property whether or not ad valorem, imposed by a governmental unit, if such tax or assessment comes due after the date of the filing of the petition."ⁿ⁶ This section is intended to overrule decisions that had held that the automatic stay prevented local governments from attaching a statutory lien to property taxes accruing subsequent to a bankruptcy filing.ⁿ⁷ The exception set forth in section 362(b)(8) excepts from the section 362(a) stay the commencement (but not the completion) of an action by the Secretary of Housing and Urban Development to foreclose a mortgage presently or previously insured under the National Housing Act and covering five or more living units.ⁿ⁸ The imposition of the stay means that a mortgagee cannot commence (other than the Secretary of HUD) or continue a foreclosure action, sue on a note, collect on a judgment or take steps to activate an assignment of rents with respect to a Bankruptcy Code debtor. The stay further means that a landlord cannot sue a debtor-tenant for rent, or except as provided in section 362(b)(10),ⁿ⁹ commence or continue an eviction action or execute on a warrant of eviction. If read strictly, the stay also means that a

mortgagee or landlord cannot send a notice of default to a Bankruptcy Code debtor.ⁿ¹⁰ It has been held that sending a termination notice or taking other action to terminate a prime lease violates the automatic stay with respect to the debtor subtenant even though the prime tenant was itself not a debtor under the Bankruptcy Code.ⁿ¹¹

It should be noted that a number of exceptions to the automatic stay with relevance to real estate matters were added by the 2005 Act. These provisions were intended to address some of the abuse problems that Congress perceived in cases of bankruptcy filings by real estate debtors. New section 362(b)(20) provides that the stay does not apply to "any act to enforce any lien against or security interest in real property" following entry of an order for relief from the stay under new section 362(d)(4), discussed *infra*, as to such real property in any prior case under the Bankruptcy Code, for a period of two years after such order, unless the debtor can show changed circumstances or good cause shown.ⁿ¹² New section 362(b)(21) provides that the stay does not apply to "any act to enforce any lien against or security interest in real property if the debtor is ineligible under section 109(g) to be a debtor" or if the Bankruptcy Code case was filed in violation of a bankruptcy court order in a prior case prohibiting the debtor from being a debtor in another Bankruptcy Code case.ⁿ¹³ Finally, new subsections 362(b)(22) and (23) relate to certain exceptions for acts related to eviction and similar proceedings in respect of residential property in which the debtor resides as tenant.ⁿ¹⁴

The standards and procedure for obtaining relief from the stay are discussed below.ⁿ¹⁵

One of the grounds for relief from the stay is a lack of "adequate protection" of an interest in property of a nondebtor party.ⁿ¹⁶ Examples of methods by which adequate protection may be provided by a trustee are set forth in *section 361 of the Code*.ⁿ¹⁷ The concept of adequate protection is also applicable in circumstances under which the trustee will be employing property in which a nondebtor party has an interest during the period when such party is prevented by the automatic stay from taking possession of the property. Under section 363, a trustee may without notice and a hearing use, sell or lease property of the estate in the ordinary course of business, and may after notice and a hearing use, sell or lease such property outside of the ordinary course of business.ⁿ¹⁸ Any entity having an interest in such property, such as a mortgagee, may under section 363(e) request the court to condition such use, sale or leasing upon the provision by the trustee of adequate protection of such interest.ⁿ¹⁹ Under section 364, a trustee may obtain financing for the debtor's business and in certain circumstances secure such financing by a lien equal or superior in right to an existing lien on property of the estate.ⁿ²⁰ The holder of the existing lien may request adequate protection of its interest in the property to be subjected to such equal or senior lien.ⁿ²¹ It should be noted that, except in connection with the proposed use of cash collateral, the Code does not automatically invest a party in interest with adequate protection--the affected party is required to affirmatively seek such protection, and the trustee is constrained to propose one or more means of providing adequate protection. The court will function to determine whether the trustee's proposal provides adequate protection as a matter of law.ⁿ²² In a hearing for relief from the stay, the party requesting relief has the burden of proof on the issue of the debtor's equity in the subject property, but the trustee has the burden of proof on all other issues including the sufficiency of the proposed adequate protection.ⁿ²³ Similarly, in adequate protection hearings under sections 363(e) and 364(d), the trustee has the burden of proof on the issue of adequate protection.ⁿ²⁴ Under section 507(b), a party that has been given adequate protection, and that suffers a deficiency in recovery from the estate notwithstanding such protection, is entitled to a distribution before every other administrative claimant in the case.ⁿ²⁵

The term "after notice and a hearing" is given a special and substantive meaning under *section 102(1) of the Code*, with "notice" being defined as such notice as is appropriate in the particular circumstances, and with a traditional concept of a hearing being modified to mean "such opportunity for a hearing as is appropriate in the particular circumstances."ⁿ²⁶ Section 102(1)(B) authorizes an act to be done without an actual hearing if a party in interest does not timely request a hearing or there is insufficient time for a hearing and the court authorizes the act to be done. The term "after notice and a hearing," therefore, does not necessarily mean that a hearing will be held or that reasonable notice will be given to a party in interest in an emergency situation. Therefore, in the context of the use, sale or leasing of property by the trustee under section 363, or of a financing with the imposition of an equal or senior lien under section 364, "notice and a hearing" for an existing secured creditor who may desire to request adequate protection may be rather cursory in circumstances when the estate requires an immediate infusion of funds from the disposition or loan.

[2] Application to Single Asset Real Estate Debtors

One provision of the Bankruptcy Reform Act of 1994 with particular relevance to real estate transactions is an amendment to section 362(d) which makes it more difficult for a debtor to prevent relief from the stay with respect to an act against "single asset real estate."²⁷ Under newly added section 362(d)(3), relief from the stay will be granted unless within 90 days from the entry of the order for relief the debtor either (1) files a plan that has a "reasonable possibility of being confirmed within a reasonable time," or (2) begins to make monthly market rate interest payments on principal equal to the value of the secured lender's collateral. The 90-day period may be extended for cause by an order entered during that period.²⁸

The potential application of this provision was substantially broadened by an amendment to the definition of "single asset real estate" pursuant to the 2005 Act that removed the requirement that the single asset real estate debtor have secured debts of not more than \$4,000,000. As a result of the amendment, the provision is applicable to all debtors that generate substantially all of their income from the operation of real property and incidental activities. The House Report accompanying the 2005 Act is instructive in indicating its sense of Congress with respect to the single asset real estate provisions and the desire for an amendment that removed the \$4,000,000 cap:

Paragraph (5) of section 1201 [*the provision that eliminated the \$4,000,000 cap and made one other change*] concerns single asset real estate debtors. A single asset real estate chapter 11 case presents special concerns. As the name implies, the principal asset in this type of case consists of some form of real estate, such as undeveloped land. Typically, the form of ownership of a single asset real estate debtor is a corporation or limited partnership. The largest creditor in a single asset real estate case is typically the secured lender who advanced the funds to the debtor to acquire the real property. Often, a single asset real estate debtor resorts to filing for bankruptcy relief for the sole purpose of staying an impending foreclosure proceeding or sale commenced by the secured lender. Foreclosure actions are filed when the debtor lacks sufficient cash flow to service the debt and maintain the property. Taxing authorities may also have liens against the property. Based on the nature of its principal asset, a single asset real estate debtor often has few, if any, unsecured creditors. If unsecured creditors exist, they may have only nominal claims against the single asset real estate debtor. Depending on the nature and ownership of any business operating on the debtor's real property, the debtor may have few, if any, employees. Accordingly, there may be little interest on behalf of unsecured creditors in a single asset real estate case to serve on a creditors' committee.

In 1994, the Bankruptcy Code was amended to accord special treatment for single asset real estate debtors. It defined this type of debtor as a bankruptcy estate comprised of a single piece of real property or project, other than residential real property with fewer than four residential units. The property or project must generate substantially all of the debtor's gross income. A debtor that conducts substantial business on the property beyond that relating to its operation is excluded from this definition. In addition, the definition fixed a monetary cap. To qualify as a single asset real estate debtor, the debtor could not have noncontingent, liquidated secured debts in excess of \$4 million. Subparagraph (5)(A) amends the definition of 'single asset real estate' to exclude family farmers from this definition. Paragraph (5)(B) amends *section 101(51B) of the Bankruptcy Code* to eliminate the \$4 million debt limitation on single asset real estate. The present \$4 million cap prevents the use of the expedited relief procedure in many commercial property reorganizations, and effectively provides an opportunity for a number of debtors to abusively file for bankruptcy in order to obtain the protection of the automatic stay against their creditors. As a result of this amendment, creditors in more cases will be able to obtain the expedited relief from the automatic stay which is made available under *section 362(d)(3) of the Bankruptcy Code*.²⁹

Despite the apparent intent of Congress to facilitate prompt relief from the stay in the case of single asset real estate

debtors,ⁿ³⁰ it is observable by examining the recent case law that where such debtors are willing to actively oppose such motions, bankruptcy courts often have been willing to interpret both the phrasing of section 362(d)(3) itself and the structure of related section 362(e) (addressing the timing of hearings for relief from the stay) in a manner that provides such debtors with maximum flexibility to reorganize even in the face of an assertive secured creditor. For example, it has been held that the 90-day period in which the debtor must file a confirmable plan or commence interest payments is intended to represent a "breathing space" such that a creditor may not even *move* for relief from the stay on the grounds set forth in section 362(d)(3) until after such period has expired.ⁿ³¹ Other courts have used the general prefatory language in section 362, which frames the type of stay "relief" available as including the "annulling, modifying, or conditioning" of the stay, in addition to "terminating" the stay, to effectively expand the statutory requirement that the debtor actually "file" a confirmable plan of reorganization within 90 days of the order for relief. For example, in *In re Archway Apartments, Ltd.*,ⁿ³² the single asset real estate debtor failed to file a plan within the 90-day period or commence the required monthly payments, but filed a plan of reorganization shortly after such period. The court found that although the secured creditor was thereby entitled to relief from the stay under the plain language of section 362(d)(3), the appropriate type of relief was to impose on the debtor a time limit within which the late filed plan had to be confirmed, after which eventuality relief from stay would be granted outright. The court justified this exercise of its inherent discretion by noting that

[w]hile Congress may have enacted § 362(d)(3) to protect the interests of secured creditors in single asset real estate cases, it did not completely abrogate the bankruptcy court's discretion to tailor the appropriate relief for failure to strictly comply with the requirements of § 362(d)(3). The language of the statute unambiguously states that the court "*shall grant relief* from the stay provided under subsection (a) of this section, such as *by terminating, annulling, modifying, or conditioning such stay*."ⁿ³³

Similarly in *In re Hope Plantation Group, LLC*,ⁿ³⁴ the court interpreted the provisions of section 362(e), which applies to all cases (not just single asset real estate), and requires continuation of the stay prior to the conclusion of the final stay hearing if there is a "reasonable likelihood" that the debtor will prevail at the conclusion of the final hearing, as effectively modifying the "reasonable possibility" language of section 362(d)(3)(A) that is specifically applicable to single asset real estate cases, such that, prior to the final hearing, the secured creditor's motion would be denied so long as the debtor demonstrated, at the preliminary hearing, a reasonable likelihood that it could later show, at a final hearing, a reasonable possibility of confirming a plan of reorganization. In its opinion, the court implicitly conceded that it was imposing a lower standard of proof on debtors than might be implied by reading the single asset real estate provisions in isolation, but reasoned that because of the advantages provided to secured creditors thereunder, the debtor should, in the absence of other generally applicable grounds for stay relief "be given every day available to meet the requirements of the Code and prepare its case for hearing."ⁿ³⁵

In another notable and highly contested case,ⁿ³⁶ involving an entity, Scotia Pacific Company LLC ("Scopac"), with extensive ownership of timberlands in the Pacific Northwest and hundreds of millions of dollars of secured debt, whose principal activity was the harvesting and management of those timberlands for commercial exploitation, the bankruptcy court declined to treat such as an entity as a "single asset real estate" debtor. As noted, the definition of "single asset real estate" requires that the real property constitute a "single property or project" and that no substantial business be conducted on the real property other than the "business of operating the real property" and incidental activities.ⁿ³⁷ In distinguishing the activities of Scopac from the typical single asset real estate debtor, the court highlighted that (1) the timber operations were spread out over diverse watersheds of varying topographies that were treated separately by regulatory authorities, (2) the sale of timber constituted a sale of goods under state law and (3) the revenue from the entity was generated from what the court characterized as the active entrepreneurial labor of the entity's 60 employees, some with highly specialized scientific skills, rather than the passive ownership of real estate itself. Rather than simply look to the literal words of the statutory definition, the bankruptcy court chose to apply what it believed to be a practical approach to cases involving real estate:

Because there is no clear definition of single property or single project, the Court must look at the

whole business enterprise and ask "What does it look like?" If the business does not own or acquire property merely with an eye for holding it and flipping it when the market turns, or idly sit and collect rent, it cannot fit the definition of single asset real estate. Here, the business was purchased with the intent to operate it. In fact, Scopac has been operating for many years, utilizing many employees with a broad range of experience and education.ⁿ³⁸

On appeal, the Court of Appeals for the Fifth Circuit affirmed the judgment of the bankruptcy court.ⁿ³⁹ The court first noted that in order for a debtor to be considered a single asset real estate debtor or "SARE," there were three requirements: (1) the debtor must have real property constituting a single property or project (other than residential real property with fewer than four residential units); (2) such real property must generate substantially all of the gross income of the debtor; and (3) there must be no substantial business conducted on the real property other than the business of operating the real property and activities incidental thereto.ⁿ⁴⁰ Because a SARE debtor must satisfy all three prongs, the court of appeals only saw a need to address the third requirement in its decision. After reviewing the legislative history of the SARE provisions and the approaches of other courts, the court essentially endorsed the practical approach of the bankruptcy court to evaluating the nature of the debtors business:

We agree with the bankruptcy court's holding that Scopac conducts substantial business other than operating the real property and activities incidental thereto. Scopac's timberland is clearly more than a passive investment. Scopac has over sixty employees and at times hires additional independent contractors to assist in conducting its business. Sophisticated operations take place on the timberland such as planning, growing, and maintaining the timber as well as building and maintenance of roads on the real estate which constitute substantial business other than the operation of the real property and activities incidental thereto. Furthermore, Scopac's sale of timber is an activity which extends beyond the sale or lease of the underlying land.ⁿ⁴¹

The court of appeals also set out a policy rationale for applying the "single asset real estate" definition narrowly:

We are also convinced that a holding that Scopac is a SARE would violate the plain language of the statute and [be] inconsistent with the meaning (both pre- and post-1994) given that term by the courts. Section 101(51B) severely limits the class of debtors which qualify as SAREs, and we have no warrant to expand that definition. SARE debtors are carved out and subjected to stringent requirements in § 362(d)(3) which expedite the time for SARE debtors to file a plan of reorganization or commence making monthly payments, failing which the automatic stay is promptly lifted. If Scopac is considered a SARE debtor, this narrow exception to the ordinary bankruptcy process would sweep broadly and require us to include such entities as owners of land or mineral interests who operate sophisticated businesses such as mining, oil and gas drilling, and large commercial farms simply by virtue of the debtor owning the land. Such a result is obviously contrary to the plain language of § 101(51B).ⁿ⁴²

In light of the court of appeals decision in *Scopac*, it seems that courts will be extremely reluctant to expand the SARE provisions to enterprises other than those which receive their revenues overwhelmingly from the sale of, or collection of rents from, land or buildings.

These cases demonstrate that notwithstanding the expressed congressional intent of providing secured creditors with expedited remedial provisions in cases where the dominant activity is the derivation of income from real property, the courts have tended to interpret the single asset real estate provisions flexibly in order to limit its relevance to cases where the filing appears abusive notwithstanding what might otherwise appear to be the literal applicability of the statute.

In addition to removing the \$4,000,000 secured debt cap on single asset real estate debtors, as part of the 2005 Act, Congress enacted a number of other provisions intended to curb what it viewed as "abusive filings."ⁿ⁴³ One such

provision is a new section 362(d)(4), which provides a new ground for relief from the automatic stay.ⁿ⁴⁴ Under this provision, cause for relief from the automatic stay may be established for a creditor whose claim is secured by an interest in real property if the court finds that the filing of the bankruptcy case was part of a scheme to delay, hinder and defraud creditors that involved either (1) a transfer of all or part of an ownership interest in real property without such creditor's consent or without court approval or (2) multiple bankruptcy filings affecting the real property. If a creditor records an order entered under that provision in compliance with applicable state law governing notice of an interest in or a lien on real property, such order is binding in any other bankruptcy case for two years from the date of entry of such order. A debtor in a subsequent case may move for relief based upon changed circumstances or for good cause shown after notice and a hearing. The provision further provides that any federal, state or local governmental unit that accepts a notice of interest or a lien in real property, must accept a certified copy of an order entered under this provision.ⁿ⁴⁵

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 362(a).

(n2)Footnote 2. 11 U.S.C. 362(k).

(n3)Footnote 3. See P 1.06[2] *supra*.

(n4)Footnote 4. 11 U.S.C. § 362(b)(3).

(n5)Footnote 5. 11 U.S.C. § 362(b)(10).

(n6)Footnote 6. 11 U.S.C. § 362(b)(18).

(n7)Footnote 7. See, e.g., *Makoroff v. Lockport*, 916 F.2d 890 (3d Cir. 1990) ; *Lincoln Sav. Bank v. Suffolk County Treasurer (In re Parr Meadows Racing Ass'n, Inc.)*, 880 F.2d 1540 (2d Cir. 1989) , cert. denied, 493 U.S. 1058, 110 S. Ct. 869, 107 L. Ed. 2d 953 (1990) . For the legislative history further explaining this subsection, see 140 Cong. Rec. H10,771 (Oct. 4, 1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. 11 U.S.C. § 362(b)(8).

(n9)Footnote 9. See, e.g., *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala. 2003) (where court held that debtor possessed no interest in lease after falling behind on lease payments, which invalidated lease by its own terms).

(n10)Footnote 10. *In re Whitt*, 79 B.R. 611 (Bankr. E.D. Pa. 1987) ; *In re Hub of Military Circle, Inc.*, 13 B.R. 288, 288-90 (Bankr. E.D. Va. 1981) . Contra *In re Sixteen to One Mining Corp.*, 9 B.R. 636 (Bankr. D. Nev. 1981) .

(n11)Footnote 11. *In re 48th Street Steakhouse*, 835 F.2d 427, 17 C.B.C.2d 1415 (2d Cir. 1987) . But see *In re Walker*, 171 B.R. 197 (Bankr. E.D. Pa. 1994) .

(n12)Footnote 12. 11 U.S.C. § 362(b)(20).

(n13)Footnote 13. 11 U.S.C. § 362(b)(21).

(n14)Footnote 14. 11 U.S.C. § 362(b)(22), (23).

(n15)Footnote 15. See PP 2.06 and 3.01[2] *infra* .

(n16)Footnote 16. 11 U.S.C. § 362(d)(1).

(n17)Footnote 17. 11 U.S.C. § 361; see P 3.01[1][b] *infra*.

(n18)Footnote 18. *11 U.S.C. § 363(b)(1), (c)(1).*

(n19)Footnote 19. *11 U.S.C. § 363(e).* In any hearing under section 363, the trustee has the burden of proof on the issue of adequate protection, and the entity holding an interest in property has the burden of proof on the issue of validity, priority or extent of such interest. *11 U.S.C. § 363(o).*

(n20)Footnote 20. *11 U.S.C. § 364.*

(n21)Footnote 21. *11 U.S.C. § 364(d).*

(n22)Footnote 22. *See 11 U.S.C. §§ 362(d), 363(e) and 364(d)(1); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 338 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).*

(n23)Footnote 23. *11 U.S.C. § 362(g).*

(n24)Footnote 24. *11 U.S.C. §§ 363(e) and 364(d)(2).*

(n25)Footnote 25. *11 U.S.C. § 507(b).*

(n26)Footnote 26. *11 U.S.C. § 102(1).*

(n27)Footnote 27. *11 U.S.C. § 362(d)(3).* As amended, the term "single asset real estate" is defined as "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental" *11 U.S.C. § 101(51B).* As noted in the text, the 2005 Act amended the definition to remove a requirement that the single asset real estate debtor have secured debts of no more than \$4,000,000. Pub. L. No. 109-8, § 1201(5)(B) (2005), *reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).*

(n28)Footnote 28. The 90-day period was amended by the 2005 Act to provide that the period could also be extended to the date 30 days after the court determines that the debtor is subject to the provision (i.e., is a "single asset real estate" debtor). Pub. L. No. 109-8, § 444 (2005), *reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).*

(n29)Footnote 29. *See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), p. 10-418 (Matthew Bender 15th Ed. Revised).*

(n30)Footnote 30. For an example of a bankruptcy court's granting prompt relief from the stay where the secured creditor demonstrated that the case involved "single asset real estate" and in the absence of opposition from the debtor, *see Four J Funding LLC v. Land Pres., LLC (In re Land Pres., LLC), 2007 Bankr. LEXIS 2288 (Bankr. D. Conn. July 2, 2007) .*

(n31)Footnote 31. *In re Hope Plantation Group, LLC, 393 B.R. 98 (Bankr. D.S.C. 2007) ; see also In re National/Northway Ltd. P'ship, 279 B.R. 17, 22 (Bankr. D. Mass. 2002) .*

(n32)Footnote 32. *206 B.R. 463 (Bankr. M.D. Tenn. 1997 (emphasis added)).*

(n33)Footnote 33. *206 B.R. 463, 465 .*

(n34)Footnote 34. *393 B.R. 98 (Bankr. D.S.C. Jun 14, 2007) .*

(n35)Footnote 35. *See id; see also In re ACA Real Estate LLC, 2008 Bankr. LEXIS 3017 (Bankr. M.D.N.C. Nov. 12, 2008) .*

(n36)Footnote 36. *In re Scotia Dev., LLC*, 375 B.R. 764 (Bankr. D. Tex.) , *aff'd*, 508 F.3d 214, 58 C.B.C.2d 1508 (5th Cir. 2007) .

(n37)Footnote 37. 11 U.S.C. § 101(51B).

(n38)Footnote 38. 375 B.R. 764, 779 .

(n39)Footnote 39. *Ad Hoc Group of Timber Noteholders v. Pacific Lumber Co. (In re Scotia Pac. Co. LLC)*, 508 F.3d 214 (5th Cir. 2007) . The bankruptcy court's decision was appealed directly to the court of appeals pursuant to the direct certification provisions of 28 U.S.C. § 158(d)(2)(A).

(n40)Footnote 40. 508 F.3d 214, 220 .

(n41)Footnote 41. 508 F.3d 214, 224-25 .

(n42)Footnote 42. 508 F.3d 214, 225 .

(n43)Footnote 43. See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), p. 10-418 (Matthew Bender 15th Ed. Revised).

(n44)Footnote 44. 11 U.S.C. § 362(d)(4), added by Pub. L. No. 109-8, § 303 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n45)Footnote 45. *Id.*

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.08

P 1.08 Disposition of Property of the Estate

Section 363 of the Code includes several important provisions allowing for the trustee's disposition of property free of existing interests and encumbrances. Section 363(f) authorizes a sale free and clear of any interest in the subject property of an entity other than the estate (for example, a mortgage lien) if:

- (1) applicable nonbankruptcy law permits such sale free and clear of such interest;
- (2) such entity consents;
- (3) the interest is a lien and the sales price exceeds the aggregate value of all liens on the property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.ⁿ¹

The House Report states that the adequate protection requirementⁿ² applies to a sale under this section and that the most frequent means of protection will be to have the affected interests attach to the proceeds of sale.ⁿ³ Under *section 363(k) of the Code*, in a sale under section 363(b) (sale outside the ordinary course of business), the holder of a lien securing an allowed claim may bid-in the claim at the sale unless the court orders otherwise "for cause."ⁿ⁴ The House Report indicates that section 363(k) is equally applicable to a sale under section 363(f), and emphasizes that only the amount of the claim that is secured by the lien on the subject property, but not the amount of other claims that the lienholder may have against the estate, may be credited on the lienholder's bid.ⁿ⁵ Moreover, the Senate Report indicates that Congress intended for secured creditors to be able to bid the entire amount of the claim, without limitation of any independent judicial valuation of the collateral under *section 506 of the Bankruptcy Code*:

Subsection [k] also provides that where a sale of the property is proposed, an entity that has an interest in such property may bid at the sale thereof and set off against the purchase price up to the amount of such entity's claim. No prior valuation under section 506(a) would limit the bidding right, since the bid at the sale would be determinative of value.ⁿ⁶

Section 363(g) provides that notwithstanding anything in section 363(f), the trustee may sell property of the estate "free and clear of any vested or contingent right in the nature of dower or curtesy."⁷ Under section 363(h), the trustee may sell property of the estate and the interest in such property of any other tenant in common, joint tenant or tenant by the entirety if:

- (1) partition is impracticable;
- (2) sale of the estate's undivided interest would yield "significantly less" for the estate than a sale of the property free of the co-ownership interests;
- (3) the benefit to the estate of a sale free of co-ownership interests outweighs any detriment to the other co-owners; and
- (4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.⁸

Section 363(i) provides in substance for a right of first refusal for any nondebtor co-owner at a sale conducted pursuant to section 363(g) or (h).⁹ It has been held that a notice of sale of property that fails to disclose a section 363(i) right of first refusal is defective and that a new sale would be conducted after a corrected notice was published.¹⁰ If the right of first refusal is not exercised, section 363(j) requires the trustee to distribute to the co-owners in accordance with their interests the net proceeds of sale exclusive of any deduction for any compensation of the trustee.¹¹

Section 363(m) provides that the reversal or modification on appeal of a court order authorizing a sale or leasing transaction outside the ordinary course of business does not affect the validity of the sale or lease to an entity that purchased or leased the property "in good faith," whether or not such entity knew of the appeal.¹² A stay pending appeal will of course affect the validity of any sale or lease effected in contravention thereof.

Section 363(n) empowers the trustee to avoid any sale at which the price was affected by collusive bidding, to recover any deficiency in price caused by such bidding, and related attorney's fees and expenses, and to seek punitive damages.¹³

Section 364 deals with financing for the business of the debtor, and authorizes the trustee to obtain unsecured credit or to incur unsecured debt in the ordinary course of business, and after notice and a hearing, outside the ordinary course of business, as an allowed administrative expense. The section also permits secured borrowings by the trustee by authorizing the creation of a lien securing such indebtedness junior, equal or prior in right to existing liens on property of the estate, with adequate protection to be accorded to existing lienholders in the case of equal or senior liens.¹⁴ The reversal or modification of a court order authorizing the creation of a section 364 priority or lien does not affect the validity thereof for proceeds actually disbursed unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.¹⁵

Section 365 deals primarily with the rejection, assumption and assignment of executory contracts and unexpired leases,¹⁶ and is of central importance to the subject of this book. The section authorizes the assumption of contracts and leases that are in default, makes provision for the cure of such defaults, prohibits termination of contracts and leases by reason of the debtor's financial condition or its Bankruptcy Code filing, and provides for assignment to third parties of contracts and leases.¹⁷ In a monumental amendment to section 365, the 2005 Act required that debtors assume or reject an unexpired lease of nonresidential real property no later than 120 days following the order for relief, with a provision for a single extension by the court for an additional 90 days. Any additional extension requires the lessor's consent.¹⁸ Section 365(h) provides certain protections for real property lessees upon the rejection of a lease by the lessor's trustee, and for the holders of timeshare interests upon the rejection of a timeshare plan by the timeshare vendor.¹⁹ Section 365(i) provides certain protections to contract vendees in possession of real property upon the

rejection of a contract by the vendor's trustee.ⁿ²⁰ Section 365(n) provides certain protections to intellectual property licensees upon the rejection of an intellectual property license by the licensor's trustee.ⁿ²¹ These and other provisions on section 365 warrant consideration of certain drafting changes in contracts, leases and leasehold mortgages.ⁿ²²

Section 365 should be read in conjunction with *section 108(b) of the Code*, which extends to 60 days after the order for relief any contractual grace period that is running at the time of entry of the order for relief (unless the contractual grace period has by its terms more than 60 days to run after the order for relief).ⁿ²³ Thus, while section 365(b) provides for an opportunity by the trustee to cure contract or lease defaults, section 108(b) extends the period before which the default is deemed to have occurred.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 363(f)*; see *In re MMH Automotive Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008) (where the court held that where a trustee was actually aware of an unrecorded lease, the lessee was entitled to notice of the sale of debtor's property; court held that a completed sale did not cut off rights of person entitled to notice but did not receive it, and because the lease had a cash-out option, sections 363(f) and 365(h) were satisfied by the affirmance of the sale order free and clear, which gave the lessee a claim for the cash-out option amount).

(n2)Footnote 2. See P 1.07 *supra*.

(n3)Footnote 3. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 345 (1977) ("House Report"), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. *11 U.S.C. § 363(k)*. For an example of a case where the bankruptcy court found sufficient "cause" to prevent the secured lender from credit bidding, see *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994) .

(n5)Footnote 5. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 309 (1977) at 345-46.

(n6)Footnote 6. S. Rep. No. 95-989, 95th Cong., 2d Sess. 55 (1978), reprinted in Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *11 U.S.C. § 363(g)*.

(n8)Footnote 8. *11 U.S.C. § 363(h)*.

(n9)Footnote 9. *11 U.S.C. § 363(i)*.

(n10)Footnote 10. *In re Fehl*, 6 C.B.C.2d 533, 19 B.R. 310 (Bankr. N.D. Cal. 1982) ; *In re Alisa P'ship*, 14 B.R. 54 (Bankr. D. Del. 1981) ; see also *In re Hat*, 310 B.R. 752 (Bankr. E.D. Cal. 2004) .

(n11)Footnote 11. *11 U.S.C. § 363(j)*.

(n12)Footnote 12. *11 U.S.C. § 363(m)*.

(n13)Footnote 13. *11 U.S.C. § 363(n)*.

(n14)Footnote 14. *11 U.S.C. § 364*.

(n15)Footnote 15. *11 U.S.C. § 364(e)*; *In re Swedeland Dev. Group, Inc.*, 16 F.3d 552 (3d Cir. 1994) . In *In re EDC Holding Co.*, 676 F.2d 945, 6 C.B.C.2d 882 (7th Cir. 1982) , the grant of a section 364 loan priority was reversed, and the lender was deprived of the priority to the extent that a portion of the loan proceeds was used to effect an improper distribution by the debtor. In *In re Saybrook*, 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992) , the court held that since "cross collateralization" of prepetition loans with a lien granted under section 364 is not authorized under section 364, such lien could be invalidated even though there was no stay pending appeal.

(n16)Footnote 16. *11 U.S.C. § 365*.

(n17)Footnote 17. *See P 3.01[5]-[7] infra*.

(n18)Footnote 18. *11 U.S.C. § 365(d)(4)*, as amended by Pub. L. No. 109-8, § 404 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The legislative history makes clear that the amendment was intended "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected." *See* H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-354 (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. *11 U.S.C. § 365(h)*.

(n20)Footnote 20. *11 U.S.C. § 365(i)*; *see P 4.01[1] infra*.

(n21)Footnote 21. *11 U.S.C. § 365(n)*.

(n22)Footnote 22. *See PP 2.01, 3.06 and 4.02 infra* .

(n23)Footnote 23. *11 U.S.C. § 108(b)*.

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.09

P 1.09 Claims Against the Estate

Under the Code, a creditor is permitted to file a proof of claim, and an equity security holder to file a proof of interest.ⁿ¹ A proof of claim or interest in a chapter 11 case is deemed filed if the liability to the creditor or equity security holder appears on the debtor's schedules filed with the court and is not listed as disputed, contingent or unliquidated.ⁿ² Under Bankruptcy *Rule 1009*, a schedule in a voluntary case may be amended on notice to any entity affected thereby. Thus, a claim originally scheduled may later be scheduled as disputed, contingent or unliquidated, but such amendment will be effected on notice to the claimant to facilitate the filing by the claimant of a proof of claim or interest. Nevertheless, the better practice is to file a proof of claim or interest in any circumstance in which the claimant does not have an overriding requirement to avoid the jurisdiction of the court.ⁿ³

The term "claim" is defined in section 101 as a:

(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; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.ⁿ⁴

The broad scope of the definition is intended to authorize the court to deal with as many liabilities of the debtor as possible in order to effect a meaningful discharge for the debtor. Thus, the court is directed to liquidate contingent and unliquidated claims. The language relating to equitable remedies appears to contemplate the conversion when possible of equitable relief into monetary damages in view of the general unavailability of specific performance and similar equitable remedies to claimants in Bankruptcy Code cases.ⁿ⁵

A filed claim or interest is deemed "allowed" unless objected to by a party in interest, including a general partner of a partnership debtor in a chapter 7 case.ⁿ⁶ Under section 502(b), certain claims are not allowable, including claims for unmatured interest and claims for taxes assessed against property of the estate in excess of the value of the estate's interest in the property.ⁿ⁷

Under section 502(b)(6), the claim of a lessor for damages arising from the rejection of a real property lease is not allowable in an amount in excess of (A) the rent reserved in the lease, without acceleration, for the greater of one year,

or 15 percent of the remaining term of the lease (but not to exceed three years rent), with the time periods commencing on the earlier of (i) the date of filing of the lessee's Bankruptcy Code petition or (ii) the date of repossession or surrender of the premises, plus (B) past due rent as of the earlier of the dates specified in clauses (i) and (ii).ⁿ⁸ This highly significant limitation on recovery should be taken into account in structuring mortgage transactions based upon underlying leases and sale-leaseback transactions.ⁿ⁹ This limitation is inapplicable to the claim of a nondebtor lessee arising from the rejection of a real estate lease by the lessor's trustee. Moreover, the Bankruptcy Code does not limit damages with respect to the rejection of contracts for sale or other real estate related agreements.

The rejection of a contract or lease is deemed under sections 365(g) and 502(g) to occur prior to the filing of the petition, except in the case of a rejection of a contract or lease which had been assumed and later rejected.ⁿ¹⁰ The claim for damages arising from the rejection is a general unsecured claim, except the claim arising from the rejection of a previously assumed agreement is allowable as an expense of administration.ⁿ¹¹ Under a 2005 amendment to the Bankruptcy Code, the administrative expense claim arising from the rejection of a "previously assumed" nonresidential lease is limited in amount to a sum equal to all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises, and the claim for the remaining sums due for the balance of the term is a non-administrative claim limited under section 502(b)(6).ⁿ¹² The effect of this limitation is to somewhat mitigate the potential adverse impact on debtors of the amendment to section 365(d)(4), discussed *supra*, requiring the debtor to make a determination on whether to assume or reject the lease no later than 210 days following the petition date without the lessor's consent. As noted, this limitation on administrative expense claims, by its terms, only applies to "previously assumed" leases. It would appear that this amendment does not apply to entirely new postpetition leases entered into by the debtor. It is possible that this distinction may result in a situation whereby, in cases in which the landlord and debtor desire to consensually modify a lease (for example to change the term or the rent) in connection with an assumption, the parties will simply terminate the old lease and enter into an entirely new postpetition leases, rather than amend the prepetition lease and assume the original lease as modified.

Section 503 provides for the allowance of administrative claims, including the actual, necessary costs and expenses of preserving the estate, claims for compensation of professionals and claims relating to the actual and necessary expenses incurred by a creditor, an indenture trustee, an equity security holder or an unofficial committee in making a substantial contribution in a chapter 9 or chapter 11 case.ⁿ¹³ Section 503 also treats as an administrative expense any taxes incurred by the estate, whether secured or unsecured, including property taxes for which liability is in rem, in personam or both, except for certain taxes on income incurred before the commencement of the case.ⁿ¹⁴ One important consequence of administrative expense treatment, aside from priority ahead of general unsecured claims, is the requirement for confirmation of a chapter 11 plan that all administrative expenses be paid in full, unless the claim holder agrees otherwise.ⁿ¹⁵ Section 505 permits the court, subject to certain exceptions, to determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction. Section 506 deals with claims of secured creditors.ⁿ¹⁶ Section 506(a) in substance creates a "split claim" for secured creditors, with a secured claim allowed to the extent of the "value of such creditor's interest in the estate's interest in such property" (the value of the collateral) and with an unsecured claim allowed for the balance. However, it should be noted that in a chapter 11 case *section 1111(b) of the Bankruptcy Code* allows a secured creditor to avoid the bifurcation of its claim into secured and unsecured components by making an election to have the claim treated as a secured claim to the full extent of the claim, notwithstanding section 506(a).ⁿ¹⁷ The procedures, including the timing, for making such the section 1111(b) election are set forth in *Bankruptcy Rule 3014*.ⁿ¹⁸

Under section 506(b), a fully secured creditor is entitled to interest, and to reasonable fees, costs and charges provided for in the agreement creating the lien.ⁿ¹⁹ Section 506(c) empowers the trustee to recover from collateral the reasonable and necessary costs and expenses of preserving or disposing of the collateral to the extent of the benefit to the secured party.ⁿ²⁰ The United States Supreme Court settled a split among various courts of appeals and ruled that only the trustee (or a debtor in possession) is authorized to bring an action under section 506(c) and that a creditor that had a claim against the estate in connection with costs incurred to preserve collateral lacked standing under the statute to

recover those costs from the secured creditor.ⁿ²¹ Section 506(d) provides that a lien is void to the extent that it secures a claim against a debtor that is not an allowed secured claim.ⁿ²² However, the United State Supreme Court has expressly held that a lien may not be "stripped" in a chapter 7 case down to the value of the collateral so as to permit the debtor, thereafter, to redeem the property for the amount of such valuation and capture the benefit of any appreciation in value occurring prior to the redemption.ⁿ²³

The priorities of distribution are set forth in section 507. That section provides for a second priority for administrative expenses (subject to the "superpriority" under section 507(b) arising from the failure of adequate protection)ⁿ²⁴ and includes special priorities for so-called "gap" claims arising after the commencement of an involuntary case, but before the entry of an order for relief, as well as for wages, salaries and commissions (including vacation, severance and sick pay), contributions to employee benefit plans, certain consumer deposits and certain taxes, including property taxes assessed before the commencement of the case and last payable without penalty no more than one year before the petition date.ⁿ²⁵ Section 508 sets forth an order of distribution in a domestic case if a creditor recovers on a claim in a foreign proceeding, or recovers from a nondebtor general partner before other creditors have recovered from the debtor partnership.ⁿ²⁶ Section 509 and Bankruptcy *Rule 3005* deal with claims of codebtors and the subrogation of a codebtor to the rights of a creditor, including subordination of a codebtor's claim against the other codebtor until the primary creditor has received full satisfaction.ⁿ²⁷

Section 510(a) provides for the enforcement of subordination agreements that are also enforceable under state law.ⁿ²⁸ Thus, a senior creditor, including a senior lienholder, may obtain in the bankruptcy court provision for payment of funds otherwise payable by the estate to a subordinated creditor. This provision recognizes the efficacy of general "subordination agreements" between different creditors, which agreements delineate the relative priority of such creditors regarding the allocation of specified distributions from a debtor or from the proceeds of a mortgaged property of a debtor as between the creditors that are party to the agreement, but it is an open question on whether section 510(a) applies to other provisions that are often contained in more complex intercreditor agreements that are typically executed in connection with complex financing transactions. Section 510(b) provides for the subordination of claims arising from the rescission of or damages arising from the purchase or sale of a security of the debtor.ⁿ²⁹ Section 510(c) embodies the principal of equitable subordination of claims and interests, and provides that a lien securing an equitably subordinated claim may be transferred to the estate.ⁿ³⁰

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 501(a)*.

(n2)Footnote 2. *11 U.S.C. § 1111(a)*.

(n3)Footnote 3. *See P 1.14[2] infra*.

(n4)Footnote 4. *11 U.S.C. § 101(5)*.

(n5)Footnote 5. *See 11 U.S.C. § 502(c); P 4.01[1] infra*.

(n6)Footnote 6. *11 U.S.C. § 502(a)*.

(n7)Footnote 7. *11 U.S.C. § 502(b)(1)-(9)*.

(n8)Footnote 8. *11 U.S.C. § 502(b)(6); see P 3.03[2] infra* for a discussion of the difficulties encountered in applying the formulation prescribed in section 502(b)(6).

(n9)Footnote 9. *See P 2.02 infra*.

(n10)Footnote 10. *11 U.S.C. §§ 365(g) and 502(g)*.

(n11)Footnote 11. *In re Klein Sleep Prods., Inc.*, 78 F.3d 18 (2d Cir. 1996) ; see also *Devan v. Simon DeBartolo Group, L.P.* (*In re Merry-Go-Round Enterprises, Inc.*), 180 F.3d 149, 42 C.B.C.2d 218 (4th Cir. 1999) ; *In re City Stores Co.*, 21 B.R. 809 (Bankr. S.D.N.Y. 1982) ; P 3.02 *infra* with respect to postpetition obligations for rent under nonresidential real property leases.

(n12)Footnote 12. 11 U.S.C. § 503(b)(7), added by Pub. L. No. 109-8, § 445 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n13)Footnote 13. 11 U.S.C. § 503.

(n14)Footnote 14. 11 U.S.C. § 503(b)(1)(B). Thus, a capital gains tax arising from a postpetition sale of property of the estate is an administrative expense. *In re Dawes*, 382 B.R. 509, 519 (Bankr. D. Kan. 2008) ; *In re Scott Cable Communications*, 227 B.R. 596, 600 (Bankr. D. Conn. 1998) . But see *In re Whall*, 391 B.R. 1 (Bankr. D. Mass. 2008) (where the bankruptcy court rejected a debtor's claim for unpaid postpetition income taxes as an administrative expense of the estate in his chapter 13 plan).

(n15)Footnote 15. 11 U.S.C. § 1129(a)(9)(A).

(n16)Footnote 16. 11 U.S.C. § 506.

(n17)Footnote 17. 11 U.S.C. § 1111(b).

(n18)Footnote 18. *Fed. R. Bank. P. 3014*.

(n19)Footnote 19. See P 2.02[2][b] *infra*. Postpetition interest on oversecured claims is allowable to the holders of nonconsensual as well as consensual liens, *United States v. Ron Pair Enters.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989) .

(n20)Footnote 20. See P 2.03[1] note 20 *infra*.

(n21)Footnote 21. *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942 (2000) .

(n22)Footnote 22. 11 U.S.C. § 506(d).

(n23)Footnote 23. *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903, 25 C.B.C.2d 1297 (1992) ; see also *Nobelman v. American Sav. Bank*, 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228, 28 C.B.C.2d 977 (1993) (chapter 13 debtor may not use section 506(a) to strip down claim secured by debtor's principal residence). The Bankruptcy Reform Act of 1994 changed section 1123(b) of the Code to bar modification of a mortgage covering only the principal residence of an individual chapter 11 debtor. 11 U.S.C. § 1123(b)(6).

(n24)Footnote 24. The 2005 Act established domestic support obligations as the first priority. Pub. L. No. 109-8, § 212 (2005). Before the 2005 Act, administrative expenses were accorded the highest priority and domestic support obligations were granted seventh priority.

For cases addressing the priority of support obligations, see, e.g., *In re Williams*, 387 B.R. 211 (Bankr. N.D. Ill. 2008) ; *Wisconsin Dep't of Workforce Development v. Ratliff*, 59 C.B.C.2d 1429, 390 B.R. 607 (E.D. Wis. 2008) ; *In re Sanders*, 55 C.B.C.2d 1891, 341 B.R. 47 (Bankr. N.D. Ala.) , *aff'd*, 347 B.R. 776 (N.D. Ala. 2006) .

(n25)Footnote 25. 11 U.S.C. § 507.

(n26)Footnote 26. 11 U.S.C. § 508.

(n27)Footnote 27. *11 U.S.C. § 509.*

(n28)Footnote 28. *11 U.S.C. § 510(a).*

(n29)Footnote 29. *11 U.S.C. § 510(b).*

(n30)Footnote 30. *11 U.S.C. § 510(c).*

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.10

P 1.10 Chapter 7 Cases

Chapter 7 is the liquidation chapter of the Code. In a chapter 7 case an interim and then a permanent trustee will be appointed to liquidate and account for the estate.ⁿ¹ A creditor's committee may be elected in a chapter 7 case.ⁿ²

Chapter 7 includes several important rules concerning distributions in partnership cases. If a deficiency in the partnership's estate exists, the trustee is required to first seek recovery from general partners who are not debtors in cases under the Code.ⁿ³ The court is empowered to reach out and administer the affairs of a nondebtor general partner to better assure recovery by the estate, to the extent that the court may order a nondebtor partner "to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from such partner, or not to dispose of property."ⁿ⁴ The nondebtor general partner, if personally liable on the claim with respect to which a deficiency exists, is liable to the estate "to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency."ⁿ⁵ The quoted language was added by the Bankruptcy Reform Act of 1994 in replacement of the phrase "for the full amount of the deficiency." The House Report accompanying the Bankruptcy Reform Act of 1994 noted that the change was aimed at addressing the issue of partner liability under the limited liability partnership form of legal entity that had been authorized by a number of states since the advent of the Bankruptcy Code in 1978.ⁿ⁶ According to the report, the language was intended to clarify that a partner in a limited liability partnership would only be liable in bankruptcy to the extent a partner would be personally liable for the deficiency under the applicable limited liability statute.

The Code does not limit the liability of an entity that became a general partner subsequent to the inurrence by the partnership of its liabilities.ⁿ⁷ Under section 723(c), the partnership's trustee may recover from the estate of a partner that is also a Bankruptcy Code debtor on a parity with the nonpartnership creditors of such partner.ⁿ⁸ This provision discards the so-called "jingle rule" in effect under the former Bankruptcy Act, which created a priority for the nonpartnership creditors of a bankrupt general partner.ⁿ⁹

Although not expressly stated in chapter 7, the assets of an estate will first be distributed to the holders of allowable secured claims on those assets. However, the trustee may avoid a lien which secures payment of a fine, penalty, forfeiture or multiple, exemplary or punitive damages, to the extent that the foregoing do not provide compensation for "actual pecuniary loss."ⁿ¹⁰ If a tax lien exists on real or personal property of the estate, certain unsecured priority creditors are given the benefit of the tax lien in lieu of the taxing authority.ⁿ¹¹

Distributions to unsecured creditors in chapter 7 cases are made, first, to the holders of administrative claims and other priority creditors provided for in section 507ⁿ¹² who have timely filed a proof of claim or tardily filed before the earlier of the date that is 10 days after the mailing to creditors of the summary of the trustee's final report or the commencement of final distribution; second, to holders of allowed unsecured claims who have timely filed proofs of claim and holders who without notice or actual knowledge of the case have filed late (but in time to receive a distribution); third, to the holders of allowed unsecured claims who have filed late; fourth, to the holders of noncompensatory claims for a fine, penalty or forfeiture, or for multiple, exemplary or punitive damages; fifth, to the payment of interest at the legal rate on the foregoing claims; and sixth, to the debtor.ⁿ¹³ If a case has been converted from chapter 11 or 13 to a chapter 7 case, chapter 7 administrative expenses have priority over the administrative expenses in the chapter 11 or 13 case.ⁿ¹⁴

The provisions regarding discharge in a chapter 7 case are set forth in section 727, including the bases for denying discharge.ⁿ¹⁵ One reason for denying a discharge is if the debtor is not an individual.ⁿ¹⁶ If a discharge is granted, its effect is set forth in section 524(a).ⁿ¹⁷ That section provides, among other things, that a Bankruptcy Code discharge voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor and operates as an injunction against the commencement or continuation of an action, the employment of process, or an act to collect, recover or offset any debt as a personal liability of the debtor.ⁿ¹⁸ It is important to note that the discharge only affects the personal liability of the debtor. Although not expressly stated in section 524 or anywhere in chapter 7, it is well established that a chapter 7 discharge of the debtor will not impair the lien created by a mortgage of debtor's property and that the right of a creditor to proceed in rem against the property in which the creditor has a lien, as distinguished from the creditor's right to recover against the debtor personally, is not affected by the discharge.ⁿ¹⁹

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. §§ 701 and 702.

(n2)Footnote 2. 11 U.S.C. § 705.

(n3)Footnote 3. 11 U.S.C. § 723(b).

(n4)Footnote 4. 11 U.S.C. § 723(b).

(n5)Footnote 5. 11 U.S.C. § 723(a).

(n6)Footnote 6. 140 Cong. Rec. H10, 767-68 (daily ed. Oct. 4, 1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filling in the Interstices*, 56 N.Y.U. L. Rev. 1173, 1179 n.29 (1981).

(n8)Footnote 8. 11 U.S.C. § 723(c).

(n9)Footnote 9. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 200 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n10)Footnote 10. 11 U.S.C. § 724(a).

(n11)Footnote 11. 11 U.S.C. § 724(b).

(n12)Footnote 12. The 2005 Act established domestic support obligations as the first priority. Pub. L. No. 109-8, § 212 (2005). Before the 2005 Act, administrative expenses were accorded the highest priority and domestic support obligations were granted seventh priority. Administrative expenses now have the second highest priority. 11 U.S.C. §

507(a)(2).

(n13)Footnote 13. 11 U.S.C. § 726(a).

(n14)Footnote 14. 11 U.S.C. § 726(b).

(n15)Footnote 15. 11 U.S.C. § 727.

(n16)Footnote 16. 11 U.S.C. § 727(a)(1).

(n17)Footnote 17. 11 U.S.C. § 524.

(n18)Footnote 18. 11 U.S.C. § 524.

(n19)Footnote 19. See, e.g., *Dewsnup v. Timm*, 502 U.S. 410, 418, 112 S. Ct. 773, 116 L. Ed. 2d 903, 25 C.B.C.2d 1297 (1992); *Johnson v. Home State Bank*, 501 U.S. 78, 82, 84, 111 S. Ct. 2150, 115 L. Ed. 2d 66, 24 C.B.C.2d 1171 (1991) ("a creditor's right to foreclose on the mortgage survives or passes through the bankruptcy"; "a bankruptcy discharge extinguishes only one mode of enforcing a claim--namely, an action against the debtor in personam--while leaving intact another--namely, an action against the debtor in rem"); *Long v. Bullard*, 117 U.S. 617 (1886); see also 4 *Collier on Bankruptcy* 524.02 (15th ed. 1999); H.R. Rep. No 95-595, 95th Cong., 1st Sess. 361 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.11

P 1.11 Chapter 11 Cases

[1] Introduction

Chapter 11, entitled "Reorganization," is the only business rehabilitation chapter of the Code. Although nonbusiness entities, including individuals,ⁿ¹ may qualify for relief under chapter 11, the chapter is typically utilized by business entities seeking to reorganize their capital structure, or otherwise arrange and distribute their assets to the business's stakeholders in a manner that is generally more flexible than the requirements of chapter 7. Chapter 11 can also be utilized to facilitate the liquidation of asset and distribution of proceeds without any reorganization of the business.ⁿ²

In all chapter 11 cases, except for a case in which a debtor is a "small business," the statute mandates that the United States trustee appoint a creditors' committee and such additional committees of creditors or equity security holders as the United States trustee deems appropriate.ⁿ³ A committee of creditors ordinarily consists of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee.ⁿ⁴ In addition, on request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if "necessary to assure adequate representation of creditors or equity security holders"ⁿ⁵ In such a situation, the United States trustee appoints the members of any such committees that are ordered by the court.ⁿ⁶ Section 1102 was amended by the 2005 Act to provide that the court may also, on request of a party in interest, order the United States trustee to change the membership of the committee if a determination is made that the change is necessary to ensure adequate representation of creditors or equity security holders.ⁿ⁷

In general, under chapter 11, the debtor is authorized to run its affairs as a debtor in possession.ⁿ⁸ In certain circumstances, including fraud, dishonesty, incompetence or gross mismanagement of the debtor's affairs, a trustee for the estate may be appointed or elected.ⁿ⁹ If no trustee is appointed, the court, in certain circumstances, may order the appointment of an examiner to investigate the debtor and its business and affairs.ⁿ¹⁰

Under *section 1112(b) of the Code*, the court on request of a party in interest shall dismiss a chapter 11 case or convert a chapter 11 case to a case under chapter 7 for cause, including substantial or continuation loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation and the unauthorized use of cash collateral substantially harmful to one or more creditors.ⁿ¹¹

Although not specifically enumerated in section 1112, a finding of a bad faith filing has also been held to constitute

cause for dismissal of a chapter 11 case. These holdings generally have been rendered in single-asset real estate cases that are filed on the eve of foreclosure and without prospects for the debtor's reorganization, particularly in so called "new debtor" situations in which an entity transfers its encumbered property to a newly formed corporation simply to file a chapter 11 petition with no meaningful prospect of reorganization.ⁿ¹² In a non-real estate case, the Court of Appeals for the Third Circuit held that a chapter 11 filing must be made for a valid reorganizational purpose and upheld the dismissal of a case for "cause" pursuant to section 1112(b) where the debtor filed its chapter 11 petition to obtain a tactical advantage in pending antitrust litigation.ⁿ¹³

[2] Plans and Confirmation Under Chapter 11

One of the seminal features of chapter 11 is the concept of a "plan," which if approved by the bankruptcy court pursuant to the requirements of the chapter, including the vote of creditors and equity holders, becomes binding on the debtor and its stakeholders. If the debtor has not filed a plan within 120 days after the entry of an order for relief or if a trustee has been appointed, or if a plan of the debtor has not been accepted within 180 days after the entry of the order for relief, any party in interest may file a plan.ⁿ¹⁴ The 120-day and 180-day periods may be expanded or contracted by the court, but the 120-day period may not be extended beyond a date that is 18 months after the date of the order for relief and the 180-day period may not be extended beyond 20 months.ⁿ¹⁵ A decision to extend or reduce the exclusive periods can be appealed to the district court on an interlocutory basis.ⁿ¹⁶ Prior to the 2005 Act, there was no statutory limitation on the ability of the court to expand the exclusive periods, and in practice, a number of bankruptcy courts routinely granted extensions of the periods--sometimes lasting for many years--in the cases of large debtors. That practice is substantially curtailed for cases commenced after October 17, 2005, by reason of the amendments to the provision under the 2005 Act that limit the extension of the 120-day and 180-day periods to 18 months and 20 months, respectively.ⁿ¹⁷

Of primary concern to real estate related creditors is the treatment of secured claims in a chapter 11 plan. If a class of creditors is "unimpaired" in a plan, that class is deemed to have accepted the plan.ⁿ¹⁸ Under *section 1124 of the Code*, a class will be unimpaired if the plan:

- (1) "leaves unaltered the legal, equitable and contractual rights" of the claims or interests of the class; or
- (2) provides for a cure of outstanding defaults in respect of and reinstates the maturity of the claims or interests in the class, compensates the members of the class for damages incurred in reasonable reliance upon any breached contractual obligation, compensates the members of the class for any actual pecuniary loss incurred by such member as a result of the failure to perform a nonmonetary obligations, and otherwise leaves unaltered the legal, equitable and contractual rights of the class.ⁿ¹⁹

If a class of creditors is impaired, the class may accept the plan by affirmative vote of at least two-thirds in amount and more than one-half in number of the voting creditors in that class.ⁿ²⁰ Solicitation of votes must be effected through a disclosure statement complying with the requirements of section 1125.ⁿ²¹

Section 1129(a) sets forth the standards for the consensual confirmation of a chapter 11 plan, including acceptance by or nonimpairment of each class of creditors and interests, with at least one class of impaired claims (determined without including any acceptance of the plan by any insider) having accepted the plan.ⁿ²² Under section 1129(a)(7), each member of an accepting class must either vote in favor of the plan or be entitled to receive or retain property having a value not less than the value which such member would have received in a liquidation of the estate under chapter 7 (the "best interests standard").ⁿ²³ Before the enactment of the 1984 Amendments, an issue arose as to whether a creditor in an unimpaired class which would receive greater value on liquidation might assert the best interests standard to prevent confirmation of an accepted plan,ⁿ²⁴ and as to whether the requirement for at least one class of claims to have accepted the plan meant acceptance by affirmative vote or a "deemed acceptance" by nonimpairment.ⁿ²⁵

The first issue was resolved in an amendment to section 1129(a)(7), which makes the best interests standard applicable

only to each *impaired* class of claims.ⁿ²⁶ The second issue was resolved in an amendment to section 1129(a)(10) providing that at least one class of impaired claims (determined without including any acceptance of the plan by any insider) must accept a plan if any impaired classes are in the plan.ⁿ²⁷

Section 1129(a)(9) requires that all administrative creditors be paid in full in cash on the effective date of the plan and provides certain minimum treatments for other priority claims, in each case unless the creditor agrees to a different treatment.ⁿ²⁸ Section 1129(a)(11) provides a final confirmation standard to the effect that confirmation is not likely to be followed by liquidation except in the case of a liquidating plan.ⁿ²⁹ This standard is sometimes referred to as the "feasibility test."

A plan may be "crammed down" over the objection of dissenting classes if it complies with section 1129(b). A dissenting and impaired class may not prevent confirmation if the plan meets all requirements of section 1129(a) other than acceptance or nonimpairment of all classes, does not discriminate unfairly, and is fair and equitable. Section 1129(b)(2)(A) specifies that "fair and equitable," as applied to a class of secured claims, includes (1) retention by each member of the class of its lien and receipt of deferred cash payments totalling the allowed amount of the secured claim of such lienholder, with such deferred cash payments having a present value not less than the value of the collateral; or (2) sale of the collateral free of liens under section 363(k),ⁿ³⁰ with the liens to attach to the proceeds; or (3) realization of the "indubitable equivalent" of the secured claims.ⁿ³¹

Under section 506(a), the holders of liens that are not fully secured will receive "split claims" in the form of a secured claim to the extent of the value of the collateral and an unsecured claim for the balance.ⁿ³² In *In re Rash*, the Supreme Court ruled that for purposes of a plan under chapter 13, which includes a secured claim cramdown provision, section 1325(a)(5), that is similar in language to section 1129(b), the collateral is to be valued under section 506(a) at its replacement value, which the Court defined as the price a willing buyer in the debtor's trade, business or situation would pay a willing seller to obtain property of like age and condition and for the same use contemplated by the debtor.ⁿ³³ The *Rash* methodology has been followed in the chapter 11 context.ⁿ³⁴ In the case of individual debtors under chapter 7 or chapter 13, the *Rash* holding has been codified in a new section 506(a)(2), added by the 2005 Act.ⁿ³⁵

The outcome of any judicially determined valuation will have a significant effect on the secured creditor's treatment. If the collateral is given a relatively low value, and a plan is confirmed under section 1129(b), then a recourse secured creditor, without more, may be compelled to retain a lien securing a relatively low amount and be relegated to unsecured creditor status for the balance. Moreover, if the debtor is to retain possession of the collateral under the plan, the secured creditor will have been denied its state law rights to realize on the collateral by foreclosure or other proceeding, and to bid-in its debt at sale in the hope that the collateral will one day appreciate. The Code seeks to redress this inequity by providing, in section 1111(b), that a class of undersecured creditors may elect to be treated as fully secured notwithstanding the split-claim approach of section 506(a) and notwithstanding that such creditors may have held nonrecourse obligations.ⁿ³⁶ This means, for example, that a nonrecourse mortgage creditor may elect in a cramdown situation to be deemed fully secured, and to retain its lien for the full face amount of its outstanding mortgage debt. However, as noted above, the present value of the payout schedule on the mortgage debt will not exceed the value of the collateral as of the effective date of the plan. A potential issue arises in each case as to the discount rate to be employed to compute the present value of the deferred cash payments.ⁿ³⁷

If a class of nonrecourse secured creditors does not elect fully secured status, then under section 1111(b) such creditors will have claims that are treated as recourse claims. Under section 506(a), the deemed recourse claim will be a secured claim to the extent of the value of the collateral, and a general unsecured claim for the deficiency.ⁿ³⁸ A class of secured creditors may not, under section 1111(b), elect fully secured status if the value of the collateral is inconsequential, or a claimant has recourse and the collateral is to be sold under section 363 or under the plan.ⁿ³⁹ Under *Bankruptcy Rule 3014*, the section 1111(b)(2) election may be made at any time prior to conclusion of the hearing on the disclosure statement or within such later time fixed by the court.

The fair and equitable test has two other significant elements: *first*, there can be no distribution to or value for a junior class unless each dissenting senior class has received one hundred percent on its allowed claims; and *second*, no class may receive more than one hundred percent on its allowed claims.ⁿ⁴⁰ This is the "absolute priority" rule. Application of the foregoing requirements to a real estate partnership that is a debtor under the Code means that the partners cannot in their capacities as partners retain an equity interest in the partnership property if a mortgagee of the property has not been fully compensated under section 1129(b).ⁿ⁴¹

The absolute priority rule arguably carried with it a corollary to the effect that equity security holders could retain an ownership interest in the reorganized enterprise if they contributed thereto new capital in the form of money or money's worth if the contribution was necessary and substantial, and the interest retained was reasonable equivalent to the investment made. In *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*,ⁿ⁴² the Supreme Court held that assuming the existence of a new value corollary or exception to the absolute priority rule, the existing ownership class of a debtor, could not, over the objection of impaired creditors, make a new value contribution and retain an equity interest without affording to the relevant market the opportunity to bid for the equity position or to propose a competing plan.ⁿ⁴³

The application among classes of the fair and equitable standard necessitates a valuation of the debtor's business in order to determine whether each dissenting class has received full payment (and not more than full payment) on its claims before the next junior class is entitled to a distribution.ⁿ⁴⁴ A valuation of this type can be lengthy and expensive and may delay the commencement of distributions to creditors. Thus, the Code encourages negotiations among the competing classes to expedite confirmation with senior classes constrained to yield some value to junior classes to win acceptance of a plan.ⁿ⁴⁵

[3] Exemptions from Transfer Taxes Under Section 1146

A chapter 11 provision with particular significance to real estate cases is section 1146(a). That section provides: "The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax."ⁿ⁴⁶ The courts have almost uniformly held that a real estate transfer tax is substantially similar to a stamp tax and, therefore, that a transfer of real property pursuant to a plan of reorganization is exempt from such tax.ⁿ⁴⁷ However, a real estate gains tax is not covered by the statute because such a tax lacks the principal attributes of a "stamp tax or similar tax," such as that the amount due be determined by the value of the item being transferred, rather than by the profitability of the transaction, and that the tax rate be a relatively small percentage of the value of the item being transferred.ⁿ⁴⁸

Because transfer taxes can be a significant expense in many jurisdictions, debtors have often sought to broadly apply the benefits of section 1146 to transactions occurring in connection with the chapter 11 case. Not surprisingly, these attempts were often challenged by local governments and taxing authorities. Until the issue was resolved in 2008 by the United States Supreme Court, courts had often been faced with the question of whether the language in section 1146 exempting the payment of stamp taxes for instruments delivered "under a plan" applied to transfers consummated prior to the confirmation of plan where such prior transfer could be considered, broadly, to be in aid of consummation of the ultimate plan. The first two courts of appeals that addressed the issue held that the provision was applicable only where the transfer at issue was authorized by the terms of a *previously confirmed* chapter 11 plan.ⁿ⁴⁹ However, in 2007, the Court of Appeals for the Eleventh Circuit held that the 1146 tax exemption "may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation transfer and the confirmed plan."ⁿ⁵⁰ Finding the statutory text ambiguous, the court of appeals interpreted the provision under "the principle that a remedial statute such as the Bankruptcy Code should be liberally construed" and its view that its reading better accounted for "the practical realities of Chapter 11 reorganization cases" because a debtor often needed to sell or otherwise transfer assets at an early stage of

the case in order to encourage the constituents to support a post-transfer plan of reorganization.ⁿ⁵¹ The Supreme Court granted certiorari to resolve the conflict among the courts of appeals.

In *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*,ⁿ⁵² the Supreme Court reversed the court of appeals. The facts of *Piccadilly Cafeterias* are fairly straightforward and commonplace. Piccadilly Cafeterias was a chain of cafeterias that experienced financial difficulties and filed a petition under chapter 11 in late 2003. Early in the case, the debtor requested court authorization to sell substantially all its assets outside the ordinary course of business pursuant to section 363, including, in reliance on section 1146(a), the exemption from any stamp taxes on the eventual transfer of the assets. The bankruptcy court conducted an auction in which the winning bidder agreed to purchase Piccadilly's assets for \$80 million. As a precondition to the sale, Piccadilly entered into a global settlement agreement with committees of senior secured noteholders and unsecured creditors, which settlement agreement dictated the priority of distribution of the sale proceeds among Piccadilly's creditors. In February 2004, the bankruptcy court approved the proposed sale and settlement agreement and also ruled that the transfer of assets was exempt from stamp taxes under section 1146(a). The sale closed on March 16, 2004.ⁿ⁵³

Piccadilly filed its initial chapter 11 plan in the bankruptcy court on March 26, 2004, and filed an amended plan on July 31, 2004. Both plans provided for distribution of the sale proceeds in a manner consistent with the settlement agreement. Before the bankruptcy court confirmed the plan, Florida filed an objection, seeking a declaration that the \$39,200 in stamp taxes it had assessed on certain of Piccadilly's transferred assets fell outside section 1146(a)'s exemption because the transfer had not been "under a plan confirmed" under chapter 11. On October 21, 2004, the bankruptcy court confirmed the plan. On cross-motions for summary judgment on the stamp-tax issue, the bankruptcy court granted summary judgment in favor of Piccadilly. This decision was affirmed by both the district court and the Court of Appeals for the Eleventh District.ⁿ⁵⁴

The Supreme Court reversed. In rendering its decision, the Court parsed through a number of statutory arguments presented by the parties.

First, the State of Florida argued that the word "confirmed," which modified the word "plan," was a past participle such that the phrase "plan confirmed" referred to a plan that had been confirmed in the past and was the definitional equivalent of "confirmed plan." The state also argued that the word "under" in the phrase "under a plan confirmed" imposed a temporal requirement because it meant "subject to" or "under the authority of" in the same way that the two other uses of the word "under" in the very same provision, section 1146(a), clearly were intended. Thus, a transfer made prior to the date of plan confirmation cannot be subject to, or under the authority of, something that did not exist at the time of the transfer, i.e., a confirmed plan. Piccadilly countered that the phrase "plan confirmed" did not necessarily have the same meaning as "confirmed plan" and that if Congress had so intended such meaning, it could have used that exact phrase, as it had in another sections of the Code, namely section 1142(b). The debtor also argued that the word "under" has varying meanings in other provisions of the Code and could just as plausibly mean "in accordance with" rather than "subject to." The Supreme Court conceded that both side's arguments on the statutory text were plausible but that the reading by Florida was the more natural.ⁿ⁵⁵

The Supreme Court then examined various other statutory arguments, placing special emphasis on the fact that section 1146(a) appears in a subchapter of the Code entitled "Postconfirmation Matters."ⁿ⁵⁶ Ultimately, the Court held that it had no need to decide the question under a strictly grammatical reading of the section because, even if the statute was ambiguous, any ambiguity should be interpreted in Florida's favor under various canons of statutory construction. The main canon relied upon by the Court was the so-called *Sierra Summit* principle that courts should "proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed."ⁿ⁵⁷ In seeking application of this principle, Florida argued that exempting preconfirmation transfers from stamp tax caused substantial administrative burdens. For one thing, because, under state law, the tax was imposed at the time of the recordation of the deed, the State contended that creating an exemption in the event that a plan was subsequently confirmed would require the refund or "unraveling" of previously collected taxes. Alternatively, if the exemption was imposed at the time

of transfer, but before actual confirmation of a plan, the State would be required to record the deed without payment, but then be burdened with having to monitor the status of the case to determine whether a plan was ultimately confirmed, and if not confirmed, seek to collect the tax in the future.ⁿ⁵⁸

The debtor made various countervailing arguments, based principally on the assertion that section 1146(a) was clearly a statute intended to preempt state tax laws. However, the Supreme Court ruled that statute simply did not clearly express an intention to exempt from taxation every type of transfer by a debtor and in particular *preconfirmation* transfers. The statute clearly applied to transfers after confirmation of a plan, but the fact that there was ambiguity on its application to earlier transfers compelled the Court, under the principles of federalism and respect for state taxation schemes espoused in *Sierra Summit*, to decline the opportunity to do so. Also, the Court specifically rejected the reasoning of the court of appeals below that the Bankruptcy Code should be viewed as broad remedial scheme, one generally intended to lessen the burden on debtors, increase distributions to creditors and thereby facilitate reorganization:

Nor are we persuaded that in this case we should construe § 1146(a) "liberally" to serve its ostensibly "remedial" purpose. Based on the Eleventh Circuit's declaration that the Bankruptcy Code is a "remedial statute," Piccadilly would stretch the disallowance well beyond what the statutory text can naturally bear. Apart from the opinion below, however, the only authority Piccadilly offers is a 1952 decision of this Court interpreting the Shipping Commissioners Act of 1872. But unlike the statutory scheme in [that case], which was "designed to secure the comfort and health of seamen aboard ship, hospitalization at home and care abroad," the Bankruptcy Code--and Chapter 11 in particular--is not a remedial statute in that sense. To the contrary, this Court has rejected the notion that "Congress had a single purpose in enacting Chapter 11." *Toibb v. Radloff*, 501 U.S. 157, 163, 111 S. Ct. 2197, 115 L. Ed. 2d 145 (1991). Rather, Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate. The Code also accommodates the interests of the States in regulating property transfers by generally leaving the determination of property rights in the assets of a bankrupt's estate to state law. Such interests often do not coincide, and in this case, they clearly do not. We therefore decline to construe the exemption granted by § 1146(a) to the detriment of the State.

As for Piccadilly's assertion that reading § 1146(a) to allow preconfirmation transfers to be taxed while exempting others moments later would amount to an "absurd" policy, we reiterate that it is not for us to substitute our view of ... policy for the legislation which has been passed by Congress. That said, we see no absurdity in reading § 1146(a) as setting forth a simple, bright-line rule instead of the complex, after-the-fact inquiry Piccadilly envisions. At bottom, we agree with the Fourth Circuit's summation of § 1146(a):

"Congress struck a most reasonable balance. If a debtor is able to develop a Chapter 11 reorganization and obtain confirmation, then the debtor is to be afforded relief from certain taxation to facilitate the implementation of the reorganization plan. Before a debtor reaches this point, however, the state and local tax systems may not be subjected to federal interference." *NVR*, 189 F.3d at 458

Lastly, to the extent the "practical realities" of chapter 11 reorganizations are increasingly rendering postconfirmation transfers a thing of the past, it is incumbent upon the Legislature, and not the Judiciary, to determine whether § 1146(a) is in need of revision.ⁿ⁵⁹

In the authors' view, although the decision in *Piccadilly Cafeterias* contains a thorough grammatical analysis of the statutory provision at issue and related provisions, the majority opinion was based mainly on principles of federalism and the Court's general reluctance to interfere with requirements of state and local tax law in the absence of a precisely

expressed congressional intent regarding the type of transfer at hand. Unless section 1146(a) is amended to clearly apply to preconfirmation transfers, the *Piccadilly Cafeterias* decision effectively requires the infeasible and nonrefundable payment of a transfer tax at the time of deed recordation unless the debtor can present a confirmation order to the taxing authority at the time of transfer.

It remains to be seen how debtors will adjust to the decision in cases where potential transfer taxes are substantial and the funds necessary to obtain a consensual chapter 11 plan are limited.ⁿ⁶⁰ This author suggests that one possible structure for alleviating the *Piccadilly Cafeterias* result, would be to structure a preconfirmation asset transfer as a lease or other transfer that is not taxable under local law, coupled with an agreement between the transferor-debtor and the transferee, approved by the bankruptcy court, that would obligates the debtor to transfer title immediately following confirmation of a chapter 11 plan. The risk to the transferee that a plan is never confirmed could be mitigated by including *de minimis* dollar purchase options in favor of the transferee, placing deeds or other transfer instruments in escrow and imposing requirements that title be transferred if a plan is not confirmed within a specific period of time. This is of course not an ideal structure and may create countervailing complexities for a purchaser who wants clear title to the property or wishes to alienate the property in a short period of time. However, this may be an approach worth exploring where transfer taxes are significant (for example, in jurisdictions such as New York City) and there is a substantial likelihood that ultimately there will be some sort of chapter 11 plan confirmed, rather than conversion to chapter 7.

Chapter 11 does not permit the confirmation of plan if a governmental unit objects and the court finds that the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933.ⁿ⁶¹ However, the governmental unit has the burden of proof on this issue of avoidance.ⁿ⁶²

FOOTNOTES:

(n1)Footnote 1. *Toibb v. Radloff*, 501 U.S. 157, 111 S. Ct. 2197, 115 L. Ed. 2d 145, 24 C.B.C.2d 1179 (1991) .

(n2)Footnote 2. *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 128 S. Ct. 2326 n.2, 171 L. Ed. 2d 203 (2008) .

(n3)Footnote 3. 11 U.S.C. § 1102.

(n4)Footnote 4. 11 U.S.C. § 1102(b)(1).

(n5)Footnote 5. 11 U.S.C. § 1102(a)(2).

(n6)Footnote 6. *Id.*

(n7)Footnote 7. 11 U.S.C. § 1102(a)(4).

(n8)Footnote 8. 11 U.S.C. §§ 1101(1), 1108.

(n9)Footnote 9. 11 U.S.C. § 1104(a), (b); see also *In re Marvel Entm't Group, Inc.*, 140 F.3d 463 (3d Cir. 1998) (extreme acrimony between the debtor and creditors together with an inherent conflict in the debtor management's role as controller of the debtor and as a creditor of debtor's holding company many merit appointment of trustee).

(n10)Footnote 10. 11 U.S.C. § 1104(c).

(n11)Footnote 11. 11 U.S.C. § 1112(b). The section was amended pursuant to the 2005 Act to add a number of enumerated types of nonexclusive "cause." 11 U.S.C. § 1112(b)(4). One additional important revision to the section was to require the court to convert or dismiss a case if the movant establishes such cause, unless there are "unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate." Previously, dismissal and conversion by the court under the section was

discretionary.

(n12)Footnote 12. *Trident Assocs. Ltd. P'ship. v. Metropolitan Life Ins. Co. (In re Trident Assocs. Ltd. P'ship)*, 52 F.3d 127, 33 C.B.C.2d 708 (6th Cir. 1995) ; see, e.g., *In re DCNC North Carolina I, LLC*, 407 B.R. 651 (Bankr. E.D. Pa. 2009) ; *Grunewaldt v. Mutual Life Ins. Co. (In re Coones Ranch)*, 7 F.3d 740 (8th Cir. 1993) ; *In re Little Creek Dev. Co.*, 779 F.2d 1068, 13 C.B.C.2d 1231 (5th Cir. 1986) ; *In re Castleton Assoc. Ltd. P'ship*, 109 B.R. 347 (Bankr. S.D. Ind. 1989) .

(n13)Footnote 13. *In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999) . The court noted that the underlying purpose of chapter 11 was the "avoidance of the consequences of economic dismemberment and liquidation, and the preservation of ongoing values in a manner which does equity and is fair to rights and interests of the parties affected." 200 F.3d 154, 159 ; see also *C-TC 9th Ave. Pshp. v. Norton Co. (In re C-TC 9th Ave. Pshp.)*, 113 F.3d 1304 (2d Cir. 1997) ("the purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state. If there is not a potential business in place worthy of protection and rehabilitation, the Chapter 11 effort has lost its *raison d'être*") (quoting *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1137 (6th Cir. 1985)) .

(n14)Footnote 14. 11 U.S.C. § 1121(c).

(n15)Footnote 15. 11 U.S.C. § 1121(d).

(n16)Footnote 16. 28 U.S.C. § 158(a)(2). This provision was added by the Bankruptcy Reform Act of 1994.

(n17)Footnote 17. 11 U.S.C. § 1121(d)(2), added by Pub. L. No. 109-8, § 411(2) (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. 11 U.S.C. §§ 1124, 1126(f).

(n19)Footnote 19. 11 U.S.C. § 1124. Prior to the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *section 1124 of the Code* provided a third method of unimpaired a class, namely, by providing for full payment in cash of the allowed amount of the claims or interests. See 11 U.S.C. § 1124(c) (repealed). This alternative was removed in response to the controversial decision in *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994) , in which the court held that a class of unsecured creditors whose claim was paid in full was not entitled to vote on a chapter 11 plan and was not entitled to postpetition interest from a debtor that was solvent on both a liquidation and reorganization basis. The nonimpairment of the class by reason of payment in full was crucial to the court's holding because section 1129(a)(7) provides with respect to each impaired class of claims, that each holder of a claim must either accept the plan or receive on account of its claim property of a value no less than the amount that such holder would receive in a chapter 7 liquidation. In a chapter 7 liquidation, an unsecured creditor is entitled to receive postpetition interest at the legal rate before the debtor can retain any property. 11 U.S.C. § 726(a)(5). See generally 140 Cong. Rec. H10,768 (daily ed. Oct. 4, 1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n20)Footnote 20. 11 U.S.C. § 1126(c).

(n21)Footnote 21. 11 U.S.C. § 1125.

(n22)Footnote 22. 11 U.S.C. § 1129(a).

(n23)Footnote 23. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 412 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n24)Footnote 24. Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148, 1156 (1981).

(n25)Footnote 25. *In re Barrington Oaks General P'ship*, 15 B.R. 952 (Bankr. D. Utah 1981) ; *In re Marston Enters.* 13 B.R. 514 (Bankr. E.D.N.Y. 1981) .

(n26)Footnote 26. 11 U.S.C. § 1129(a)(7).

(n27)Footnote 27. 11 U.S.C. § 1129(a)(10).

(n28)Footnote 28. 11 U.S.C. § 1129(a)(9).

(n29)Footnote 29. 11 U.S.C. § 1129(a)(11).

(n30)Footnote 30. See P 1.08 *supra*. A good discussion of the application of the fair and equitable standard is set forth in *In re Edgewater Motel, Inc.*, 85 B.R. 989 (Bankr. E.D. Tenn. 1988) .

(n31)Footnote 31. 11 U.S.C. § 1129(b)(2)(A).

(n32)Footnote 32. 11 U.S.C. § 506(a).

(n33)Footnote 33. *Associates Commer. Corp. v. Rash*, 520 U.S. 953, 958, 964, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997) .

(n34)Footnote 34. *HSBC Bank USA v. UAL Corp. (In re UAL Corp.)*, 351 B.R. 916 (N.D. Ill., 2006) ; *In re Preventive Maint. Servs.*, 359 B.R. 607, 610 (Bankr. W.D. La. 2007) ; *Amresco New England II L.P. v. Vescio (In re Vescio)*, 227 B.R. 352 (Bankr. D.Vt. 1998) (applying *Rash* formulation in chapter 11 cases).

(n35)Footnote 35. 11 U.S.C. § 506(a)(2), added by Pub. L. No. 109-8, § 327 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The provision also provides that replacement value shall be without deduction for costs of sale or marketing.

(n36)Footnote 36. 11 U.S.C. § 1111(b). A good discussion of the genesis and operation of section 1111(b) is contained in *In re Tampa Bay Assocs., Ltd.*, 864 F.2d 47 (5th Cir. 1989) ; *In re DRW Prop. Co.*, 14 C.B.C.2d 1032, 57 B.R. 987 (Bankr. N.D. Tex. 1986) . See also *In re Constitution Plaza Assocs. Ltd. P'ship*, 161 B.R. 563 (Bankr. D. Conn. 1993) ; and *In re Mesa Bus. Park P'ship*, 127 B.R. 144 (Bankr. W.D. Tex. 1991) . A thorough article on the operation of section 1111(b) is Carlson, *Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuation of Collateral*, 6 Bankr. D.J. 253 (1989). See also Schian, *Section 1111(b)(2): Preserving the In Rem Claim*, 67 Am. Bankr. L.J. 479 (1993).

(n37)Footnote 37. In a chapter 13 case, the United States Supreme Court has held that the proper discount rate is the national prime rate as adjusted for the specific risks of the debtors, without regard to the rate set out in the parties' security agreement. *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004) .

(n38)Footnote 38. If a class of secured creditors holds a valid lien, but the collateral is valueless, it may nevertheless elect fully unsecured, recourse status. *In re Atlanta West VI*, 91 B.R. 620 (Bankr. N.D. Ga. 1988) .

(n39)Footnote 39. See generally Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133 (1979). The sale exception is inapplicable if the property is sold at private sale without affording the secured creditor an opportunity to bid its debt. *In re Woodridge N. Apts., Ltd.*, 15 B.C.D. 799 (Bankr. N.D. Cal. 1987) .

(n40)Footnote 40. 124 Cong. Rec. H11,104 (Sept. 28, 1978) (Statement of Rep. Edwards), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(i) (Matthew Bender 15th Ed. Revised).

(n41)Footnote 41. *In re Pine Lake Vill. Apt. Co.*, 6 C.B.C.2d 713, 19 B.R. 819 (Bankr. S.D.N.Y. 1982) . If the

partners are not permitted to retain their partnership interests, the interests would have to be transferred to the next senior class. If such class is unwilling to take on the burdens and liabilities that flow with the partnership interests the partnership will probably be constrained to wind up its affairs and liquidate.

(n42)Footnote 42. 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) .

(n43)Footnote 43. See P 2.07[2] *infra*.

(n44)Footnote 44. See Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 Case W. Res. L. Rev. 301, 352-63 (1982).

(n45)Footnote 45. 2 Case W. Res. L. Rev. 301, 362 (1982).

(n46)Footnote 46. Before the 2005 Act, which deleted the former subsections (a) and (b) of the Bankruptcy Code section, the provision was section 1146(c). Thus, all of the cases arising prior to the 2005 Act that interpret or apply the provision will refer to section 1146(c) rather than the current section 1146(a).

(n47)Footnote 47. See, e.g., *In re Jacoby-Bender, Inc.*, 758 F.2d 840 (2d Cir. 1985) .

(n48)Footnote 48. *In re 995 Fifth Ave. Assoc., L.P.*, 963 F.2d 503 (2d Cir. 1992) .

(n49)Footnote 49. *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Inv. Co. of Del., Inc.)*, 335 F.3d 243 (3d Cir. 2003) ; *NVR Homes, Inc. v. Clerks of the Circuit Courts (In re NVR, L.P.)*, 189 F.3d 442 (4th Cir. 1999) , *cert. denied*, 528 U.S. 1117, 120 S. Ct. 936, 145 L. Ed. 2d 815 (2000) .

(n50)Footnote 50. *In re Piccadilly Cafeterias, Inc.*, 484 F.3d 1299, 1304 (2007) (per curiam).

(n51)Footnote 51. *Id.*

(n52)Footnote 52. 128 S. Ct. 2326, 171 L. Ed. 2d 203 (2008) .

(n53)Footnote 53. 128 S. Ct. 2326, 2330 .

(n54)Footnote 54. *In re Piccadilly Cafeterias, Inc.*, 484 F.3d 1299, 1304 (2007) (per curiam); *In re Piccadilly Cafeterias, Inc.*, 379 B.R. 215, 226 (SD Fla. 2006) .

(n55)Footnote 55. 128 S. Ct. 2326, 2333 .

(n56)Footnote 56. 128 S. Ct. 2326, 2336 .

(n57)Footnote 57. *California State Bd. of Equalization v. Sierra Summit, Inc.* , 490 U.S. 844, 851-852, 109 S. Ct. 2228, 104 L. Ed. 2d 910 (1989) .

(n58)Footnote 58. 128 S. Ct. 2326, 2337 .

(n59)Footnote 59. 128 S. Ct. 2326, 2338-39 (internal quotations and citations omitted).

(n60)Footnote 60. See, e.g., *In re New 118th, Inc.*, 398 B.R. 791 (Bankr. S.D.N.Y. 2009) (where the court held, in a case with limited funds, that "although the sale of the Rental Properties occurred before confirmation, the delivery of the deeds took place after confirmation, and was necessary to the consummation of the plan. The transfers were, therefore, made 'under a plan confirmed,' and are exempt from the payment of stamp or similar taxes under § 1146(a)").

(n61)Footnote 61. 11 U.S.C. § 1129(d); see *In re Scott Cable Communications*, 227 B.R. 596 (Bankr. D. Conn. 1998) (denying confirmation of plan, whose principal purpose was to avoid payment of capital gains tax on sale of

assets).

(n62)Footnote 62. *Id.*

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.12

P 1.12 Chapter 12 Cases

The 1986 Amendments added to the Code a new chapter 12 to provide special treatment for family farmers.ⁿ¹ As originally enacted, chapter 12 had a sunset provision which provided for its repeal on October 1, 1993. However, Congress periodically extended such expiration from time to time.ⁿ² As part of the 2005 Act, Congress eliminated the sunset provision and permanently enacted chapter 12, while at the same time extending its benefits to "family fisherman" and making other important changes to chapter 12.ⁿ³

Chapter 12 is patterned very closely after chapter 13; it has fewer attributes of chapter 11.

Family farmer is defined in *section 101(18) of the Code* and includes individuals and spouses, corporations and partnerships.

- (1) The individual debtor with or without spouse must have no more than \$3,544,525 in debt (secured and unsecured);ⁿ⁴
- (2) Not less than 50 percent of the noncontingent, liquidated debts must arise out of a farming operation (excluding mortgages on the principal residence);
- (3) The debtor and spouse receive more than 50 percent of their gross income for the preceding taxable year or each of the second and third preceding taxable years from the farming operation.ⁿ⁵

A corporation or partnership is a family farmer if (1) more than 50 percent of the stock or equity is held by one family, including relatives; (2) the family or relatives conduct the farming operation; (3) more than 80 percent of the value of the assets are related to the farming operation; (4) it has a debt structure the same as an individual; and (5) the stock of the corporation is not publicly traded.ⁿ⁶

"Family farmer with regular annual income" is defined in section 101(19) as one whose annual income is sufficiently stable and regular to make payments under a plan under chapter 12. "Farming operation" is defined in section 101(21) as including farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry or livestock, and production of poultry or livestock products in an unmanufactured state.

In addition to the automatic stay of section 362, the family farmer has the benefit of the codebtor stay adopted from chapter 13.ⁿ⁷

As noted, as part of the 2005 Act, chapter 12 was also made applicable to "family fishermen." In the case of the utilization of chapter 12 by a family fisherman:

- (1) The individual debtor with or without spouse must have no more than \$1,642,500 in debt (secured and unsecured);ⁿ⁸
- (2) Not less than 80 percent of whose aggregate noncontingent, liquidated debts must arise out of a commercial fishing operation (excluding mortgages on the principal residence); and
- (3) The debtor and spouse must have received more than 50 percent of their gross income for the preceding taxable year from the commercial fishing operation.ⁿ⁹

Also, a corporation or partnership can be a family fisherman if it meets tests that are substantially the same as the tests applicable to determining whether a corporation or partnership qualifies as a family farmer.

In chapter 12 cases, a standing trustee serves as a trustee. In the absence of a standing trustee, the United States trustee shall appoint one disinterested person to serve as trustee.ⁿ¹⁰

If the debtor is a debtor in possession, it is given all the rights and powers of a chapter 11 trustee (except the duty to investigate and report under sections 1106(a)(3) and (4)), including authority to operate the farm.ⁿ¹¹ Chapter 12 does not define "debtor in possession." The debtor in possession may be removed on request of a party in interest for cause including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the commencement of the case.ⁿ¹²

Section 361, which describes certain methods of providing adequate protection to creditors, is rendered inapplicable in chapter 12 by section 1205. In its place, section 1205 requires protection as specified in subsections 361(1) and (2) for any decrease in the value of the *property* securing a creditor's claim. This formulation was intended to forestall any ruling granting to an unsecured creditor payment for lost "opportunity costs" under the holding of *In re American Mariner Industries, Inc.* ⁿ¹³ However, the *American Mariner* holding has been overturned by the Supreme Court in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.* ⁿ¹⁴ Pursuant to section 1205(b)(3), payment of reasonable rent customary in the community based on rental value, net income and earning capacity of the property may also be employed to provide adequate protection.

Farm land, farm equipment or property used to carry out a commercial fishing operation (including a commercial fishing vessel) that is subject to a lien may be sold by the trustee free and clear of the lien without consent of the lienor except that the proceeds of the sale will remain subject to the lien.ⁿ¹⁵ This provision is intended to permit the debtor to scale down the operation of the farm or fishing operation by selling unnecessary property.ⁿ¹⁶

Section 1208(c) contains various grounds for dismissing a chapter 12 case. These are essentially similar to the grounds listed in section 1307 with some adaptation from section 1112, except that sections 1307(c) and 1112(b) offer the option of converting to chapter 7 if the court finds that to be in the best interest of the estate. Under section 1208(c), no such option exists. Pursuant to section 1208(d), however, the court may order conversion or dismissal if the debtor committed fraud in connection with the case.

Only the debtor may file a chapter 12 plan, even if the debtor is ousted from possession.ⁿ¹⁷ The plan is to be filed within 90 days after the filing of the petition unless the time is extended by the court, which may extend the 90-day period if "the need for an extension is attributable to circumstances for which the debtor should not justly be held

accountable."ⁿ¹⁸

The plan provisions in section 1222 are very similar to those listed for chapter 13 plans in section 1322.ⁿ¹⁹ Some differences pertain: for example, a chapter 12 plan may modify the rights of a residential mortgagee (the exception in section 1322(b)(2) is not included in section 1222); a chapter 12 plan may provide for sale of property or distribution of property among those having an interest in it; and, in certain instances, it may provide for payment of secured claims over a period longer than the three or five years specified in section 1322(c) as the outside time limits for making plan payments.ⁿ²⁰ In addition, under chapter 12 (unlike under chapter 13), the debtor can treat certain priority tax claims arising from the sale or other disposition of any farm asset used in the debtor's farming operation as an unsecured claim.ⁿ²¹ Thus, a capital gains tax arising from the debtor's postpetition sale of a qualifying asset does not have to be paid in full under a chapter 12 plan.ⁿ²²

An expedited confirmation hearing is intended.ⁿ²³ Section 1224 requires, after "expedited" notice, that the hearing be *concluded* not later than 45 days after the filing of the plan. This time period may be lengthened for cause, including case backlog, but this exception should be used sparingly.ⁿ²⁴

Section 1225 sets forth the confirmation requirements. As in chapter 13 cases, there is no requirement that unsecured creditors vote on or accept a plan. The "best interests" test is applicable, i.e., unsecured creditors must receive at least as much as they would receive in a chapter 7 liquidation.ⁿ²⁵ With respect to secured claims, the standards are the same as in chapter 13, i.e., the holder accepted the plan or will retain the lien and receive property of a value on the plan's effective date not less than the allowed amount of the claim, or the collateral will be surrendered to the creditor.ⁿ²⁶

Pursuant to section 1225(b), on objection, the court must find either that (1) unsecured creditors will receive full payment of the allowed claim, (2) all of the debtor's projected disposable income to be received in the three year period specified in section 1222(c) will be applied to plan payments or (3) the value of the property to be distributed under the plan in the three-year period, or such longer period as the court may approve, beginning on the date that the first distribution is due under the plan, is not less than the debtor's projected disposable income for such period.ⁿ²⁷ Disposable income is defined in section 1225(b)(2) to include deduction for necessary expenses in the operation of the debtor's business. The provision is intended to preserve the debtor's rights in "*minor* businesses not directly related to the farming operation."ⁿ²⁸

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 103-65 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. *See P 1.02 supra*.

(n3)Footnote 3. Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The provisions relating to chapter 12 were included in title X (§§ 1001-1007) of the 2005 Act.

(n4)Footnote 4. It should be noted that pursuant to the *section 104 of the Bankruptcy Code* this maximum debt amount for qualification as a "family farmer" is subject to triennial adjustment. The above amount applies to cases commenced on or after April 1, 2007.

(n5)Footnote 5. It has been held that an individual who rents farmland to a corporate entity in exchange for rental payments satisfied the gross income from "farming operation" test and therefore qualified for chapter 12 relief because the debtor's receipt of the rental income was subject to traditional agricultural risks. *In re Maynard*, 50 C.B.C.2d 1486, 295 B.R. 437 (Bankr. S.D.N.Y. 2003) ; *see also In re Osborne*, 323 B.R. 489 (Bankr. D. Or. 2005) (the eligibility requirements for chapter 12 "farming operations" should be liberally interpreted); *In re Armstrong*, 812 F.2d 1024, 16 C.B.C.2d 238 (7th Cir. 1987) (rent paid to debtor at beginning of lease was not income from farming operations because

it was insulated from usual risks of farming); *In re Gibson*, 57 C.B.C.2d 42, 355 B.R. 807, 810 (Bankr. E.D. Cal. 2006) (individual did not qualify for chapter 12 relief where lease back to corporation in exchange for rent was intended to shift the responsibility for farming to someone else and to avoid the risks attendant to farming while the debtor attempted to resell the property).

(n6)Footnote 6. 11 U.S.C. § 101(18)(B).

(n7)Footnote 7. 11 U.S.C. § 1201.

(n8)Footnote 8. It should be noted that pursuant to the *section 104 of the Bankruptcy Code* this maximum debt amount for qualification as a "family fisherman" is subject to same type of triennial adjustment affecting other code provisions including the "family farmer" provisions. The amount reflected represents the adjustment affected on April 1, 2007, and all prior adjustments. For the current adjustment, see 72 Fed. Reg. 7082-83 (Feb 14, 2007) .

(n9)Footnote 9. 11 U.S.C. § 101(19A).

(n10)Footnote 10. 11 U.S.C. § 1202.

(n11)Footnote 11. 11 U.S.C. § 1203.

(n12)Footnote 12. 11 U.S.C. § 1204.

(n13)Footnote 13. 734 F.2d 426, 10 C.B.C.2d 910 (9th Cir. 1984) ; see P 2.02[2] note 23 *infra*.

(n14)Footnote 14. 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n15)Footnote 15. 11 U.S.C. § 1206.

(n16)Footnote 16. Joint Explanatory Statement of the Committee of the Conference, 132 Cong. Rec. H8,999 (Oct. 2, 1986) ("Joint Statement").

(n17)Footnote 17. 11 U.S.C. § 1221; Joint Statement at H8,999.

(n18)Footnote 18. 11 U.S.C. § 1221, as amended by Pub. L. No. 103-65 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. See P 1.13 *infra*.

(n20)Footnote 20. See P 1.13 *infra*.

(n21)Footnote 21. 11 U.S.C. § 1222(a)(2)(A).

(n22)Footnote 22. *In re Dawes*, 382 B.R. 509, 519 (Bankr. D. Kan. 2008) , *aff'd*, *United States v. Nazar (In re Dawes)*, 2009 U.S. Dist. LEXIS 19961 (D. Kan. Mar. 12, 2009) (discussing legislative history and purpose of provision).

(n23)Footnote 23. Joint Statement at H8,999.

(n24)Footnote 24. Joint Statement at H8,999.

(n25)Footnote 25. 11 U.S.C. § 1225(a)(4).

(n26)Footnote 26. 11 U.S.C. § 1225(a)(5).

(n27)Footnote 27. *11 U.S.C. § 1125(b)(1)*. The last alternative was added to the provision by the 2005 Act.

(n28)Footnote 28. Joint Statement at H8,999.

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.13

P 1.13 Chapter 13 Cases

The principal real estate issues in chapter 13 cases center on the debtor's right to reinstate a defaulted and accelerated residential mortgage and the right of a debtor to "modify" the rights of the holder of a mortgage secured by a debtor's principal residence.ⁿ¹

Section 1322(b) of the Code provides in pertinent part that a plan may

(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of the holders of unsecured claims ... ;

(3) provide for the curing or waiving of any default;

... ;

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

... .

Section 1322(d) provides for the payment periods under a chapter 13 plan. The provision was extensively modified by the 2005 Act. Under the provision, as amended, if the current monthly income of the debtor and the debtor's spouse, when multiplied by 12, is greater than certain specified median family income levels of the applicable state, the plan may not provide for payments over a period of greater than five years. If the current income of the debtor and the debtor's spouse is less than the applicable median family income level, the plan may not provide for payments over a period longer than three years unless otherwise approved by the court for cause, but the court may not approve a period longer than five years.ⁿ²

The courts have generally agreed that the reinstatement of a residential mortgage that has been defaulted and accelerated prior to the filing of a chapter 13 petition does not "modify" the mortgagee's rights in violation of section 1322(b)(2).ⁿ³

Until amendments to section 1322 by the Bankruptcy Reform Act of 1994, the question of when a debtor could cure a mortgage default under section 1322(b)(5) was unclear. There were conflicting views in three of the circuits.

The Court of Appeals for the Seventh Circuit, in *In re Clark*,ⁿ⁴ held that a debtor filing a petition after a judgment but prior to a sale may exercise section 1322(b)(5) cure rights and thereby reinstate an accelerated mortgage. The court in *Clark* relied heavily on the fact that under the relevant state law, a mortgagee has only a lien on the mortgaged property even after a foreclosure judgment is entered, and that in such "lien theory" states a foreclosure judgment merely "confirms" the acceleration but does not cause title to pass to the mortgagee.ⁿ⁵ The *Clark* case left unaddressed the issue of whether debtors who file postjudgment petitions in "title theory" states may exercise section 1322(b)(5) cure rights.

By contrast, the Court of Appeals for the Third Circuit, in *In re Roach*,ⁿ⁶ held that a debtor could not cure a defaulted mortgage after the mortgagee obtains a foreclosure judgment. The court in *Roach* relied heavily on the fact that under New Jersey law, after entry of a foreclosure judgment, the mortgage is merged into the final judgment of foreclosure and the mortgagee's rights arise solely from the judgment. Thus, the court reasoned that, as a result of the merger, there was no longer a mortgage to be cured and restored in the context of section 1322(b)(5).

The Court of Appeals for the Sixth Circuit, in *Federal Land Bank v. Glenn (In re Glenn)*,ⁿ⁷ found no "clear-cut statutory language or legislative history that points unerringly to a construction of the statute that is free from challenge," and therefore sought a "pragmatic" result.ⁿ⁸ The court held that the cut-off date for the exercise of section 1322(b)(5) cure rights is the date of a foreclosure sale, concluding that such a rule represents a sensible compromise in light of the statute's objectives of providing cure rights for debtors and protecting the rights of mortgagees of private homes. The court reasoned that the date of sale is a "measurable, identifiable event of importance in the relationship of the parties"ⁿ⁹ and that the debtor would have ample opportunity prior to the sale to either negotiate to cure the default or file a chapter 13 petition. The court in *Glenn* rejected the relevance of state property law to the interpretation of section 1322(b)(5),ⁿ¹⁰ in contrast with the approach in *Clark*. Many of these issues have been settled by the Bankruptcy Reform Act of 1994.ⁿ¹¹ The Act added section 1322(c)(1) to the Code, which provides "a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured under [sections 1322(b)(3) or 1322(b)(5)] until such residence is sold at a foreclosure sale that is conducted in accordance with applicable bankruptcy law."ⁿ¹² The House of Representatives Report accompanying the 1994 Act explicitly criticized the decision in *In re Roach* and explained:

This section of the bill safeguards a debtor's rights in a chapter 13 case by allowing the debtor to cure home mortgage defaults at least through completion of a foreclosure sale under applicable nonbankruptcy law. However, if the State provides the debtor more extensive "cure" rights (through, for example, some later redemption period), the debtor would continue to enjoy such rights in bankruptcy.ⁿ¹³

Thus, it is now clear that until the date of a foreclosure sale a debtor is permitted to cure a mortgage default under section 1322(b)(5), notwithstanding any contrary result under state law which could be construed as terminating the debtor's right to cure at an earlier date. In addition, although the language of the statute does not directly address the issue, it is clear from the legislative history quoted above that Congress intended the foreclosure sale date to be a minimum floor and expected that bankruptcy courts would apply any applicable state law which provides debtors with a longer period in which to cure a mortgage default.

On the other hand if, under the state foreclosure statute, a mortgagor cannot cure a default following the date of the sale, the Bankruptcy Code will not extend that cure right to a later date notwithstanding the state law requirement that such sale subsequently be confirmed by a court. Thus, at least two courts of appeals have rejected the contention that the reference in section 1322(c)(1) to "a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law" has the effect of requiring that a foreclosure sale be in fact final under state law before the right to cure can be

terminated. In one case,ⁿ¹⁴ the Court of Appeals for the Seventh Circuit held that under Illinois law, the occurrence of the sale itself is the determinative event for setting the outer temporal limit on the right to cure:

Under state law, after the completion of the judicial sale, assuming that the redemption period has run, the purchaser at that sale has a presumptive right to eventual ownership of the property, a right contingent on the highly circumscribed authority of the state court to void the sale on any of the four grounds set forth in the statute. Although the Illinois courts have employed language that, read alone, might suggest that the judicial sale does not actually occur until confirmation, these cases must be read in the context of the entire statutory scheme that requires confirmation, unless one of four statutory exceptions apply. To read the Illinois courts' statements that the sale does not "legally" occur until the confirmation out of context creates a right to cure up until the time of confirmation that simply is unavailable under the state statutory scheme and, indeed, that would frustrate the operation of that scheme. The appropriate reading of this precedent is that, once a judicial sale takes place, a potentially binding contract exists that may not be enforced until confirmed by the court. ... Ms. Colon attempted to redeem her residential property after the judicial sale. Because Ms. Colon had no right to redeem the residence at the time she filed her plan under Chapter 13, the bankruptcy court certainly did not abuse its discretion in determining that the automatic stay should be lifted and the state court permitted to determine whether the foreclosure sale conducted prior to the filing of the Chapter 13 petition suffered from any of the statutory infirmities [under Illinois law] that would render it void. If the state court determines that the sale was valid, the sale will be final, and Ms. Colon will have been deprived of no right under either the Bankruptcy Code or Illinois law. If the sale is void, she will have the rights under the Code and state law of a debtor whose property has not yet undergone a judicial sale.ⁿ¹⁵

In another case,ⁿ¹⁶ the Court of Appeals for the Sixth Circuit held that the fact that the redemption period extended the time in which a deed may be effective under state law did not change the discrete timing of the foreclosure sale:

We are not persuaded that the phrase "conducted in accordance with applicable non-bankruptcy law" expands the meaning of "foreclosure sale" to encompass a state-law redemption period. As we see it, this language does no more than require that the sale adhere to procedures mandated by state law. It may be that the language indicates that Congress intended state law to be determinative of what constitutes a "foreclosure sale," but Michigan law plainly conceives of a foreclosure sale as a discrete event that occurs at a specified time and place. It is true that the deed acquired by a purchaser at a Michigan foreclosure sale does not become operative until the running of the redemption period, but a delay in the time when the deed becomes fully effective simply does not equate to a delay in the time of the sale.

... .

We are satisfied that 1322(c)(1) terminates a debtor's right to cure a home mortgage default "when the gavel comes down on the last bid at the foreclosure sale."ⁿ¹⁷

The filing of a petition during the redemption period may raise the related issue of whether the section 362(a) automatic stay tolls the expiration of the redemption period.ⁿ¹⁸ The prevalent view, generally expressed in the chapter 11 cases but applicable in the chapter 13 context, is that because the passage of time during the redemption period is not an "act" or "proceeding" by a creditor within the meaning of 362(a), the automatic stay will not toll the expiration of the redemption period.ⁿ¹⁹ However, one court has suggested that the opposite result may be reached in jurisdictions which require that a creditor take some affirmative action in order to obtain full title to the property upon the expiration of the redemption period.ⁿ²⁰ It should be noted that *section 108(b) of the Code* may be available to a debtor seeking to extend the statutory redemption period even if the automatic stay is not.ⁿ²¹ Section 108(b) provides that when a debtor "may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act," and the period for so doing has not expired as of the filing of the petition, the trustee is given until the end of such period, "including any suspension of such period occurring on or after the commencement of the case," or 60 days, whichever is

later, to perform such act.ⁿ²²

The issue of tolling of equitable redemption periods during the pendency of a chapter 13 case was recently addressed before the Court of Appeals for the Second Circuit in *In re Canney*.ⁿ²³ The issue before the court in *Canney* was whether the automatic stay applied to toll the statutory redemption period of a chapter 13 debtor with respect to a foreclosure judgment against certain real property. The court held that since the automatic stay prevents only certain affirmative acts taken by a creditor, and the running of time was not such an act, section 362 did not preserve an otherwise expired right of redemption under Vermont law.ⁿ²⁴ The only relevant tolling provision was section 108(b), which has the effect of tolling the period for 60 days. Since the redemption period, as extended by section 108(b), lapsed without redemption by the debtor, the equity of redemption was extinguished completely, and full title, both legal and equitable, vested automatically with the mortgagee.ⁿ²⁵ Notably, the facts in *Canney* involved a mortgage on property that was not the debtor's principal residence, and the reasoning concerning the effect of sections 362 and 108 should apply with equal force to any mortgage redemption periods, whether in chapter 7, chapter 11, chapter 12 or chapter 13 and irrespective of the type of property involved.ⁿ²⁶

It should be noted that, until 1994, a line of cases had held that when a debtor filed a petition subsequent to a foreclosure sale and the expiration of the redemption period, the trustee could recapture the property for the estate on fraudulent conveyance grounds if the foreclosure sale price did not constitute reasonably equivalent value.ⁿ²⁷ In fact, some courts suggested that a foreclosure sale at a price less than 70 percent of the fair market value of the property could not meet the reasonable equivalence standard and should be set aside as a matter of law.ⁿ²⁸ However, in *BFP v. Resolution Trust Corp.*,ⁿ²⁹ the United States Supreme Court held that a noncollusive mortgage foreclosure sale properly conducted under state law could not be avoided as a fraudulent transfer under section 548 of the *Bankruptcy Code*. The Supreme Court reasoned that as long as the foreclosure sale is properly conducted, "reasonably equivalent value" for purposes of section 548 is the price in fact received at the sale. Although the *BFP* decision did not address whether a sale could be set aside under section 544(b) of the *Bankruptcy Code*,ⁿ³⁰ which incorporates state fraudulent conveyance statutes, the decision does call into question the use by courts of federally-created standards that have the effect of clouding the finality of properly conducted state-law foreclosure sales.

It is clear that a foreclosing mortgagee should be aware of the questionable finality of each step in the foreclosure process given the array of tools available to the debtor in chapter 13 cases.

In *Nobelman v. American Savings Bank*,ⁿ³¹ the United States Supreme Court resolved a split among the circuits concerning whether section 506(a)ⁿ³² permits a chapter 13 debtor to bifurcate the claim of a lender secured by the debtor's principal residence into separate secured and unsecured claims in order to subject the secured claim only to the nonmodification provisions of section 1322(b)(2). Until the decision in *Nobelman*, several courts of appeals had held that a chapter 13 debtor could use section 506(a) to (1) strip down the mortgagee's lien so that it secured a claim equal to the judicially determined value and treat the remainder of the claim as unsecured, (2) satisfy the unsecured portion at a fraction of the face amount and (3) treat the secured portion only in accordance with the requirements of section 1322(b)(2). *Nobelman* held that such bifurcation would not be permitted because it impermissibly modified the "rights" of the mortgagee as reflected in the relevant mortgage instrument, including

the right to repayment of the principal in monthly installments over a fixed term at specified ... rates of interest, the right to retain the lien until the debt is paid off, the right to accelerate the loan upon default and to proceed against petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency claims after foreclosure ... These are rights that were "bargained for by the mortgagor and the mortgagee," ... and are rights protected from modification by § 1322(b)(2).ⁿ³³

Although *Nobelman* involved a chapter 13 debtor and addressed the rights of a mortgagee under section 1322(b)(2) only, its holding is now applicable to a chapter 11 debtor by reason of a 1994 amendment to section 1123(b) that added paragraph (5), which contains identical language to that found in section 1322(b)(2).ⁿ³⁴ The legislative history of the

amendment states that it was intended to "conform[] the treatment of residential mortgages in chapter 11 to that in chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence."³⁵

One question left unanswered by *Nobelman* is whether the nonmodification protections of section 1322(b)(2), which the Supreme Court specifically held applied to an undersecured mortgage, also applied to a completely unsecured mortgage, such as a junior mortgage that was underneath an undersecured senior mortgage. Some lower courts have focused on language in *Nobelman* that emphasized the *rights* of mortgagees, irrespective of the collateral value, to hold that section 1322(b)(2) applies to all residential mortgages, even those that are totally unsecured.³⁶ Under this view, as long as the collateral underlying a lien is the debtor's principal residence, the lien cannot be voided under section 1322(b)(2) because to do so would modify the "rights of holders of ... a claim secured only by a security interest in real property that is the debtor's principal residence." The majority of courts, however, including all courts of appeals that have addressed the issue, have focused on the fact that a creditor that holds a lien with no value cannot, under the plain language of section 506(a), be the holder of a "secured claim," which is the antecedent for the inclusion of such holder within the nonmodification exception in section 1322(b)(2).³⁷ Those courts have held that a totally unsecured mortgage--as distinguished from an undersecured mortgage--could be modified. Although this result seems arbitrary--because, under *Nobelman*, a junior mortgage with even one dollar of equity could not be modified at all, while one without that single dollar of equity would be subject to modification--until the issue is clarified by the Supreme Court in a further decision, the prevailing view appears to place the treatment of junior residential mortgages subject to the vagaries and uncertainties of the valuation process.

The reasoning of *Nobelman* has been extended to prohibit lien stripping of *nonresidential* mortgages in chapter 13 cases as a means of extending a modified payment stream on mortgages past the five-year limitation period on plan payments in section 1322(d). In *Enewally v. Washington Mutual Bank (In re Enewally)*,³⁸ the bankruptcy court approved a chapter 13 plan in which the debtor bifurcated a claim secured by a mortgage on a rental (i.e., nonresidential property) into a secured component and an unsecured component. Such bifurcation was of course itself not prohibited, because the nonmodification provisions of section 1322(b)(2) only applies to mortgages on a debtor's principal residence. In particular, the debtor's proposed chapter 13 plan bifurcated the loan into (1) a secured portion, which would receive payments of the original amortization amount for such period of the remainder of the original loan term that was necessary to payoff the now-reduced principal balance (which period would extend for more than five years) and (2) an unsecured portion, which would be paid at 17 cents on the dollar. The bankruptcy court approved such plan by explaining that "[a] chapter 13 plan may treat a secured debt under two statutory alternatives. First, the plan may modify the rights of a holder of a secured claim pursuant to § 1322(b)(2). Second, the plan may cure any default and maintain payments on the secured claim pursuant to § 1322(b)(5)."³⁹ The bankruptcy court observed that a chapter 13 debtor could not invoke both the modification provisions of section 1322(b)(2) to reduce the monthly payment and maintain such reduced monthly payments for the term of the original note if such term would extend beyond the five-year plan payment limitation in section 1322(d). However, because the debtors proposed to continue making the same payments at the original interest rate until the secured debt (albeit now reduced in principal amount) was paid in full, the bankruptcy court identified another "typical strategy to deal with an undersecured creditor that is not secured by the debtor's principal residence." In endorsing this tactic, the bankruptcy court held that the proposed modification could be made under section 1322(b)(5) with a bifurcation of the secured debt under section 506(a). In other words, the secured debt would first be reduced under section 506(a) to the fair market value of the collateral, then the "cure and maintain" provisions of section 1322(b)(5) would allow the reduced secured debt to be paid over the life of the original note on the original interest terms. Because the debtors proposed to continue making the same absolute payments amount, and based on the original interest rate, until the secured debt was paid in full, the bankruptcy court reasoned that the five-year limit for plan payments in section 1322(d) was not applicable.

Applying this reasoning, the bankruptcy court modified the size of the secured claim to the fair market value determined under section 506(a) (\$210,000), then permitted the debtor to pay down the secured claim over the term of the original note, which extended beyond the five-year life of the plan. The unsecured portion of the lender's total claim

(approximately \$31,000) was given the same treatment as the other unsecured creditors under the plan (distribution equal to 17 percent of such claims), which would be repaid over the five-year plan with the remainder to be discharged upon successful completion of the plan.

The district court reversed, and the court of appeals affirmed the reversal, holding that under the dictates of *Nobelman* bifurcation of secured debt must take place within the context and parameters of a chapter 13 plan, and therefore the five-year limitation of section 1322(d) must be satisfied. As the court of appeals noted:

Although the bankruptcy court's analysis is arguably much closer to the original vision of the Bankruptcy Code than the district court's holding, we are not writing on a clean slate. The Supreme Court has spoken directly in *Dewsnup* and *Nobelman*. *Dewsnup* cautioned against courts fashioning a "broad new remedy" under § 506(a) where the remedy was not "mentioned somewhere in the Code itself or in the annals of Congress." In *Nobelman*, the Supreme Court explained that, in a Chapter 13 plan, stripping down an undersecured lien to the value of the underlying collateral pursuant to § 506(a) valuation, "would require a modification of the rights of the holder of the security interest" pursuant to § 1322(b)(2). In order to hold that the debtor's lien stripping proposal is viable under the "cure and maintain" provision of § 1322(b)(5), we would have to hold that § 506(a) coupled with § 1322(b)(5) provides a new remedy allowing modification of secured debts in Chapter 13 independent of § 1322(b)(2). The logic of *Dewsnup* and *Nobelman* do not permit this construction. As both the district court and bankruptcy court noted, lien stripping on debts secured by real property that is not the debtor's primary residence is permissible in Chapter 13, even after *Nobelman*. However, it must be accomplished in a manner consistent with § 1322(b)(2). Because § 1322(b)(2) does not allow a modified secured debt to be paid over a period of time longer than the plan term, the debtors' proposed plan modification must be disallowed.

Thus, we agree with the district court that: (1) § 1322(b)(2) by itself does not permit the debtors to repay the secured claim over a period longer than the plan term; (2) a chapter 13 debtor may not invoke both a modification of a secured creditor's claim under § 1322(b)(2) and the right to "cure and maintain" beyond the plan term as authorized under § 1322(b)(5); and (3) a modification of secured debt under Chapter 13 must be accomplished in a manner consistent with § 1322(b)(2). Therefore, a debtor may not use § 506(a) in combination with § 1322(b)(5) to reduce the secured claim and repay it over a period longer than the plan term.ⁿ⁴⁰

Another question not addressed by *Nobelman* concerned the interpretation of section 1322(c)(2), which is an exception to the antimodification provision of section 1322(b)(2). Section 1322(c)(2), a provision dealing with so-called short-term mortgages, provides:

(c) Notwithstanding subsection (b)(2) and applicable nonbankruptcy law ... (2) in a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title.ⁿ⁴¹

The issue under the statute is whether the term "as modified" applies to the original payment schedule or the mortgagee's claim. If the former interpretation is correct, in the case of a short-term mortgage, only the original payment schedule with respect to timing can be modified in a manner that complies with the cramdown provision of section 1325(a)(5). If the latter interpretation is correct, such a mortgage claim can be bifurcated under section 506(a) into secured and unsecured portions, and only the secured portion needs to be treated under section 1325(a)(5).

The two courts of appeals that have addressed the issue have reached different results. In *In re Witt*,ⁿ⁴² the Court of

Appeals for the Fourth Circuit held that a mortgage of the type covered by section 1322(c)(2) could not be bifurcated and crammed down under section 1325(a)(5); rather the debtor could only modify the schedule of payments on such a claim. The court reasoned that because the subject of "payment" was the focus of section 1322(c)(2), it was likely "as a matter of common sense" that the modifier "as modified" was a reference to the main subject of the statute.ⁿ⁴³ By contrast, in *In re Paschen*,ⁿ⁴⁴ the Court of Appeals for the Eleventh Circuit held that the only reading of the statute that was consistent with the structure of section 1325(a)(5), which expressly permits the bifurcation of claims but does not expressly address modification of payment schedules, and that complied with the statutory canon of the rule of the last antecedent, was that short-term mortgages (i.e., those that came within the scope of section 1322(c)(2)) were indeed exceptions to the holding of *Nobelman*.ⁿ⁴⁵ Given the different interpretations by two circuit courts of appeals, there is a distinct possibility that the United States Supreme Court will have to once again address the issue of the ability of a chapter 13 debtor to strip down a home mortgage.

It should be noted that the nonmodification protections of section 1322(b)(2) and section 1123(b)(5), as clarified by *Nobelman*, are strictly limited by the statute to "a claim secured only by a security interest in real property that is the debtor's principal residence." Not surprisingly, in interpreting section 1322(b)(5), courts have recently reviewed and referred to the legislative history of section 1123(b)(5), which, as noted, was amended in 1994 to prevent the modification of the rights of holders of a secured claim "secured only by a security interest in real property that is the debtor's principal residence."ⁿ⁴⁶ A number of courts have stated that the anti-modification protections were narrowly tailored to protect residential lenders as a means of encouraging residential home lending.ⁿ⁴⁷ According to the court in *Lomas Mortgage Inc. v. Louis*,ⁿ⁴⁸ that legislative history reveals that Congress deliberately tracked the antimodification language of section 1322(b)(2) and intended conformity of treatment between chapter 13 and chapter 11:

This amendment conforms the treatment of residential mortgages in chapter 11 to that in chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence. ... [The provision] does not apply to a commercial property, or to any transaction in which the creditor acquired a lien on property other than real property used as the debtor's residence.ⁿ⁴⁹

Thus, the protection of section 1322(b)(2) will not apply to a mortgage on a multifamily property in which one unit constitutes the debtor's principal residence and the other are income producing units.ⁿ⁵⁰ Nor will it apply to a residence that was bifurcated into a two family unit, in which one unit was used as a principal residence and the other was rented out to a tenant.ⁿ⁵¹

In addition, a serious consequence of this limitation is that the presence in many residential mortgage forms of boilerplate language which arguably adds personal property to the lender's collateral may adversely affect the lender by permitting the debtor to modify the lender's entire claim in a chapter 13 plan. For example, in *Sapos v. Provident Institution of Savings*, the Court of Appeals for the Third Circuit has held that language that includes "rents, issues and profits," "replacements and additions," "any and all appliances, machinery, furniture and equipment (whether fixtures or not)," and "wall to wall carpeting" in the collateral takes the mortgages in question out of the scope of section 1322(b)(2).ⁿ⁵² In a more recent case, the same court of appeals held that the inclusion in the mortgage of an assignment of rents clause and a security interest in an escrow account did not take the mortgage out of the protection of section 1322(b)(2) because, under the relevant state law, the rents constituted an interest in real property and the escrow funds did not constitute additional collateral granted by the mortgagor since, under state law, the mortgagor had no interest in the escrow funds.ⁿ⁵³ On the other hand, the Court of Appeals for the Sixth Circuit has held that language in a mortgage that required fire insurance did not constitute additional security for purposes of the section.ⁿ⁵⁴

It should be noted that the 2005 Act added a specific definition of "debtor's principal residence," defined to mean "a residential structure, including incidental property, without regard to whether that structure is attached to real property; and includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer."ⁿ⁵⁵ Based on

the language of the definition, for which there is no published legislative history, the primary thrust of the definition appears to be an intent to clarify that the term applies to residences of a type that were other than traditional single family homes.⁵⁶ However, in the absence of discernable legislative history, the purpose of the specific phrase "including incidental property," within the definition is not so clear. It may be that this language is intended to overrule cases such as *Sapos* that had the effect of adversely treating mortgages that covered the type of incidental assets such as appliances, machinery and carpeting that are arguably nonseverable in a functional sense from the residential structure itself.

Courts have construed the nonmodification protection of section 1322(b)(2) so narrowly and the right of a chapter 13 debtor to otherwise modify a lien as so fundamental that in one recent case, the Court of Appeals for the First Circuit has held that where lien modification was permitted because of the presence of multifamily units, such modification would not even be nullified by a post plan payment default by the debtor and the subsequent grant to the lender of relief from the automatic stay.⁵⁷ Therefore, given the critical protection afforded home mortgage lenders by sections 1322(b)(2) and 1123(b)(5), it would seem advisable for lenders to review their standard mortgage forms and consider removing language which has the effect of only negligibly improving the lender's collateral position while making the lender's entire claim vulnerable in the context of a chapter 11 or chapter 13 case.

Also, in the case of multifamily units, if permitted by state law and where bifurcation is possible, such as in the case of separate physical units on a single lot, lenders may wish to consider taking a separate mortgage on the borrower's residence, with a portion of the aggregate debt secured only by that mortgage, and a separate mortgage with attributable debt on the other units in a multifamily complex, so that the separate residential mortgage and related claim could enjoy the benefits of the antimodification provisions of section 1322(b)(2) or section 1123(b)(5), as the case may be. Of course, the viability of such a structure would require that the lender be comfortable with having the debt attributable to the residence not be directly cross collateralized with the income producing units in the complex. It may be that a lender will be comfortable with such a scenario if the claim attributable to the residential unit reflects significant equity value of the borrower. Indeed, it would seem that although direct cross collateralization of the residential claim with the nonresidential property would not be permitted, many equivalent benefits could be achieved by incorporating cross defaults into the two loan instruments so that a default on the nonresidential mortgage would lead to a default under the principal residence-secured loan. Such a cross default provision, of a type which are common in many commercial loan agreements, should not be treated as nullifying the benefits of sections 1322(b)(2) and 1123(b)(5) since they arguably affect only the payment schedule on the residential loan (i.e., by leading to the possibility of the acceleration of the resident-secured loan upon default under the nonresident-secured loan) rather than the scope of the "security interest" for the claim, which appears to be the sole limitation on the applicability of such Code sections.

FOOTNOTES:

(n1)Footnote 1. See generally Cohen, *The Undersecured Home Mortgage: Does the Supreme Court's Decision in Nobelman Stymie the Debtor?*, 3 J. Bankr. L. & P. 61 (1993); Connolly, *Limits on Residential Mortgage Lender Protection Under Section 1322(b)(2) of the Bankruptcy Code*, 9 Ga. St. U. L. Rev. 647 (1993); Sable, *A Chapter 13 Debtor's Right to Cure Default Under Section 1322(b): A Problem of Interpretation*, 57 Am. Bankr. L.J. 127 (1983); Comment, *Accelerated Mortgages: An Unsolved Problem of Interpretation in Chapter 13*, 19 Hous. L. Rev. 954 (1982); Comment, *Home Foreclosures Under Chapter 13 of the Bankruptcy Reform Act*, 30 UCLA L. Rev. 637 (1983).

(n2)Footnote 2. 11 U.S.C. § 1322(d).

(n3)Footnote 3. See, e.g., *Litton v. Wachovia Bank (In re Litton)*, 330 F.3d 636 (4th Cir. 2003); *In re Thompson*, 894 F.2d 1227, 22 C.B.C.2d 250 (10th Cir. 1990); *In re Metz*, 820 F.2d 1495, 1497, 17 C.B.C.2d 63, 66 (9th Cir. 1987); *In re Clark*, 738 F.2d 869, 872, 10 C.B.C.2d 1280, 1283 (7th Cir. 1984); *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 246, 10 C.B.C.2d 549, 562 (5th Cir. 1984); *DiPierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 27-28, 6 C.B.C.2d 1201, 1205 (2d Cir. 1982); *In re Christian*, 35 B.R. 229, 231 (Bankr. N.D. Ga. 1983). The debtor's right to cure any default under section 1322(b)(5) includes the right to pay the mortgage arrearages which triggered

acceleration and to reinstate the original payment schedule of the mortgage. *See, e.g., DiPierro v. Taddeo (In re Taddeo) supra*, 685 F.2d 24, 26-28, 6 C.B.C.2d 1201, 1205-06 ; *In re Ivory*, 32 B.R. 788, 790-91, 9 C.B.C.2d 351, 354 (Bankr. D. Or. 1983) . However, the right to cure a mortgage default does not include the right to stretch a mortgage which was fully matured by its terms prepetition. *In re Baxter*, 29 C.B.C.2d 58, 155 B.R. 285 (Bankr. D. Mass. 1993) ; *In re Gianguzzi*, 145 B.R. 792 (Bankr. S.D.N.Y. 1992) .

(n4)Footnote 4. 738 F.2d 869, 10 C.B.C.2d 1280 (7th Cir. 1984) .

(n5)Footnote 5. 738 F.2d 869, 871, 10 C.B.C.2d 1280, 1282 .

(n6)Footnote 6. 824 F.2d 1370, 17 C.B.C.2d 493 (3d Cir. 1987) .

(n7)Footnote 7. 760 F.2d 1428, 12 C.B.C.2d 1303 (6th Cir.) , cert. denied, *Miller v. First Fed. of Mich.*, 474 U.S. 849, 106 S. Ct. 144, 88 L. Ed. 2d 119 (1985) .

(n8)Footnote 8. 760 F.2d 1428, 1435, 12 C.B.C.2d 1303, 1311 .

(n9)Footnote 9. *Id.*

(n10)Footnote 10. 760 F.2d 1428, 1436, 12 C.B.C.2d 1303, 1312 . The reasoning in *Glenn* was followed in *In re Thompson*, 894 F.2d 1227, 22 C.B.C.2d 250 (10th Cir. 1990) .

(n11)Footnote 11. Pub. L. No. 103-394 (1994).

(n12)Footnote 12. 11 U.S.C. § 1322(c)(1).

(n13)Footnote 13. 140 Cong. Rec. H10,769 (daily ed. Oct. 4, 1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n14)Footnote 14. *Colon v. Option One Mortg. Corp.*, 319 F.3d 912 (7th Cir. 2003) .

(n15)Footnote 15. 319 F.3d 912, 921-22 .

(n16)Footnote 16. *Cain v. Wells Fargo Bank, N.A. (In re Cain)*, 423 F.3d 617, 54 C.B.C.2d 1438 (6th Cir. 2005) .

(n17)Footnote 17. 423 F.3d 617, 619 (citations and internal quotations omitted).

(n18)Footnote 18. *See P 1.07 supra.*

(n19)Footnote 19. *See, e.g., Federal Land Bank v. Glenn (In re Glenn)*, 760 F.2d 1428, 12 C.B.C.2d 1303 (6th Cir.) , cert. denied, *Miller v. First Fed. of Mich.*, 474 U.S. 849, 106 S. Ct. 144, 88 L. Ed. 2d 119 (1985) ; *Johnson v. First Nat'l Bank*, 719 F.2d 270, 9 C.B.C.2d 579 (8th Cir. 1983) , cert. denied, 465 U.S. 1012, 104 S. Ct. 1015, 79 L. Ed. 2d 245 (1984) ; *Westergaard v. Cucumber Creek Dev. Inc. (In re Cucumber Creek Dev., Inc.)*, 9 C.B.C.2d 639, 33 B.R. 820 (D. Colo. 1983) ; *Cramer v. Markee (In re Markee)*, 8 C.B.C.2d 1331, 31 B.R. 429 (Bankr. D. Idaho 1983) ; *In re New Town Mall*, 5 C.B.C.2d 1530, 17 B.R. 326 (Bankr. D.S.D. 1982) . But see, e.g., *Jenkins v. Peet (In re Jenkins)*, 6 C.B.C.2d 677, 19 B.R. 105 (D. Colo. 1982) .

(n20)Footnote 20. *Johnson v. First Nat'l Bank*, 719 F.2d 270, 277, 9 C.B.C.2d 579, 587 .

(n21)Footnote 21. *See, e.g., In re Owens*, 27 B.R. 946 (Bankr. E.D. Mich. 1983) ; *In re Murphy*, 7 C.B.C.2d 74, 22 B.R. 663 (Bankr. D. Colo. 1982) ; *In re Construction Leasing & Inv. Corp.*, 20 B.R. 546 (Bankr. M.D. Fla. 1982) ; *Bank of Commonwealth v. Bevan*, 6 C.B.C.2d 699, 13 B.R. 989 (Bankr. E.D. Mich. 1981) .

(n22)Footnote 22. 11 U.S.C. § 108(b).

(n23)Footnote 23. 284 F.3d 362 (2d Cir. 2002) .

(n24)Footnote 24. 284 F.3d 362, 372 .

(n25)Footnote 25. *Id.*

(n26)Footnote 26. See *Prado v. Cash Am. Advance, Inc. (In re Prado)*, 55 C.B.C.2d 1502, 340 B.R. 574 (Bankr. S.D. Tex. 2006) ; see also *In re 210 Roebling, LLC*, 336 B.R. 172 (Bankr. E.D.N.Y. 2005) .

(n27)Footnote 27. See *In re Littleton*, 888 F.2d 90 (11th Cir. 1989) ; *Abramson v. Lakewood Bank & Trust Co.*, 647 F.2d 547 (5th Cir. 1981) , cert. denied, 454 U.S. 1164, 102 S. Ct. 1038, 71 L. Ed. 2d 320 (1982) ; *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980) ; *Berge v. Sweet (In re Berge)*, 9 C.B.C.2d 530, 33 B.R. 642 (Bankr. W.D. Wis. 1983) ; P 2.04 *infra* .

(n28)Footnote 28. See, e.g., *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980) ; *In re Wheeler*, 34 B.R. 818 (Bankr. N.D. Ala. 1983) ; *Berge v. Sweet (In re Berge)*, 9 C.B.C.2d 530, 33 B.R. 642 (Bankr. W.D. Wis. 1983) .

(n29)Footnote 29. 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) .

(n30)Footnote 30. The Supreme Court emphasized that its opinion addressed mortgage foreclosures of real estate only and expressly declined to address the considerations bearing upon other types of foreclosures and forced sales, including sales to satisfy tax liens.

(n31)Footnote 31. 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228, 28 C.B.C.2d 977 (1993) .

(n32)Footnote 32. 11 U.S.C. § 506(a).

(n33)Footnote 33. 508 U.S. 324, 329, 113 S. Ct. 2106, 2110, 124 L. Ed. 2d 228, 235, 28 C.B.C.2d 977, 981 .

(n34)Footnote 34. 11 U.S.C. § 1123(b)(5), added by Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n35)Footnote 35. H.R. Rep. No. 103-835, 103d Cong., 2d Sess. 46 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b)(ii) (Matthew Bender 15th Ed. Revised).

(n36)Footnote 36. See, e.g., *In re Bauler*, 215 B.R. 628 (Bankr. D. N.M. 1997) ; *DeHart v. United States, IRS (In re Metropolitan Metals)*, 210 B.R. 249 (Bankr. D. Minn. 1997) ; *In re Barnes*, 207 B.R. 588 (Bankr. N.D. Ill. 1997) .

(n37)Footnote 37. See *Eastern Savings Bank v LaFata (In re LaFata)*, 483 F.3d 13, 57 C.B.C.2d 1430 (1st Cir. 2007) ; *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2002) ; *Lane v. W. Interstate Bancorp (In re Lane)*, 280 F.3d 663, 47 C.B.C.2d 1320 (6th Cir. 2002) ; *In re Pond*, 252 F. 3d 122 (2d Cir. 2001) ; *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357, 1359 (11th Cir. 2000) ; *McDonald v. Master Fin., Inc. (In re McDonald)*, 205 F.3d 606, 611-12 (3d Cir.) , cert. denied, 531 U.S. 822, 121 S. Ct. 66, 148 L. Ed. 2d 31 (2000) ; *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277, 291-93 (5th Cir. 2000) .

(n38)Footnote 38. 368 F.3d 1165 (9th Cir. 2004) .

(n39)Footnote 39. 368 F.3d 1165, 1170 (quoting from bankruptcy court decision).

(n40)Footnote 40. 368 F.3d 1165, 1172 .

(n41)Footnote 41. 11 U.S.C. § 1322(c)(2).

(n42)Footnote 42. *113 F.3d 508 (4th Cir. 1997)* .

(n43)Footnote 43. *113 F.3d 508, 511* .

(n44)Footnote 44. *296 F.3d 1203 (11th Cir. 2002)* .

(n45)Footnote 45. *296 F.3d 1203, 1208* .

(n46)Footnote 46. *11 U.S.C. § 1123(b)(5)*.

(n47)Footnote 47. *See, e.g., 1st 2nd Mortgage Co. of NJ, Inc. v. Ferandos (In re Ferandos), 402 F.3d 147, 151, 53 C.B.C.2d 1580 (3d Cir. 2005)* (the legislative history indicates "that it was designed to protect and promote the increased production of homes and to encourage private individual ownership of homes as a traditional and important value in American life").

(n48)Footnote 48. *82 F.3d 1, 7 (1st Cir. 1996)* .

(n49)Footnote 49. *Id.* (citing H.R. Rep. No. 103-835, 103d Cong., 2d Sess. 46 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt 9(b)(ii) (Matthew Bender 15th Ed. Revised)).

(n50)Footnote 50. *Carvalho v. Federal Nat'l Mortgage Ass'n (In re Carvalho), 335 F.3d 45, 50 C.B.C.2d 609 (1st Cir. 2003)* ; *In re Bulson, 54 C.B.C.2d 819, 327 B.R. 830 (Bankr. W.D. Mich. 2005)* .

(n51)Footnote 51. *Scarborough v. Chase Manhattan Mortgage Corp. (In re Scarborough), 461 F.3d 406, 56 C.B.C.2d 1026 (3d Cir. 2006)* ; *see also Litton Loan Servicing, LP v. Beamon, 298 B.R. 508 (N.D.N.Y. 2003)* .

(n52)Footnote 52. *Sapos v. Provident Inst. of Sav., 967 F.2d 918 (3d Cir. 1992)* ; *Wilson v. Commonwealth Mortg. Corp., 895 F.2d 123 (3d Cir. 1990)* . *But see In re Davis, 989 F.2d 208, 212, 28 C.B.C.2d 942, 946 (6th Cir. 1993)* (holding that reference to "rents, royalties, profits and fixtures" refers to benefits that are "merely incidental to an interest in real property" not constituting additional security for purposes of section 1322(b)(2)).

(n53)Footnote 53. *Mortgage Co. of New Jersey, Inc. v. Ferandos (In re Ferandos), 402 F.3d 147 (3d Cir. 2004)* .

(n54)Footnote 54. *In re Davis, 989 F.2d 208, 212, 28 C.B.C.2d 942, 946 (6th Cir. 1993)* .

(n55)Footnote 55. *11 U.S.C. § 101(13A)*, added by Pub. L. No. 109-8, § 306(c)(1) (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n56)Footnote 56. *See Reinhardt v Vanderbilt Mortgage and Finance Inc. (In re Reinhardt), 563 F.3d 558 (6th Cir. 2009)* ; *Ennis v. Green Tree Servicing, LLC. (In re Ennis), 558 F.3d 343, 61 C.B.C.2d 519 (4th Cir. 2009)* . In 2008, the U.S. Supreme Court, in a footnote, confined the definition of "debtor's principal residence" to use by bankruptcy debtors. *Burgess v. United States, U.S. 128 S. Ct. 1572, 170 L. Ed. 2d 478 (2008)* .

(n57)Footnote 57. *Carvalho v. Federal Nat'l Mortgage Ass'n (In re Carvalho), 335 F.3d 45, 50 C.B.C.2d 609 (1st Cir. 2003)* .

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 1 Survey of Bankruptcy Code Provisions Affecting Real Estate Transactions *

1-1 Collier Real Estate Trans & Bankruptcy Code P 1.14

P 1.14 The Bankruptcy Rules

[1] Introduction

This section contains a summary of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") that may affect procedures and litigation arising in Bankruptcy Code cases dealing with real property. In view of the substantial percentage of real estate- related cases that involve a partnership as the debtor, the summary also covers the Bankruptcy Rules relating to partnership petitions and other partnership matters. Certain Bankruptcy Rules not referred to herein may come into play in the course of a real estate-related case under the Bankruptcy Code; accordingly, the full text of the Bankruptcy Rules should be consulted to the extent required in the circumstances. In addition, many bankruptcy courts have specific local rules that may be relevant in a particular case.

The Bankruptcy Rules, revised in light of the Bankruptcy Reform Act of 1978, became effective on August 1, 1983, pursuant to 28 U.S.C. § 2075, on order of the United States Supreme Court, and by Congress' failure to take negative action with respect to them. The Rules include Official Forms which are required to be followed in substantial measure. The Official Forms may be changed by the Judicial Conference of the United States without the need of action by the Supreme Court or Congress.ⁿ¹

The Bankruptcy Rules are rather extensive, and it is best to assume that some rule exists with respect to a procedural problem that comes to light. It is also important to bear in mind that the Rules affect only matters of procedure and do not deal with substantive rights. Furthermore, pursuant to 28 U.S.C. § 2075, the Rules may not be inconsistent with any statutory provisions; accordingly, if a matter of procedure is in the Bankruptcy Code, it will probably not be found in the Rules. On March 30, 1987, the Chief Justice of the United States Supreme Court transmitted to each of the Senate and the House of Representatives amendments to the Bankruptcy Rules that were adopted by the Supreme Court pursuant to 28 U.S.C. § 2075. The amendments to the Bankruptcy Rules in large part reflected the changes required by the adoption of the Bankruptcy Amendments and Federal Judgeship Act of 1984.ⁿ² These amendments became effective on August 1, 1987. A second group of substantial amendments became effective on August 1, 1991, to reflect changes made to the Code by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986.ⁿ³ A third set of amendments to the rules became effective on August 1, 1993, to reflect certain technical and stylistic changes and amend several rules to provide that certain specific hearings are not required unless requested. Additionally, less extensive amendments have been made to the rules at other times.ⁿ⁴

In response to the 2005 Act, the Advisory Committee on Bankruptcy Rules prepared and recommended for local court adoption Interim Bankruptcy Rules designed to implement changes made by the amendments. The Interim Rules are intended to apply until the Federal Rules of Bankruptcy Procedure are amended to implement the 2005 legislation, and are effective only in cases commenced on or after October 17, 2005, and only in the judicial districts that have adopted them by local rule or court order.ⁿ⁵

The Interim Bankruptcy Rules were superseded on December 1, 2008, with the adoption of new Federal Rules of Bankruptcy Procedure.ⁿ⁶ Further Federal Rules of Bankruptcy Procedure amendments were enacted effective December 1, 2009.ⁿ⁷

The Federal Rules of Bankruptcy Procedure are divided into nine parts, roughly dealing sequentially with the progress of a Bankruptcy Code case. Unless otherwise stated therein, the Rules apply to cases under each chapter of the Code. Part I contains rules relating to the commencement of voluntary and involuntary cases under the Code and to the entry of the order for relief in an involuntary case. Part II deals with a number of administrative matters, including appointment of trustees, notices to and meetings of creditors and equity security holders, examination of the debtor and employment of professional persons. Part III deals with claims and distribution to creditors and equity interest holders. This part prescribes the forms of proofs of claim, the time and place of filing of proofs of claim, classification of claims and interests, and the filing of plans and disclosure statements. Part IV includes rules relating to motions for relief from the automatic stay, claims of exemptions, and matters relating to dischargeability of debts. Part V relates to courts, court clerks and court records. Part VI deals with collection and disposition of assets of the estate, including matters relating to postpetition transfers, use, sale or lease of property of the estate, appointment of appraisers and auctioneers, assumption, rejection and assignment of executory contracts and abandonment or disposition of property. Part VII sets forth the rules of procedure for adversary proceedings. Part VIII governs appeals to the district court or to a bankruptcy appellate panel. Part IX contains general provisions, including the definition of certain terms, computation of time periods and authority to extend or diminish the time periods otherwise prescribed in the Rules for the giving of certain notices. The Official Forms accompanying the Rules include the form of voluntary petition, form of involuntary petition, form of ballot for accepting or rejecting a plan, form of proof of claim and forms of certain court orders.

In particular, Official Form 6 (Schedules) requires, among other things, that debtors provide on Schedule A detailed information regarding all real property in which the debtor has any legal, equitable or future interest, including all property owned as a co-tenant, community property, or in which the debtor has a life estate. The information required includes a description and location of all such property, the nature of the debtor's interest, the current value (without deducting any secured claim or exemption) and the amount of any secured claim against such real property interest.

[2] Commencement of Cases--the Petition and Order for Relief

Under *Rule 1002*, a petition commencing a case under the Bankruptcy Code is to be filed with the clerk of the bankruptcy court. If no clerk of the bankruptcy court is present in a particular jurisdiction, the petition is to be filed with the clerk of the district court.ⁿ⁸

The filing requirements for a voluntary petition filed on behalf of a partnership are a matter of substantive law and outside the scope of the Bankruptcy Rules.ⁿ⁹ A petition against a partnership that does not meet the requirements for a voluntary petition is treated as an involuntary petition under section 303(b)(3). *Rule 1004* requires that the petitioning partners and any other petitioners shall "promptly send to or serve on each general partner who is not a petitioner a copy of the petition."ⁿ¹⁰ The clerk in such circumstances is required to issue forthwith a summons for service on each general partner who is not a petitioner. *Rule 1004* refers to *Rule 1010*, which prescribes the form and manner of service of the summons. The summons may be served in accordance with *Rule 7004(a)*, which provides for personal service, and by *Rule 7004(b)* providing for service by first class mail. If such service cannot be effected, the court may order the summons and petition to be served by mailing copies to the recipient's last known address and by not less than one publication in a manner and form directed by the court.ⁿ¹¹

Under *Rule 1011(a)*, in the case of an involuntary petition against a partnership, a nonpetitioning general partner, or a person that is alleged to be a general partner but denies the allegation, may contest the petition. Under *Rule 1011(b)*, defenses and objections to the petition are to be presented in the manner prescribed by *Fed. R. Civ. P. 12* and filed and served within 21 days after service of the summons. The time for filing and service of the response may be modified if service is made by publication on a party or partner not residing or found within the state in which the bankruptcy court sits.

The party contesting the involuntary petition may not raise any claim against the petitioner in its answer other than for the purpose of defeating the petition.ⁿ¹² Under *Rule 1013(a)*, the issues raised by a contested petition are to be determined by the court "at the earliest practicable time." The court may enter an order for relief, dismiss the petition or enter other appropriate orders. *Rule 1018* identifies specific Rules set forth in Part VII of the Bankruptcy Rules, dealing with adversary proceedings, relating to the contest of an involuntary petition.

In the context of an involuntary liquidation case under chapter 7, prior to the entry of an order for relief, a party in interest may move for the appointment of an interim trustee under *section 303(g) of the Bankruptcy Code*.ⁿ¹³ The movant must furnish a bond in an amount approved by the court as a condition to the appointment of an interim trustee. The bond must contain an indemnity for the benefit of the debtor for costs, attorney's fees, expenses and damages allowable under *section 303(i) of the Code*.ⁿ¹⁴ The order appointing the interim trustee shall state the reason the appointment is necessary and shall specify the trustee's duties.ⁿ¹⁵

Under *Rule 1007*, the debtor is obligated to file a list of creditors and of equity security holders and certain schedules and statements, including a schedule of executory contracts and unexpired leases. Time periods for such filings are prescribed in *Rule 1007(c)*, but the time periods may be extended by order of the court. In a chapter 11 reorganization case, *Rule 1007(d)* also requires the filing of a list of the holders of the 20 largest unsecured claims. In the context of a partnership case, the general partners are required to prepare and file the schedule of assets and liabilities and other financial information relating to the partnership as specified in *Rule 1007(g)*. In addition, the court may order any general partner to file a statement of personal assets and liabilities with the court within such time as the court may fix.

Under *Rule 1008*, all petitions, lists, schedules, statements and amendments thereto must be verified or contain an unsworn declaration provided in *28 U.S.C. § 1746*.

Under *Rule 1009(a)*, voluntary petitions, lists, schedules, statements and the like may be amended by the debtor as a matter of course at any time before the case is closed. The debtor is required to give notice of the amendment to the trustee and to any entity affected by the amendment, and under *Rule 1009(d)* the clerk of the court is required to transmit copies of all amendments to the United States trustee. Notice of the amendment to affected parties is particularly important in the case of scheduled creditors in chapter 11 cases, inasmuch as a creditor whose claim is accurately scheduled and is not disputed is not required under the Bankruptcy Code to file a proof of claim.ⁿ¹⁶ Therefore, if schedules are amended to place a previously undisputed claim into dispute, the affected creditor must be notified so that it may take the necessary steps to file a proof of claim. The substantive provisions regarding the proper venue of a Bankruptcy Code case, including change of venue, are set forth in sections 1408, 1404, 1410 and 1412 of title 28.ⁿ¹⁷ In general, a Bankruptcy Code case can be commenced in the district court for the district in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of the case has been located for the 180 days immediately preceding such comment.ⁿ¹⁸ A case also may be commenced in the district court for the district in which there is pending a Bankruptcy Code case concerning the subject entity's affiliate, general partner, or partnership.ⁿ¹⁹

Rule 1014 governs dismissal and transfer of cases and changes of venue. Under *Rule 1014(a)(1)*, a case filed in a proper district, on timely motion of a party in interest or on the court's own motion, and after hearing on notice to the petitioners, the United States trustee and other entities as directed by the court, may be transferred to another district in

the interests of justice or for the convenience of parties. Under *Rule 1014(a)(2)*, if a petition is filed in an improper district, on timely motion of a party in interest, or on the court's own motion, and after hearing on notice to the petitioners, the United States trustee and other entities as directed by the court, the case may be dismissed or transferred to another district if the court determines that the transfer is in the interests of justice or for the convenience of the parties. If petitions commencing cases under the Code are filed in different districts by or against (1) the same debtor, (2) a partnership and one or more of its general partners, (3) two or more general partners of the same partnership or (4) a debtor and an affiliate, then on motion filed in the district in which the first petition is filed, and after hearing on notice to the petitioner, the United States trustee and other entities as directed by the court, the court may determine, in the interests of justice or for the convenience of the parties, the district or districts in which the case or cases should proceed. Except as otherwise ordered by the court in the district in which the first petition is filed, proceedings on the other petitions are to be stayed by the courts in which they have been filed until the determination as to the proper district has been made.ⁿ²⁰

Under *Rule 1015*, dealing with administrative consolidation of cases, if two or more petitions in the same court are pending against a partnership and one or more of its general partners, or two more or of its general partners or a debtor and an affiliate, the court may order joint administration of the estates. The court is required under *Rule 1015(b)*, prior to the entry of such an order of joint administration, to give consideration to the protection of creditors of different estates against potential conflicts of interest. The court may issue such protective orders as may be required to avoid unnecessary costs and delay.ⁿ²¹ Under *Rule 2009(a)*, if the court orders a joint administration of two or more estates pursuant to *Rule 1015(b)*, creditors may elect a single trustee for the jointly administered estates.ⁿ²²

Rule 1017 sets forth the procedures for dismissal of a case, including for want of prosecution, and, in the case of an individual debtor's case, for abuse.ⁿ²³ *Rule 1018* prescribes the rules that apply to all proceedings relating to a contested involuntary proceedings, contested petitions commencing ancillary cases, and proceedings to vacate an order for relief.ⁿ²⁴ *Rule 1019* contains extensive rules concerning the effect of conversion of a chapter 11 reorganization case, chapter 12 family farmers' debt adjustment case or chapter 13 individual debt adjustment case to a chapter 7 liquidation case.

[3] Notices; Meetings and Examinations

Rule 2002 contains extensive provisions for notices to parties in interest of various matters. Under *Rule 2002(a)*, with certain exceptions,ⁿ²⁵ a 21-day notice is prescribed for, among other things: (1) the meeting of creditors pursuant to *section 341 of the Bankruptcy Code*;ⁿ²⁶ (2) a proposed use, sale or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the notice period or directs another method of giving notice; (3) a hearing on approval of a compromise or settlement of a controversy, other than approval of an agreement pursuant to *Rule 4001(d)* (relating to agreements involving relief from the automatic stay, prohibiting or conditioning the use, sale or lease of property, providing adequate protection, use of cash collateral and obtaining credit) unless the court for cause shown directs that notice not be sent; (4) in chapter 7 liquidation, chapter 11 reorganization and chapter 12 family farmer cases, the hearing on dismissal or conversion of the case to another chapter, with certain exceptions; (5) the time fixed to accept or reject a proposed modification of a plan; (6) the time fixed for filing objections and the hearing to consider confirmation of a chapter 12 plan; and (7) the time fixed for filing proofs of claim pursuant to *Rule 3003(c)*.ⁿ²⁷ *Rule 2002(b)*, with certain exceptions,ⁿ²⁸ prescribes a 28-day notice of the time fixed for filing objections to, and the hearing to consider approval of, a disclosure statement, and of the time fixed for filing objections to, and the hearing to consider confirmation of, a chapter 9, chapter 11, or chapter 13 plan.

A notice of proposed use, sale or lease of property must include the time and place of any public sale, the terms and conditions of any private sale and the time fixed for filing objections thereto. A notice of proposed use, sale or lease of property, including real property, is deemed sufficient if it generally describes the property involved.ⁿ²⁹ *Rule 6004*, dealing with use, sale or lease of property, should be consulted in connection with a notice given under *Rule 2002(c)(1)*.ⁿ³⁰

Under *Rule 2002(d)*, notice to equity security holders in a chapter 11 reorganization case (including limited partners of a partnership), unless otherwise ordered by the court, is required to advise such persons of (1) the entry of an order for relief; (2) any meeting of equity security holders held pursuant to *section 341 of the Bankruptcy Code*;n31 (3) a hearing on the proposed sale of all or substantially all of the debtor's assets; (4) a hearing on dismissal or conversion of the case to another chapter; (5) the time fixed for filing objections to and the hearing to consider approval of a disclosure statement; (6) the time fixed for filing objections to and the hearing to consider confirmation of a plan; and (7) the time fixed to accept or reject a proposed plan modification.

Rule 2002(e) provides that in a chapter 7 liquidation case, if it appears from the schedules that there are no assets from which a dividend can be paid, the notice of the meeting of creditors may include a statement to that effect, that it is unnecessary to file claims, and that if sufficient assets ultimately became available for the payment of a dividend, further notice will be given for the filing of claims.

Under *Rule 2002(f)*, the clerk, or some other person as the court may direct, is required to give to the debtor, all creditors and indenture trustees notice by mail of (1) the order for relief; (2) dismissal or conversion of a case or the suspension of proceedings under section 305; (3) the time allowed for filing claims pursuant to *Rule 3002*; (4) the time fixed for filing a complaint objecting to a debtor's discharge pursuant to *section 727 of the Bankruptcy Code* as provided in *Rule 4004*;n32 (5) the time fixed for filing a complaint to determine the dischargeability of a debt pursuant to *section 523 of the Bankruptcy Code* as provided in *Rule 4007*; (6) the waiver, denial or revocation of a discharge; (7) entry of an order confirming a chapter 9, 11 or 12 plan; (8) a summary of the trustee's final report and account in a chapter 7 case if the net proceeds realized exceed \$1,500; (9) a notice under *Rule 5008* regarding the presumption of abuse; (10) a statement under section 704(b)(1) as to whether the debtor's case would be presumed to be an abuse under section 707(b); and (11) the time to request a delay in the entry of the discharge under sections 1141(d)(5)(C), 1228(f) and 1328(h).

Under *Rule 2002(h)*, in a chapter 7 case, the court may, after 90 days following the first date set for the meeting of creditors pursuant to *section 341 of the Code*, direct that all notices required under *Rule 2002(a)* be mailed only to creditors whose claims have been filed and creditors who are still permitted to file claims by reason of an extension granted under *Rules 3002(c)(1)* and *3002(c)(2)*.n33 Under *Rule 2002(i)*, copies of all notices to be mailed under *Rule 2002* are also to be mailed to committees elected pursuant to section 705 or appointed pursuant to *section 1102 of the Code* or to their authorized agents. In addition, the court may order that certain notices be transmitted to the United States trustee and be mailed only to the committees or their authorized agents. Under *Rule 2002(j)*, copies of notices required to be mailed to all creditors under *Rule 2002* shall also be mailed to certain governmental agencies under certain circumstances, including in chapter 11 cases to the Securities and Exchange Commission at any place the Commission designates and to the District Director of Internal Revenue for the district in which the case is pending.

Rule 2002(k) prescribes the notices to be sent to the United States trustee.

Under *Rule 2002(l)*, the court may order notice by publication if it finds that notice by mail is impracticable or that it is desirable to supplement such notice.

Rule 2002(m) authorizes the court to enter orders from time to time designating the matters in respect to which, the entity to whom, and the form and manner in which, notices are to be sent except as otherwise provided in the Rules. Such order have become commonplace in major chapter 11 cases in order to streamline and economize the notice process.

Under *Rule 2003*, the United States trustee shall call a meeting of creditors to be held not less than 21 nor more than 40 days after the entry of the order for relief (35 days in chapter 12 cases and 50 days in chapter 13 cases). If there is an appeal from or motion to vacate the order, or a pending motion to dismiss the case, the United States trustee may set a

later time for the meeting. This rule complements *section 341 of the Bankruptcy Code*.

Under *Rule 2004(a)*, on motion of any party in interest, the court may order the examination of any entity. The examination of an entity under *Rule 2004* or of the debtor under *section 343 of the Code* may relate only to the acts, conduct or property, or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate or its right to a discharge. The attendance of an entity for examination and the production of documentary evidence may be compelled in the manner provided in *Rule 9016* for the attendance of witnesses at a hearing or trial.ⁿ³⁴ Under *Rule 2005*, the court may issue an order compelling attendance at an examination.

Rule 2007.1, dealing with the election and appointment of a trustee or the appointment of an examiner in a chapter 11 case sets forth the procedures for the election of a trustee, requires the application for an appointment to be made only by the United States trustee, and sets forth certain items of information to be included in the application.

[4] Claims

Rule 3001(a) defines a proof of claim as a written statement setting forth a creditor's claim. This Rule also prescribes an Official Form of the proof of claim.ⁿ³⁵ Under *Rule 3001(b)*, a proof of claim may be executed by a creditor's authorized agent except as provided in *Rule 3004* and *3005*. *Rule 3004* authorizes the filing by the debtor or the trustee of a proof of claim on behalf of a creditor under certain circumstances, and *Rule 3005* authorizes the filing of a proof of claim by an entity that is or may be liable with the debtor to a creditor, or who has secured that creditor, if the creditor has not filed a proof of claim. These Rules are intended to effectuate the provisions of *subsections 501(b) and (c) of the Bankruptcy Code*.

Under *Rule 3001(c)*, when a claim, or an interest in property of the debtor securing a claim, is based on a writing, the original or a duplicate shall be filed with a proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of loss or destruction shall be filed with the claim. Under *Rule 3001(d)*, a claimant claiming a security interest in property of the debtor is required to provide with the proof of claim evidence of perfection of the security interest.ⁿ³⁶

Rule 3001(e) deals with transferred claims and the method for demonstrating that the transferee is the appropriate party to assert the claim against the debtor. Under *Rule 3001(e)(i)*, if a claim has been transferred other than for security before a proof of claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee. Under *Rule 3001(e)(2)*, if a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee with the bankruptcy court. After the filing of such evidence of transfer, the clerk of the bankruptcy court shall immediately notify the transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 21 days of the mailing of the notice, or within any additional time allowed by the bankruptcy court. If the transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, the bankruptcy court shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor. Under *Rule 3001(e)(3)*, if a claim other than one based on a publicly traded note, bond or debenture has been transferred for security before proof of the claim has been filed, the transferor, transferee, or both may file a proof of claim for the full amount. The proof of claim shall be supported by a statement setting forth the terms of the transfer. If either the transferor or transferee files a proof of claim, the clerk of the bankruptcy court shall immediately notify the other party by mail of the right to join in the filed claim. If both the transferor and the transferee file proofs of the same claim, the proofs are to be consolidated. In the absence of an agreement between the transferor and transferee of the claim providing for their respective rights concerning voting, distributions and participation in the administration of the estate, after a hearing on notice, the court shall enter such orders respecting such matters as may be appropriate. This Rule affects the holder of an assignment of rents or leases under a real estate mortgage, and comes into play in the circumstance under which a

lessee under an assigned lease becomes a Bankruptcy Code debtor and the mortgage falls into default.ⁿ³⁷

Under *Rule 3001(f)*, a proof of claim executed and filed in accordance with the Bankruptcy Rules constitutes *prima facie* evidence of the validity and amount of the claim. This rule is consistent with *section 502(a) of the Bankruptcy Code*.

Except as provided in *Rule 1019(3)* (relating to claims filed in a chapter 11 or 13 case that has been converted to a chapter 7 case), *Rule 3003* (eliminating the filing requirement for creditors or equity security holders whose claims are scheduled and are not disputed, contingent or unliquidated), *Rule 3004* (dealing with filing of claims by the debtor or trustee on behalf of a creditor) and *Rule 3005* (dealing with claims filed on behalf of a creditor by a co-obligor of the debtor), an unsecured creditor or equity security holder must file a proof of claim or interest.ⁿ³⁸ Proofs of claim are to be filed in accordance with Bankruptcy *Rule 5005(a)*, which requires such filing to be made with the clerk of the bankruptcy court in the district where the case is pending. Under *Rule 5005(a)*, a judge of the district court may permit a proof of claim or interest, a complaint and other specified documents to be filed with the judge and is directed to forthwith transmit these papers to the clerk of the bankruptcy court. Additionally, *Bankruptcy Rule 5005(a)* provides for filing by electronic means, where permitted by local rules.ⁿ³⁹

Under *Rule 3002(c)*, in a chapter 7 liquidation, chapter 12 family farmer's debt adjustment, or chapter 13 individual's debt adjustment case, with certain exceptions, a proof of claim shall be filed within 90 days after the first date set for the meeting of creditors called pursuant to *section 341(a) of the Bankruptcy Code*. A significant exception is set forth in *Rule 3002(c)(3)*, which provides that an unsecured claim that becomes allowable because of a judgment may be filed within 30 days after the judgment becomes final if the judgment is for the recovery of money or property from the claimant or denies or avoids the claimant's interest in property. This Rule provides further that the claim shall not be allowed if the judgment imposes a liability which is not satisfied, or a duty which is not performed within the 30-day period or such further time as the court may permit. Another significant exception to the 90-day rule is set forth in *Rule 3002(c)(4)*, which permits the filing of a claim arising from the rejection of an executory contract or unexpired lease of the debtor within such time as the court may direct. In these circumstances, the executory contract or unexpired lease may be rejected after the expiration of 90 days after the first date set for the meeting of creditors, and hence the claim could not arise and therefore could not be filed within the original 90-day period.

Rule 3003 applies to the filing of proofs of claim in chapter 9 and 11 cases. As distinguished from chapter 7 and 13 cases, under *Rule 3003(c)(2)*, a creditor or equity security holder in a chapter 9 or 11 case whose claim or interest is scheduled and is not disputed, contingent or unliquidated need not file a proof of claim.ⁿ⁴⁰ However, in view of the debtor's latitude in amending the schedules and the possibility that a claim listed as undisputed may be newly reflected as disputed in a schedule amendment, it therefore is highly advisable that creditors and equity security holders file proofs of claim or interests. Under *Rule 3003(c)(1)*, any creditor or indenture trustee may file a proof of claim. Under *Rule 3003(c)(3)*, the court shall fix and for cause shown may extend the time within which proofs of claim or interest may be filed. *Rule 3003(c)(3)* is qualified by the specific provisions of *Rule 3002(c)(2)-(4)* and *(c)(6)*.

Rule 3007 requires that an objection to the allowance of a claim shall be in writing and filed, and that a copy of the objection, with notice of hearing thereon, shall be mailed or otherwise delivered to the claimant, the debtor or debtor in possession and the trustee at least 30 days prior to the hearing.

Under *Rule 3008* a party in interest may move for reconsideration of an order allowing or disallowing a claim against the estate.

[5] The Plan Process

Rule 3014 governs the filing of an election pursuant to *Bankruptcy Code section 1111(b)* and, therefore, is of considerable importance for secured creditors in single asset real estate chapter 11 cases.ⁿ⁴¹ Under this Rule, the

election to apply section 1111(b)(2) by a class of secured creditors in a chapter 9 or 11 case may be made at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix. The election must be in writing and signed unless made at the hearing on the disclosure statement. Under section 1111(b)(1)(A)(i), if in a particular case the holders of a claim of the type dealt with under section 1111(b) constitute a class, the election is to be effected by at least two-thirds in amount and more than half in number of the allowed claims of such class. Under *Rule 3014*, the election, if made by the majorities required by section 1111(b)(1)(A)(i), shall be binding on all members of the class with respect to the plan. The Advisory Committee Note accompanying *Rule 3014* helps explain how the section 1111(b)(2) election is handled in actual practice:

Pursuant to § 1111(b)(1) of the Code, a nonrecourse secured loan is converted, automatically, into a recourse loan thereby entitling the creditor to an unsecured deficiency claim if the value of the collateral is less than the debt. The class, however, may retain the loan as a nonrecourse loan by electing application of § 1111(b)(2) by the majorities stated in § 1111(b)(1)(A)(i). That section does not specify any time periods for making the election.

Rule 3014 provides that if no agreement is negotiated, the election of § 1111(b)(2) of the Code may be made at any time prior to conclusion of the hearing on the disclosure statement. Once the hearing has been concluded, it would be too late for a secured creditor class to demand different treatment unless the court has fixed a later time. This would be the case if, for example, a public class of secured creditors should have an approved disclosure statement prior to electing under § 1111(b).

Generally it is important that the proponent of a plan ascertain the position of the secured creditor class before a plan is proposed. The secured creditor class must know the prospects of its treatment under the plan before it can intelligently determine its rights under § 1111(b). The rule recognizes that there may be negotiations between the proponent of the plan and the secured creditor leading to a representation of desired treatment under § 1111(b). If that treatment is approved by the requisite majorities of the class and culminates in a written, signed statement filed with the court, that statement becomes binding and the class may not thereafter demand different treatment under § 1111(b) with respect to that plan. The proponent of the plan is thus enabled to seek approval of the disclosure statement and transmit the plan for voting in anticipation of confirmation. Only if the plan is not confirmed may the class of secured creditors thereafter change its prior election.

While this rule and the Code refer to a class of secured creditors it should be noted that ordinarily each secured creditor is in a separate and distinct class. In that event, the secured creditor has the sole power to determine application of § 1111(b) with respect to that claim.ⁿ⁴²

Rule 3015 addresses the filing, objection to confirmation and modification of a plan in a chapter 12 family farmer's debt adjustment or a chapter 13 individual's debt adjustment case. In chapter 9 municipality and chapter 11 reorganization cases, the Rules that govern the disclosure statement and plan process are set forth in *Rules 3016-3022*. In particular, *Rule 3017* deals with notice of a hearing to consider a disclosure statement and any objections or modifications thereto, the determination by the court whether the disclosure statement should be approved, the establishment by the court of a time within which the holders of claims and interest may accept or reject the plan and the fixing of a date for the hearing on confirmation.ⁿ⁴³ *Rule 3017* further provides that on approval of the disclosure statement the following be sent to all creditors and equity security holders and, in a chapter 11 case, to the United States trustee: (1) the plan, or court-approved summary of the plan; (2) the disclosure statement; (3) notice of the time within which acceptances and rejections of the plan may be filed; and (4) such other information as the court may direct. In addition, a form of ballot conforming to the appropriate Official Form shall be mailed to creditors and equity security holders entitled to vote on the plan.

Rule 3018 deals with the acceptance or rejection of a chapter 9 or chapter 11 plan and provides, among other things, that a court may temporarily allow a claim or interest in an amount which the court deems proper, for the purpose of

accepting or rejecting a plan, notwithstanding the pendency of an objection to the claim or interest. *Rule 3020*, which addresses the confirmation of a chapter 9 or chapter 11 plan, was amended effective December 1, 1999, to provide that an order confirming a plan is stayed until the expiration of 10 days after the entry of the order, unless the court orders otherwise.ⁿ⁴⁴

[6] The Automatic Stay; Use, Sale or Lease of Property; Cash Collateral; Postpetition Credit

Rule 4001 deals with relief from the automatic stay, prohibiting or conditioning the use, sale or leasing of property, use of cash collateral, obtaining credit and agreements relating to the foregoing. Thus *Rule 4001* relates to matters commonly affecting creditors and other parties in interest in real estate bankruptcy cases.

Rule 4001(a)(1) provides that a motion for relief from the automatic stay, and a motion to prohibit or condition the use, sale or lease of property pursuant to section 363(e), shall be made in accordance with *Rule 9014*. *Rule 4001(a)(3)* provides for a stay of the order granting a motion for relief from an automatic stay until the expiration of 14 days after the entry of the orders unless the court orders otherwise.ⁿ⁴⁵ *Rule 9014* relates to the conduct of contested matters under the Bankruptcy Code (as distinguished from adversary proceedings under Part VII of the Rules and simple applications). A contested matter is commenced by a motion and is a less formal proceeding than an adversary proceeding.

Under section 362(e) of the *Bankruptcy Code*, the automatic stay is terminated 30 days after a party in interest files a request with the court under section 362(d) for relief from the stay of any act against property of the estate, unless the court, after notice and a hearing, orders that the stay be continued pending the conclusion of, or as the result of, a final hearing and determination under section 362(d). A hearing under section 362(e) may be a preliminary hearing or may be consolidated with a final hearing under section 362(d). Section 362(e) provides further that the court shall order the stay continued pending conclusion of the final hearing under section 362(d) if a reasonable likelihood exists that the party opposing relief from the stay will prevail at the conclusion of the final hearing. If the hearing under section 362(e) is a preliminary hearing, then the final hearing must be concluded not later than 30 days after the conclusion of the preliminary hearing, unless "the 30-day period is extended with the consent of the parties in interest or for a specific time which the court finds is required by compelling circumstances."ⁿ⁴⁶

Under *Rule 4001(a)(2)*, a party in interest may obtain *ex parte* relief from the stay, or may make an *ex parte* request to prohibit or condition the use, sale or lease of property pursuant to section 363(e), if (1) it clearly appears from the specific facts shown by affidavit or by a verified motion that immediate and irreparable injury, loss or damage will result before the adverse party or its attorney can be heard in opposition, and (2) the movant's attorney certifies in writing to the court the efforts, if any, which have been made to give notice and the reasons why notice should not be required. If *ex parte* relief is granted under this Rule, or under section 362(f) or 363(e),ⁿ⁴⁷ as applicable, the successful party shall immediately give oral notice of such relief to the trustee or debtor in possession and to the debtor and shall forthwith mail or otherwise transmit to such other adverse party or parties a copy of the order granting relief from the stay. The adverse party may on two days' notice to the party who obtained relief or on shorter notice (as the court may prescribe) move for reinstatement of the stay, or reconsideration of the order prohibiting or conditioning the use, sale or lease of property. In the event of such a motion, the court is required to proceed "expeditiously" to hear and determine the motion.

Rule 4001(b) deals with the use of cash collateral. Under section 363(c)(2), the trustee may not use cash collateral unless an entity that has an interest in it consents or the court, after notice and a hearing, authorizes the use. Pursuant to *Rule 4001(b)(1)*, a motion for authorization to use cash collateral commences a contested matter under *Rule 9014*; the motion is to be served on any entity which has an interest in the cash collateral, on any committee elected pursuant to section 705 or appointed pursuant to section 1102, or its authorized agent, or, if no committee has been appointed, and in chapter 9 cases, on the creditors of the debtor included on the list filed pursuant to *Rule 1007(d)* of the Bankruptcy Rules, and on such other entities as the court may direct. Under *Rule 4001(b)(2)*, the court may commence a final

hearing on the motion no earlier than 14 days after service of the motion. Upon request of the movant, the court may conduct a preliminary hearing before such 14-day period expires, but the court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending the final hearing. Under *Rule 4001(b)(3)*, notice of the hearing shall be given to the same parties on whom service of the motion is required under *Rule 4001(b)(1)*, and to such other entities as the court may direct.

Rule 4001(c) deals with motions for authority to obtain credit. The procedure set forth in *Rule 4001(c)* for obtaining credit is substantially the same as the procedure for obtaining an order authorizing use of cash collateral.

Rule 4001(d) relates to agreements concerning relief from the automatic stay, prohibiting or conditioning the use, sale or lease of property, providing adequate protection,ⁿ⁴⁸ use of cash collateral and obtaining credit. *Rule 4001(d)(1)* provides that a motion for approval of such an agreement (including an agreement pursuant to which a secured creditor consents to the imposition of a senior or equal lien), shall be served on any committee elected pursuant to section 705 or appointed pursuant to *section 1102 of the Code*, or its authorized agent, or if no such committee is created, and in all chapter 9 cases, on the creditors named on the list filed pursuant to *Rule 1007(d)*, and on such other entities as the court may direct. The motion must be accompanied by a copy of the agreement. Notice of the motion and the time within which objections may be filed and served on the trustee shall be mailed to the parties on whom service is required under *Rule 4001(d)(1)* and to such other entities as the court may direct. Unless otherwise fixed by the court, objections must be filed within 14 days of the mailing of the notice. Under *Rule 4001(d)(3)*, if no objection is filed, the court may enter an order approving or disapproving the agreement without conducting a hearing. If an objection is filed, or if the court determines to hold a hearing, the court shall hold a hearing on no less than five days' notice to the objector, the movant, the parties on whom service of the motion is required under *Rule 4001(d)(1)*, and to such other entities as the court may direct.

Rule 4001(d)(4) provides that the procedures established under *Rules 4001(d)(1)-(3)* need not be followed if the parties entitled to notice under such Rules had sufficient notice and opportunity for a hearing in the context of a motion made under *Rule 4001(a), (b) or (c)*, and of the relief requested therein, that the secured creditor could be affected in the manner ultimately agreed to by such creditor in the *Rule 4001(d)* agreement.

Pursuant to *Rule 4003(a)* relating to exemptions, the debtor is required to list the property claimed as exempt under *section 522 of the Bankruptcy Code* on the schedule of assets required to be filed under *Rule 1007*. If the debtor fails to claim exemptions or file the schedule within the time specified in *Rule 1007*, a dependent of the debtor may claim exemptions within 30 days thereafter. Objections to a claim for exemption must be filed by the trustee or any creditor within 30 days after conclusion of the meeting of creditors held pursuant to Section 341(a), or the filing of any amendment to the schedule of assets, unless, within such 30-day period, further time is granted by the court. Under *Rule 4003(c)* the objecting party has the burden of proving that the exemptions are not properly claimed.

Under *Rule 4003(d)*, a proceeding by the debtor to avoid a lien or other transfer of property exempt under *section 522(f) of the Bankruptcy Code* shall be initiated by a motion under *Rule 9014*.

Rules 4004-4008 deal with the grant or denial of discharge in a chapter 7 case and related matters.

[7] Courts and Clerks

Part V of the Bankruptcy Rules deals generally with courts and clerks. It should be noted that *Rule 5006* requires the clerk of the bankruptcy court to issue a certified copy of the record of any proceeding in a case under the Code or of any paper filed with the court, on payment of any prescribed fee. The certification procedure may be critical in demonstrating the absence of a notice of appeal and the finality of court orders relating to the sale, use or leasing of any property of the estate.ⁿ⁴⁹

[8] Collection and Liquidation of the Estate; Use, Sale and Leasing of Property

Part VI of the rules deals with collection and liquidation of the estate. Under *Rule 6001*, any entity asserting the validity of a transfer under *section 549 of the Code* (postpetition transfers) has the burden of proof.

Under *Rule 6002(a)*, any "custodian" required under the Code to deliver property in its possession or control to the trustee shall promptly file a report and account with the United States trustee with respect to the property of the estate and the administration thereof.ⁿ⁵⁰ This requirement is particularly significant in cases in which a state court receiver is relieved of jurisdiction through the filing by or against a debtor of a Bankruptcy Code petition.ⁿ⁵¹ Under *Rule 6002(b)*, the court is authorized after notice and a hearing to determine the "propriety of the administration" of the property of the estate by the prepetition custodian, including the reasonableness of all disbursements.

Rule 6003 was added in 2007 to limit certain types of relief, such as motions to use, sell or lease property of the estate or assume an executory contract or unexpired lease, that may be granted in the first 21 days of a bankruptcy case.

Rule 6004 deals with use, sale or leasing of property of the estate and is of particular importance in the case of real estate related Bankruptcy Code cases. In view of the particular importance of this Rule, it is set forth in full below:

(a) *Notice of Proposed Use, Sale, or Lease of Property.* Notice of a proposed use, sale, or lease of property, other than cash collateral, not in the ordinary course of business shall be given pursuant to *Rule 2002(a)(2), (c)(1), (i), and (k)* and, if applicable, in accordance with § 363(b)(2) of the Code.

(b) *Objection to Proposal.* Except as provided in subdivisions (c) and (d) of this rule, an objection to a proposed use, sale, or lease of property shall be filed and served not less than seven days before the date set for the proposed action or within the time fixed by the court. An objection to the proposed use, sale, or lease of property is governed by *Rule 9014*.

(c) *Sale Free and Clear of Liens and Other Interests.* A motion for authority to sell property free and clear of liens or other interests shall be made in accordance with *Rule 9014* and shall be served on the parties who have liens or other interests in the property to be sold. The notice required by subdivision (a) of this rule shall include the date of the hearing on the motion and the time within which objections may be filed and served on the debtor in possession or trustee.

(d) *Sale of Property Under \$2,500.* Notwithstanding subdivision (a) of this rule, when all of the nonexempt property of the estate has an aggregate gross value less than \$2,500, it shall be sufficient to give a general notice of intent to sell such property other than in the ordinary course of business to all creditors, indenture trustees, committees appointed or elected pursuant to the Code, the United States trustee and other persons as the court may direct. An objection to any such sale may be filed and served by a party in interest within 14 days of the mailing of the notice, or within the time fixed by the court. An objection is governed by *Rule 9014*.

(e) *Hearing.* If a timely objection is made pursuant to subdivision (b) or (d) of the rule, the date of the hearing thereon may be set in the notice given pursuant to subdivision (a) of this rule.

(f) *Conduct of Sale Not in the Ordinary Course of Business.*

(1) *Public or Private Sale.* All sales not in the ordinary course of business may be by private sale or by public auction. Unless it is impracticable, an itemized statement of the property sold, the name of each purchaser, and the price received for each item or lot or for the property as a whole if sold in bulk shall be filed with the clerk on completion of a sale. If the property is sold by an auctioneer, the auctioneer shall file the statement, transmit a copy thereof to the United States trustee, and furnish a copy to the

trustee, debtor in possession, or chapter 13 debtor. If the property is not sold by an auctioneer, the trustee, debtor in possession, or chapter 13 debtor shall file the statement, and transmit a copy thereof to the United States trustee.

(2) *Execution of Instruments.* After a sale in accordance with this rule the debtor, the trustee, or debtor in possession, as the case may be, shall execute any instrument necessary or ordered by the court to effectuate the transfer to the purchaser.

(g) *Sale of Personally Identifiable Information.*

(1) *Motion.* A motion for authority to sell or lease personally identifiable information under § 363(b)(1)(B) shall include a request for an order directing the United States trustee to appoint a consumer privacy ombudsman under § 332. *Rule 9014* governs the motion which shall be served on: any committee elected under § 705 or appointed under § 1102 of the Code, or if the case is a chapter 11 reorganization case and no committee of unsecured creditors has been appointed under § 1102, on the creditors included on the list of creditors filed under *Rule 1007(d)*; and on such other entities as the court may direct. The motion shall be transmitted to the United States trustee.

(2) *Appointment.* If a consumer privacy ombudsman is appointed under § 332, no later than seven days before the hearing on the motion under § 363(b)(1)(B), the United States trustee shall file a notice of the appointment, including the name and address of the person appointed. The United States trustee's notice shall be accompanied by a verified statement of the person appointed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

(h) *Stay of Order Authorizing Use, Sale, or Lease of Property.* An order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise.

As discussed above, *Rule 2002(a)(2)* provides for a 21-day notice of a proposed use, sale or lease of property of the estate other than in the ordinary course of business; *Rule 2002(c)(1)* governs the content of the notice; and *Rule 2002(i)* provides for copies of the notices to be sent to committees (or their authorized agents) appointed in the case. The reference in *Rule 6004(a)* to section 363(b)(2) is a reference to the premerger notification requirements of the Hart-Scott-Rodino Antitrust Improvement Act of 1976,ⁿ⁵³ and requires that a proposed sale or lease of property of the estate be deferred until the 15th day after actual receipt by the Federal Trade Commission and by the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice of the trustee's notice of the proposed transaction, unless the court orders otherwise, or unless such time period is extended in accordance with certain provisions of the Hart-Scott-Rodino Antitrust Improvement Act.ⁿ⁵⁴ It should be noted that under section 363(b), court approval for the use, sale or lease of property is not required in the absence of timely filing of an objection.

Under *Rule 6005*, the order of the court approving the employment of an appraiser or an auctioneer shall fix the amount or rate of compensation. This Rule also renders ineligible officers or employees of the judicial branch of the United States or the United States Department of Justice to act as an appraiser or an auctioneer. There is no residence or licensing requirement imposed that may disqualify a person to act as an appraiser or auctioneer.

Rule 6006 deals with assumption, rejection and assignment of executory contracts and unexpired leases. Under *Rule 6006(a)*, a proceeding to assume, reject or assign an executory contract or unexpired lease other than as part of a plan, is treated as a contested matter under *Rule 9014*. Under *Rule 6006(b)*, a motion by a party to an executory contract, or unexpired lease in a chapter 9 municipality case, chapter 11 reorganization case, chapter 12 case or chapter 13 individual's debt adjustment case, to require the trustee to determine whether to assume or reject the agreement, is likewise treated as a contested matter under *Rule 9014*. Under *Rule 6006(c)*, notice of a motion made pursuant to

subdivision (a) or (b) is required to be given to the other parties to the contract or lease, to other parties in interest as the court may direct, and, except in a chapter 9 case, to the United States trustee. There is no requirement of an actual hearing if no request is made. *Rule 6006(d)* provides that an order authorizing the trustee to assign an executory contract or unexpired lease under section 365(f) is stayed until the expiration of 14 days after the entry of the order, unless the court orders otherwise.ⁿ⁵⁵

Rule 6006 was amended in 2007 to permit omnibus motions to reject, or assume and assign, multiple executory contracts or unexpired leases if certain procedural requirements are satisfied that are intended to ensure that the nondebtor parties receive effective notice of the motion. The rule permits an omnibus motion for up to 100 executory contracts or unexpired leases in a single motion.

Under *Rule 6007(a)*, unless otherwise directed by the court, the trustee shall give notice of a proposed abandonment or disposition of property to the United States trustee, all creditors, indenture trustees and committees elected pursuant to section 705 or appointed pursuant to section 1102. An objection may be filed and served by a party in interest within 14 days of the mailing of the notice or otherwise within the time fixed by the court. *Rule 6007(b)* provides that a party in interest may file and serve a motion requiring the trustee to abandon property of the estate. Under amendments to the Rules effective August 1, 1993, a hearing is not required if a hearing is not requested or if there is no opposition to the motion.

Under *Rule 6008*, the trustee may, by a motion and after hearing on such notice as the court may direct, if so authorized by the court, redeem property from a lien or from a sale to enforce a lien in accordance with applicable law.

[9] Adversary Proceedings

Part VII of the Rules governs adversary proceedings. *Rule 7001* enumerates the kinds of proceedings which are adversary proceedings, including: (1) a proceeding to recover money or property, other than a proceeding to compel the debtor to deliver property to the trustee or a proceeding under section 554(b) or 725, or under *Rule 2017* or *Rule 6002*;ⁿ⁵⁶ (2) a proceeding to determine the validity, priority or extent of a lien or other interest in property, other than a proceeding under *Rule 4003(d)*;ⁿ⁵⁷ (3) a proceeding to obtain approval under section 363(h) for the sale of both the interest of the estate and of a co-owner in property;ⁿ⁵⁸ (4) a proceeding to object to or revoke a discharge; (5) a proceeding to revoke an order or confirmation of a chapter 11, 12 or 13 plan; (6) a proceeding to determine the dischargeability of a debt; (7) a proceeding to obtain an injunction or other equitable relief except when a chapter 9, chapter 11, chapter 13, or chapter 13 plan provides for the relief; (8) a proceeding to subordinate any allowed claim or interest, except when a chapter 9, chapter 11, chapter 12, or chapter 13 plan provides for subordination; (9) a proceeding to obtain a declaratory judgment relating to any of the foregoing; and (10) a proceeding to determine a claim or cause of action removed under to 28 U.S.C. § 1452.ⁿ⁵⁹ Under *Rule 7002* and many of the Part VII Rules following *Rule 7002*, designated provisions of the Federal Rules of Civil Procedure are incorporated by reference into the Part VII Rules. In addition, the Part VII Rules include provisions applicable only to Bankruptcy Code cases, relating to service of a summons and complaint (*Rule 7004*), general rules of pleading (*Rule 7008*), presentation of defenses and objections (*Rule 7012*), counterclaims and cross-claims (*Rule 7013*), and joinder (*Rule 7019*), among other matters.

[10] Appeals

Part VIII of the Rules relates to appeals to the district court or to a bankruptcy appellate panel, as well as direct appeals from the bankruptcy court to a court of appeals. Under a provision added to title 28 of the United States Code by the 2005 Act, a court of appeals shall have jurisdiction over appeals otherwise heard by district courts in the first instance if the bankruptcy court, the district court, or the bankruptcy appellate panel, or all the appellees and appellants acting jointly, make certain certifications, including a certification that the judgment, order or decree involves a question of law for which there is no controlling law or a certification that an immediate appeal may materially advance the progress of the case or proceeding.ⁿ⁶⁰

An appeal from a final judgment, order or decree of a bankruptcy judge to a district court or bankruptcy appellate panel is taken by the timely filing of a notice of appeal with the clerk of the bankruptcy court.ⁿ⁶¹ The notice of appeal shall conform substantially to the appropriate Official Form.ⁿ⁶² Under *Rule 8001(b)*, an interlocutory appeal taken under 28 U.S.C. § 158(a) shall also be taken by filing a notice of appeal, accompanied by a motion for leave to appeal prepared in accordance with *Rule 8003* and with proof of service given in accordance with *Rule 8008*. Unless otherwise provided by a local rule promulgated pursuant to *Rule 8018*,ⁿ⁶³ under *Rule 8001(e)*, consent to the hearing of an appeal by a district court may be given in a separate statement of consent executed by a party or contained in the notice of appeal or cross-appeal. The statement of consent shall be filed before the transmittal of the record pursuant to *Rule 8007(b)*, or within 30 days of the filing of the notice of appeal, whichever is later. The Court of Appeals for the First, Sixth, Eighth, Ninth and Tenth Circuits have established bankruptcy appellate panels and have adopted local rules governing consent. In effect, consent is implied if no objection is raised to the appeal to the panel.

Under *Rule 8002(a)*, a notice of appeal shall be filed with the clerk of the bankruptcy court within 14 days of the date of the entry of the judgment, order or decree appealed from. A notice of appeal filed after the announcement of a decision or order, but before entry of a judgment, order or decree is deemed filed on the actual date of entry. If a timely notice of appeal is filed, any other party may file a notice of appeal within 14 days after the date on which the first notice of appeal was filed, or within the time otherwise prescribed under *Rule 8002*, whichever last occurs. Under *Rule 8002(c)*, the court may extend the time for filing the notice of appeal by any party for a period not to exceed 21 days from the expiration of the time otherwise prescribed under *Rule 8002(a)* or 14 days from the date of entry of the order granting the motion, whichever is later. The request for an extension must be made before the time for filing of the notice of appeal has expired, except that a request made no more than 21 days after expiration of the time for filing a notice of appeal may be granted upon a showing of excusable neglect. However, the power of a bankruptcy judge to extend the time for filing the notice of appeal does not apply to an appeal from a judgment, order or decree that (1) grants relief from the automatic stay, (2) authorizes the sale or lease of property or the use of cash collateral under section 363, (3) authorizes the obtaining of credit under section 364, (4) authorizes the assumption or assignment of an executing contract or unexpired lease under section 365, (5) approves a chapter 11 disclosure statement or (6) confirms a chapter 9, chapter 11, chapter 12 or chapter 13 plan. *Rule 8003* governs the content of a motion for leave to appeal. *Rule 9006(a)*,ⁿ⁶⁴ governs the manner of computation of the 14-day appeal period.

Rule 8005 governs the issuance of a stay pending an appeal. A motion for a stay from a judgment, order or decree of the bankruptcy judge ordinarily must in the first instance be presented to the bankruptcy court. The bankruptcy court may suspend or order the continuation of other proceedings in the case under the Code, or make other appropriate orders during the pendency of an appeal on such terms as will protect the rights of all parties in interest. A motion for such relief may be made to the district court or to the bankruptcy appellate panel, but the motion must show why such relief was not obtained first from the bankruptcy judge. The district court or the bankruptcy appellate panel may condition relief it may grant under *Rule 8005* on the filing of a bond or other appropriate security with the bankruptcy court. When an appeal is taken by a trustee, a bond or other appropriate security may be required, but when an appeal is taken by the United States or an officer or agency thereof or by direction of any department of the government, a bond or other security shall not be required.

Rule 8013 provides that on an appeal, the district court or bankruptcy appellate panel may affirm, modify or reverse a bankruptcy judge's judgment, order or decree or remand with instructions for further proceedings. However, findings of fact, whether based on oral or documentary evidence, may not be set aside unless clearly erroneous, and due regard must be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses.

Rule 8017 governs stays of judgments rendered by the district court or the bankruptcy appellate panel. Under *Rule 8017(a)*, an automatic stay of judgments is rendered by the district court or the bankruptcy appellate panel for the period of 14 days after entry thereof, unless otherwise ordered by the court. Under *Rule 8017(b)*, the district court or bankruptcy appellate panel may further stay its judgment pending an appeal to the court of appeals. The stay shall not

extend more than 30 days after the entry of the judgment unless the period is extended for cause shown. If prior to expiration of the stay the party that obtained the stay files an appeal to the court of appeals, the stay shall continue in effect until final disposition of the appeal. A bond or other security may be required as a condition to the grant or continuation of the stay of the judgment. A bond or other security also may be required if a trustee obtains a stay, but shall not be required if the stay is obtained by the United States or an officer or agency thereof or at the direction of any department of the government. *Rule 8017(c)* provides that the foregoing provisions of *Rule 8017* do not limit the power of the court of appeals or any judge thereof to stay proceedings pending an appeal, or to suspend, modify or restore or grant an injunction during such pendency or to make any other appropriate orders to preserve the *status quo* or the effectiveness of a judgment subsequently to be entered.

[11] General Provisions; Certain Definitions; Notice Periods; Contested Matters

Part IX of the Bankruptcy Rules contains certain general provisions. *Rule 9001* sets forth the definitions of certain terms employed in the Bankruptcy Rules. The definition of the term "debtor" set forth in *Rule 9001(5)* is applicable in the context of an act to be performed by a debtor, or when it is necessary to compel attendance of a debtor for examination and the debtor is not a natural person. Thus, if the debtor is a corporation, the term "debtor" includes, if so designated by the court, any or all of its officers, directors, trustees or members of a similar controlling body, a controlling stockholder or member, or any other person in control. If the debtor is a partnership, the term "debtor" includes any or all of its general partners, or, if designated by the court, any other person in control.

Rule 9006 deals with the computation, enlargement and reduction of time periods elsewhere prescribed in the Bankruptcy Rules or by the Federal Rules of Civil Procedure made applicable by the Bankruptcy Rules. *Rule 9006(a)* sets forth the method for computation of time periods. It should be noted that under *Rule 9006(a)*, as amended December 1, 2009, all deadlines stated in days, no matter what the length, are computed in the same way. The day of the event that triggers the deadline is not counted. *Rule 9006(a)(6)* sets forth a definition of the term "legal holiday" that should be consulted in connection with computation of time periods. The provisions of *Rule 9006(a)* are particularly important in measuring the period within which a notice of appeal must be filed under *Rule 8002* in order to perfect an appeal. This computation is of considerable practical importance in the context of a transaction involving an order approving the sale or lease of property, inasmuch as such transactions are often consummated only after the expiration of the period during which a notice of appeal from the order may be filed.

Under *Rule 9006(b)(1)*, the bankruptcy court for cause shown may at any time, in its discretion, with or without motion or notice, order the enlargement of a time period if the request therefor is made before the expiration of the period originally prescribed or as previously extended. In addition, a motion for enlargement may be made after the expiration of the specified period upon a showing of excusable neglect. It should be noted, however, that the court may not enlarge the time for taking action under *Rule 1007(d)* (filing list of 20 largest creditors in chapter 9 municipality or chapter 11 reorganization case), *Rule 2003(a)* (the meeting of creditors), *Rule 2003(d)* (filing of motion for resolution of certain election disputes), *Rule 7052* (issuance of findings by the court), *Rule 9023* (motion for a new trial), and *Rule 9024* (relief from judgment or order). Similarly, under *Rule 9006(b)(3)* enlargement is limited under the other Bankruptcy Rules enumerated therein only to the extent and under the conditions stated in those Rules. Under *Rule 9006(c)(1)*, the court is generally given authority for cause shown in its discretion with or without motion or notice to shorten time periods. However, under *Rule 9006(c)(2)*, reduction is not permitted under *Rule 2002(a)(7)* (notice of time fixed for filing proofs of claim), *Rule 2003(a)* (meeting of creditors), *Rule 3002(c)* (time fixed for filing proofs of claim), *Rule 3014* (section 1111(b)(2) election), *Rule 3015* (filing of plan in chapter 13 individual debt adjustment cases), *Rule 4001(b)(2)* (commencement of final hearing on motion for authorization to use cash collateral), *Rule 4001(c)(2)* (commencement of final hearing on motion for authority to obtain credit), *Rule 4003(a)* (filing by a dependent of claim for exemptions), *Rule 4004(a)* (filing of complaint objecting to debtor's discharge under section 727(a)), *Rule 4007(c)* (filing of complaint to determine dischargeability of any debt), *Rule 8002* (time for filing notice of appeal), and *Rule 9033(b)* (objections to proposed findings of fact and conclusions of law).

Rule 9006(d) provides that written motions which are not heard *ex parte*, and notice of any hearing, shall be served not later than seven days before the time specified for the hearing unless a different period is fixed by the rules or by order of the court. When a motion is supported by an affidavit, the affidavit must be served with the motion. Except as otherwise provided in *Rule 9023* (service of notice of entry), opposing affidavits may be served not later than one day before a hearing, unless otherwise permitted by the court.

Under *Rule 9006(e)*, service of process and other papers and notices by mail is deemed complete on mailing.

Under *Rule 9006(f)*, if service is effectuated by mailing or under *Fed. R. Civ. P. 5(b)(2)(C)* or *(D)*, three days are to be added to any prescribed period "[w]hen there is a right or requirement to act or undertake some proceedings within a prescribed period after service."

Under *Rule 9007*, the court shall designate, if not otherwise specified in the Rules, the time within which and the entities to whom and the form and matter of notices to be given. The court may, when feasible, order any notices under the Rules to be combined.

Rule 9014 governs contested matters. This Rule specifies the rules contained in Part VII of the Bankruptcy Rules that apply to contested matters.

Rule 9029 authorizes each district court by action of a majority of the judges thereof to make and amend local bankruptcy rules. The district court may authorize the bankruptcy judges of the district to make rules of practice and procedure not inconsistent with the Bankruptcy Rules and which do not prohibit or limit the use of the Official Forms. On April 27, 1995, the United States Supreme Court announced an amendment to *Rule 9029* which provides that "[a] local rule imposing a requirement of form shall not be enforced in a manner that causes a party to lose rights because of a nonwillful failure to comply with the requirement."⁶⁵ As explained by the Advisory Committee on Bankruptcy Rules, the provision is intended "to protect against loss of rights in the enforcement of local rules relating to matters of form."⁶⁶ The Advisory Committee Note to the 1995 amendment provides the following example: "a party should not be deprived of a right to a jury trial because its attorney, unaware of--or forgetting--a local rule directing that the jury demands be noted in the caption of the case, includes a jury demand only in the body of the pleading."⁶⁷ The amendment became effective on December 1, 1995.

Rule 9034 requires that a copy of the pleadings, motions, objections and similar documents identified in the Rule be transmitted to the United States trustee within the time required by the Rules for the service of such documents.

Rule 9036 (Notice by Electronic Transmission), which was added in 1993, authorizes entities to receive notices by electronic transmission instead of by mail. According to the Advisory Committee Note, the new rule was added to provide flexibility for banks, credit card companies, taxing authorities and other entities that ordinarily receive notices by mail in a large volume in bankruptcy cases, to arrange to receive by electronic transmission all or part of the information required to be contained in such notices.⁶⁸ Notice by electronic means is complete upon transmission.

[12] United States Trustees

The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986⁶⁹ repealed chapter 15 of the Bankruptcy Code,⁷⁰ which provided for the United States trustee pilot program. Instead, the Act provided for the phasing in of a national United States Trustee system under the schedule set forth in section 302 thereof.⁷¹ Prior to the complete phase-in of the United States trustee system, the Bankruptcy Rules included a Part X, which integrated the functions of the United States trustees in pilot districts into certain of the administrative provisions of the Rules. In view of the repeal of chapter 15 and the complete replacement of the pilot program with a permanent United States trustee system, Part X of the Rules was abrogated as of August 1, 1991, and the United States trustees' functions were integrated into Parts I through IX of the Rules.

FOOTNOTES:

(n1)Footnote 1. *Fed. R. Bankr. P. 9009*.

(n2)Footnote 2. Pub. L. No. 98-353, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised). For a discussion of certain provisions of the 1984 Amendments affecting bankruptcy court jurisdiction, *see P 1.03 supra*.

(n3)Footnote 3. Pub. L. No. 99-554, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. In recent years, there have generally been amendments every year, effective December 1. *See* Collier on Bankruptcy, ch. 1001 & App. Pt. 2(a) (Matthew Bender 15th Ed. Revised).

(n5)Footnote 5. According to an August 22, 2005, memorandum from the Standing Committee on Rules of Practice and Procedure of the Judicial Conference, "[t]he Interim Rule have been drafted so they are integrated into, and are consistent with, the Federal Rules of Bankruptcy Procedure With the Federal Rules of Bankruptcy Procedure, they apply as one set of rules for cases and proceedings governed by the Act."

(n6)Footnote 6. Effective December 1, 2008, *Bankruptcy Rules 1005, 1006, 1007, 1009, 1010, 1011, 1015, 1017, 1019, 1020, 2002, 2003, 2007.1, 2015, 3002, 3003, 3016, 3017.1, 3019, 4002, 4003, 4004, 4006, 4007, 4008, 5001, 5003, 6004, 7012, 7022, 7023.1, 8001, 8003, 9006, 9009 and 9024* were amended. Additionally, new *Bankruptcy Rules 1021, 2007.2, 2015.1, 2015.2, 2015.3, 5008 and 6011* were adopted.

(n7)Footnote 7. Effective December 1, 2009, *Bankruptcy Rules 1007, 1011, 1019, 1020, 2002, 2003, 2006, 2007, 2007.2, 2008, 2015, 2015.1, 2015.2, 2015.3, 2016, 3001, 3015, 3017, 3019, 3020, 4001, 4002, 4004, 6003, 6004, 6006, 6007, 7004, 7012, 8001, 8002, 8003, 8006, 8009, 8015, 8017, 9006, 9027 and 9033* were amended. New *Bankruptcy Rule 7058* was enacted.

(n8)Footnote 8. Note of the Advisory Committee on Bankruptcy Rules accompanying *Fed. R. Bankr. P. 1002*, as amended in 1987, *reprinted in* Collier Pamphlet Ed., Bankruptcy Rules (Matthew Bender).

(n9)Footnote 9. *Fed. R. Bankr. P. 1004*. The 2002 amendment to *Fed. R. Bankr. P. 1004*, which became effective December 1, 2002, deleted subdivision (a) (concerning voluntary petitions) of the rule so that the rule could not be construed as requiring the consent of all of the general partners to the filing of a voluntary petition, even if fewer than all of the general partners would have the authority under applicable nonbankruptcy law to commence a bankruptcy case for the partnership. The amendment also retitled the rule to reflect that it applies only to involuntary petitions filed against partnerships. The Supreme Court has held in the corporate context that applicable nonbankruptcy law determines whether authority exists for a particular debtor to commence a bankruptcy case. *See* 2002 Advisory Committee Note to *Fed. R. Bankr. P. 1004*.

(n10)Footnote 10. Formerly *Fed. R. Bankr. P. 1004(b)*. The 2002 amendment to *Fed. R. Bankr. P. 1004*, effective December 1, 2002 if not changed by Congress, deleted subdivision (a) (concerning voluntary petitions) of the rule, retitled the rule to reflect that it applies only to involuntary petitions filed against partnerships and changed the wording of the "Involuntary Petition" portion slightly.

(n11)Footnote 11. *Fed. R. Bankr. P. 1010, 7004(c)*.

(n12)Footnote 12. *Fed. R. Bankr. P. 1011(d)*.

(n13)Footnote 13. The interim trustee is appointed by the United States trustee. 11 U.S.C. § 303(g); *see P 1.14[12] infra*.

(n14)Footnote 14. Under section 303(i), if an involuntary petition is dismissed, the court may grant to the debtor a judgment against the petitioner for costs and reasonable attorney's fees. If the petition was filed in bad faith, the judgment may also include actual and punitive damages.

(n15)Footnote 15. *Fed. R. Bankr. P. 2001(c)*.

(n16)Footnote 16. *11 U.S.C. § 1111(a)*.

(n17)Footnote 17. *28 U.S.C. §§ 1408-1410, 1412*.

(n18)Footnote 18. *28 U.S.C. § 1408(1)*.

(n19)Footnote 19. *28 U.S.C. § 1408(2)*.

(n20)Footnote 20. *Fed. R. Bankr. P. 1014(b)*.

(n21)Footnote 21. *Fed. R. Bankr. P. 1015(c)*.

(n22)Footnote 22. *Fed. R. Bankr. P. 2009(a)*.

(n23)Footnote 23. *Fed. R. Bankr. P. 1017*.

(n24)Footnote 24. *Fed. R. Bankr. P. 1018*.

(n25)Footnote 25. The *Rule 2002(a)* notices are to be sent to the debtor, the trustee, all creditors and indenture trustees. The exceptions referred to involve *Rule 2002(h)* (notices to creditors may be limited after specified period to creditors that have filed claims or who are still entitled to file claims), *Rule 2002(i)* (notices to committees or their agents, with authority to order service of certain notices only on committees or their agents, and creditors and equity holders that have filed requests for copies of notices), and *Rule 2002(l)* (notice by publication).

(n26)Footnote 26. The section 341 meeting may include an examination of the debtor and, in a chapter 7 case, the election of a trustee or a creditors' committee.

(n27)Footnote 27. *See P 1.14[4] infra*.

(n28)Footnote 28. The exceptions relate to publication notice under *Rule 2002(l)* where the court finds that notice by mail is impracticable or that it is desirable to have supplemental notice.

(n29)Footnote 29. *Fed. R. Bankr. P. 2002(c)(1)*.

(n30)Footnote 30. *See P 1.14[8] infra*.

(n31)Footnote 31. The meeting of equity security holders will be called by the United States trustee. *11 U.S.C. § 341(b)*; *see P 1.14[12] infra*.

(n32)Footnote 32. *Rule 4004(a)* prescribes the time in chapter 7 and 11 cases for the filing of a complaint objecting to the debtor's discharge. The court may extend the time pursuant to *Rule 4004(b)*.

(n33)Footnote 33. *Rule 3002(c)(1)* deals with extensions of time for filing proofs of claim by governmental units and *Rule 3002(c)(2)* deals with extensions on behalf of an infant or incompetent person or the representative of either.

(n34)Footnote 34. *Rule 9016*, dealing with the subpoena power, incorporates by reference *Fed. R. Civ. P. 45*.

(n35)Footnote 35. *See P 2.51 infra*, for a form of proof of claim for damages arising out of the rejection of a real

estate lease.

(n36)Footnote 36. Under general practice, evidence of perfection is provided by photocopying the part of a mortgage or copy of a Uniform Commercial Code financing statement, as applicable, showing the recording or filing information.

(n37)Footnote 37. *See P 2.03 infra.*

(n38)Footnote 38. As noted at *P 1.14[2] supra*, schedules can be amended and, therefore, a claim originally scheduled as undisputed may be rescheduled as disputed, thus requiring filing of a proof of claim. The better practice is to file a proof of claim at the outset of a case in all circumstances.

(n39)Footnote 39. *Fed. R. Bankr. P.5005(a)(2).*

(n40)Footnote 40. *See note 35 supra.*

(n41)Footnote 41. For a discussion of section 1111(b), *see P 1.11 supra.*

(n42)Footnote 42. Advisory Committee Note to *Fed. R. Bankr. P. 3014.*

(n43)Footnote 43. *See P 2.07 infra* for a description of chapter 11 plans involving real property encumbered by a mortgage.

(n44)Footnote 44. *Fed. R. Bankr. P. 3020(e).*

(n45)Footnote 45. The Advisory Committee Note that accompanied the 1999 amendments to the Federal Rules of Bankruptcy Procedure indicated that paragraph (3) was added to *Rule 4001(a)(3)* in order to provide sufficient time for a party to request a stay pending appeal for an order granting relief from an automatic stay before the order is enforced or implemented.

(n46)Footnote 46. *11 U.S.C. § 362(e)*, as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994).

(n47)Footnote 47. Section 362(f) provides:

Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

Section 363(e) provides:

Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

(n48)Footnote 48. Adequate protection agreements relating to income producing real estate often deal with the allocation of rental receipts to operating expenses and may also provide for lifting of the automatic stay to permit

foreclosure by the mortgagee if a plan has not been filed or confirmed by a specified date. *See P 2.03 infra* dealing with assignments of rent and of leases.

(n49)Footnote 49. Under *section 363(m) of the Code*, unless a stay pending appeal is obtained, the modification or reversal of an order authorizing the sale of property of the estate will not affect the validity of the transfer to a party purchasing in good faith. Knowledge of the pendency of an appeal from the order does not constitute bad faith. *See also Fed. R. Bankr. P. 6004*, quoted at *P 1.14[8] infra* .

(n50)Footnote 50. The term "custodian" is defined in section 101(11) to include prepetition receivers, trustees and assignees for the benefit of creditors, and persons authorized to take possession of a debtor's property to enforce a lien.

(n51)Footnote 51. A state court receiver may be subject to a turnover order under section 542.

(n52)Footnote 52. *See P 1.14[3] supra*.

(n53)Footnote 53. *15 U.S.C. § 18A*.

(n54)Footnote 54. *11 U.S.C. § 363(b)(2)*. Prior to the 1994 Amendments, the Bankruptcy Code section simply provided for a 10-day waiting period with extension only upon court order.

(n55)Footnote 55. The amendments to the Federal Rules of Bankruptcy Procedure, that became effective December 1, 1999, added subdivision (d) to *Fed. R. Bankr. P. 6006* to provide sufficient time for a party to request a stay pending appeal of an order authorizing the assignment of an executory contract or unexpired lease under § 365(f) before the assignment is consummated.

(n56)Footnote 56. Section 554(b) deals with abandonment of property of the estate; section 725 deals with authority of a chapter 7 trustee to dispose of property to a secured creditor, bailor and the like; *Fed. R. Bankr. P. 2017* deals with prepetition transfers of money or property by a debtor to an attorney; and *Fed. R. Bankr. P. 6002* deals with the turnover of property to the trustee by a custodian.

(n57)Footnote 57. *Fed. R. Bankr. P. 4003(d)* governs motions to avoid a transfer of section 522(f) exempt property.

(n58)Footnote 58. Section 363(h) provides:

Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if--

(1) partition in kind of such property among the estate and such co-owners is impracticable;

(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;

(3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and

(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

(n59)Footnote 59. *28 U.S.C. § 1452* permits a party to remove to the district court any civil cause of action (other

than a tax court proceeding or proceeding to enforce a governmental unit's police or regulatory power) if the district court would have jurisdiction of the case under 28 U.S.C. § 1334(b). Under 28 U.S.C. § 1334, the district court has original but not exclusive jurisdiction over proceedings arising in or related to Bankruptcy Code cases. *See P 1.03 supra*.

(n60)Footnote 60. 28 U.S.C. § 158(d)(2), added by Pub. L. No. 109-8, § 1233 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n61)Footnote 61. *Fed. R. Bankr. P. 8001(a)*; *see* Fed. R. Bankr. P., discussed *infra*, governing the time for filing a notice of appeal.

(n62)Footnote 62. *Fed. R. Bankr. P. 8001(a)*.

(n63)Footnote 63. *Fed. R. Bankr. P. 8018* authorizes the circuit councils and district courts to promulgate rules governing appeals from the bankruptcy court. *See* Collier Bankruptcy Practice Guide Local Rules Pamphlets (Matthew Bender).

(n64)Footnote 64. *See* discussion at P 1.14 [11] *infra*.

(n65)Footnote 65. *Fed. R. Bankr. P. 9029(a)(2)*.

(n66)Footnote 66. *Fed. R. Bankr. P. 9029(a)(2)*; Advisory Committee Note to the 1995 Amendment.

(n67)Footnote 67. *Fed. R. Bankr. P. 9029(a)(2)*; Advisory Committee Note to the 1995 Amendment.

(n68)Footnote 68. *Fed. R. Bankr. P. 9036*; Advisory Committee Note to the 1993 Amendment.

(n69)Footnote 69. Pub. L. No. 99-554, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n70)Footnote 70. The 2005 Act added a new chapter 15 to the Code, "Ancillary and Other Cross-Border Cases." Pub. L. No. 109-8, § 801 (2005).

(n71)Footnote 71. Section 302 of the 1986 Act was amended by the Judicial Improvements Act of 1990, Pub. L. No. 101-650, extending the time period under which the judicial districts in Alabama and North Carolina have to enter into the United States Trustee system. Except in these districts, all judicial districts now have United States trustees.

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.01

P 2.01 Drafting Considerations

[1] Mortgages--Default Provisions Generally

The default and remedies provisions in mortgages are ordinarily divided into three segments. The first is the default clause itself, which describes the events constituting defaults under the mortgage. These events may be deemed to have occurred only after the lapse of a specified grace period, or after the giving of notice and the lapse of a specified grace period, or instantly without notice or any period of grace. The second segment sets forth the mortgagee's rights to accelerate the indebtedness secured by the mortgage after the occurrence of a default. This provision may deem acceleration to have been effected automatically and without notice upon the occurrence of a mortgage default, or upon the giving of notice of acceleration by the mortgagee, or upon the giving of notice of acceleration and the lapse of a specified period without cure of the default. The third segment of a default and remedies provision sets forth the remedies in respect of the mortgagor and the mortgaged property which may be pursued by the mortgagee after default, acceleration and nonpayment of the accelerated indebtedness.

It is clear that the automatic stay provisions of the Code enjoin the pursuit and enforcement of mortgage remedies upon the filing of a Bankruptcy Code petition by or against a mortgagor.ⁿ¹ It appears further that the automatic stay will reach into the default and acceleration clauses as well, with the result that the mere giving of notice may be enjoined,ⁿ² and the duration of a grace period may be extended.ⁿ³ Accordingly, in circumstances under which the automatic stay impairs the operation of a default clause, a mortgagee may be constrained to obtain relief from the stay to place the mortgage in default status in the first instance, and thereafter seek additional relief to permit the exercise of its mortgage remedies. Although it is generally true that a mortgagee will seek to obtain the tightest possible default provisions, with limited notice requirements and short grace periods, if any, the possible imposition of the automatic stay warrants even more careful scrutiny of default provisions from the viewpoint of a mortgagee.

Section 362(a)(3) enjoins all entities from engaging in any act to obtain possession of property of or from the estate or to exercise control over property of the estate; section 362(a)(4) enjoins the taking of any act to enforce any lien against property of the estate; and section 362(a)(6) enjoins any act to collect, assess or recover a prepetition claim against the debtor.ⁿ⁴ Given the fundamental protective nature of the automatic stay, bankruptcy courts often have a tendency to interpret section 362(a) broadly and apply it to actions that do not literally come within the language of the statute. Accordingly, a meaningful risk exists that the issuance of a notice of default or notice of acceleration relating to a defaulted mortgage will run afoul of the automatic stay proscriptions as an act to obtain possession of or control over

property of an estate, to enforce a lien, or to collect or recover on a claim.ⁿ⁵ Moreover, if a petition under the Code is filed after the occurrence of a default but prior to the expiration of a grace period provided for in a mortgage, the Code not only stays actions against the debtor and the mortgaged property in respect of the default but also extends the grace period itself. Section 108(b) provides that a contractual grace period that is running at the time of filing of a petition will be continued until the later of (1) the expiration of the grace period provided for in the mortgage, or (2) 60 days after the order for relief.ⁿ⁶ Therefore, the automatic stay provisions of the Code, operating in tandem with section 108(b), mean that:

- (1) under a default clause providing for notice and a period of grace, if the mortgagor's Bankruptcy Code petition is filed prior to the sending of notice, the sending of the notice may be enjoined;
- (2) under a default clause providing for notice and a period of grace, if the mortgagor's Bankruptcy Code petition is filed after the sending of notice but prior to the expiration of the period of grace, the period of grace will be extended as provided in section 108(b) and the mortgage will not be in default in respect of the affected covenant until such period has elapsed without cure;
- (3) under a default clause providing for a period of grace without notice, if the mortgagor's Bankruptcy Code petition is filed after the occurrence of the default but prior to the expiration of the period of grace, the period of grace will be extended as provided in section 108(b), and the mortgage will not be in default in respect of the affected covenant until such period has elapsed without cure; and
- (4) under a default clause providing for no notice or period of grace, if the mortgagor's Bankruptcy Code petition is filed after the occurrence of the default, the mortgage will be in default as of and after the filing.

In the circumstances described in paragraph (1) above, it is apparently necessary for the mortgagee first to commence a contested matter seeking relief from the automatic stay under *section 362(d)(1) of the Code* for "cause" to permit the sending of the notice of default.ⁿ⁷ If such permission is granted by the court, and the default is not timely cured, the mortgagee may be constrained to commence a separate contested matter seeking modification or lifting of the stay to permit the initiation of state law proceedings to foreclose the mortgage. A further complexity may be raised if the default provisions require the sending of a subsequent notice following the expiration of the grace period before remedies against the collateral may proceed. In that case, it would be advisable for a mortgagee to seek in its motion for relief from the stay the contingent right to send the second notice in the event that the cure period on the default notice is not cured. In the circumstances described in paragraphs (2) and (3) above, the mortgagee may omit the commencement of the first contested matter, and will be able to assert the existence of a mortgage default and to commence the contested matter seeking leave to foreclose only after the periods described in paragraphs (2) and (3) have elapsed. In the circumstance described in paragraph (4) above, the mortgagee may immediately commence a contested matter seeking modification or lifting of the automatic stay to permit the initiation of state court proceedings.^{n7a}

The critical importance of the distinction between self operative acceleration clauses and clauses that arguably require the sending of notice or other act requiring relief from the automatic stay was visibly demonstrated by a recent decision of the Court of Appeals for the Third Circuit. Although the decision discussed below has not been published in the official reporter, thus limiting its precedential effect, it is nonetheless noteworthy for its analysis of a fact pattern that is often found in commercial transactions--the contractual election of remedies that require the taking of specific steps, such as notice. In *In re Optel*,^{n7b} the court faced the question of determining the total amount of a creditor's claim that arose under a purchase and sale agreement containing a clause that permitted the creditor/seller (Nationwide) to demand from the debtor/purchaser (TVMAX) a higher payment over time (the "Note Election Amount"), in the event that a specified lump sum cash payment (the "Deferred Payment"), representing a portion of the original purchase price, was not made following demand at the specified time when such demand for the Deferred Payment was permitted.

In *Optel*, the date upon which the creditor was entitled to demand the Deferred Payment had not yet occurred as of the petition date, and the creditor therefore had not yet taken the critical step of providing the debtor with notice of its demand for the Deferred Payment, nor, of course, notice of its demand for the higher payment over time (the Note Election Amount) as its elected remedy for the debtor's failure to make the Deferred Payment.^{n7c} Predictably, after the due date for the Deferred Payment passed during the bankruptcy case without payment, the creditor sought relief from the automatic stay in order to deliver the notices that would entitle it to demand the Deferred Payment and the higher Note Election Amount. Such relief was not granted by the time the debtor's chapter 11 plan was confirmed, and the court was then called upon to determine whether the creditor's allowed claim would be the unmatured amount owed on the petition date (i.e., the Deferred Payment), or the higher amount that would have been owed with the passage of time and the taking of steps called for in the agreement (i.e., the Note Election Amount). The debtor challenged the creditor's claim for the higher amount by arguing:

Notwithstanding Nationwide's contentions, Nationwide's Claim number 1797 arose pre-petition, and its value must be based on the amount of the claim as of the Petition Date. Pursuant to 11 U.S.C. § 362, the filing of a voluntary bankruptcy petition "operates as a stay, applicable to all entities, of ... [an] action or proceeding ... to recover a claim against the debtor that arose before the commencement of the case". Thus, Debtors' filing of a voluntary petition froze the claim at its amount as of the petition date, i.e., \$6,000,000, based on the fact that the requisite amount of time had not passed since the closing date of January 11, 1995. That events triggering the \$10,000,000 provision might have occurred absent the stay is irrelevant, as the claim amount is frozen at the amount as of the Debtors' filing of the petition.^{n7d}

In finding in favor of the debtor, the court found it critical that at the time of the bankruptcy filing, the Deferred Payment had not yet matured, and the critical steps that entitled Nationwide to receive the higher payment over time--notice of demand for the Deferred Payment, followed by election of the remedy of the higher payment over time--had not yet occurred. In the court's analysis, there was a distinction between the unmatured Deferred Payment amount, which would be inevitably owed upon the passage of time and thus became accelerated upon the bankruptcy filing, and the higher Note Election Amount, which required the creditor to take enforcement steps that were stayed.

While Nationwide was able to assert a claim for the Deferred Payment although its right to payment had not matured by the petition date, due to the operation of the automatic stay it was not able to take any steps to increase its recovery under the Agreement of Sale. See *In re PCH Assocs.*, 122 B.R. 181, 198 (Bankr. S.D.N.Y. 1990) (citing *In re Texaco*, 73 B.R. 960, 966, and *Manville*, 43 B.R. at 297-98) (there is a distinction between "acceleration of a debt upon the filing of the bankruptcy petition for the purpose of the filing of a proof of claim ... and acceleration for the purpose of taking actions against a debtor in violation of the automatic stay.").

The Debtors correctly assert that, by virtue of the automatic stay, Nationwide's claim was "frozen" in the amount of \$6 million. Because Nationwide did not obtain relief from the automatic stay, it was unable to give notice, as required pursuant to section § 2(b)(i) of the Agreement of Sale, that it was exercising its right to receive the Deferred Payment. We therefore affirm the District Court's determination that Nationwide is to receive a distribution on account of its claim in the amount of \$6 million.^{n7e}

In disallowing the higher claim, it is noteworthy that the court of appeals relied on the failure of the creditor to take the perfunctory step of notice and demand--acts which are of course stayed by operation of section 362--as the principal basis for its decision. As possible alternatives, the court might have come to the same result by relying on section 502(b)(2) to disallow the claim for the increment under a theory that the higher Note Election Amount consisted in part of unmatured interest,^{n7f} or on other alternative theories, such as the argument that the higher amount constituted an unenforceable liquidated damages provision. Although not stated, under the court's analysis, if the higher amount had

become due by operation of the contract upon the failure of the debtor to make the Deferred Payment on a date certain, as such period may have been extended by section 108(b), it is possible that the creditor's claim for the Note Election Amount would have been allowed. It is arguable that the Note Election Amount should have been allowed by the court in any scenario given the broad definition of "claim" in the Code. Nonetheless, under the reasoning adopted by the court, it was the requirement of affirmative action by the creditor under the agreement, which action was stayed, that was decisive to its decision. Thus, the *Optel* decision vividly highlights the value of self-operative provisions with respect to contractual provisions that relate to amounts due and also indicates that care should be given in drafting acceleration clauses, so as to consider including all potential payment amounts.

Another disadvantage of default clauses that require the giving of notices is the possibility that a court will strictly construe the notice provisions in the document in a manner that treats an actual notice to a defaulting mortgagor as the equivalent of no notice because the form and manner of notice did not precisely conform to the requirements of the agreement. In one case, involving the occurrence of a default by a general partner under a partnership agreement, followed by a properly served default notice from the limited partner upon the general partner, the expiration of the contractual grace period, and a later agreement to forbear from actually terminating the general partner's interest until a subsequent forbearance termination notice was sent, the bankruptcy court construed such an ultimate forbearance termination notice sent prior to the bankruptcy case filing as improper and ineffective in light of it not being sent to all of the notice parties in the original agreement, notwithstanding that the general partner had actual notice of the termination to which he responded with a bankruptcy filing.^{7g}

Accordingly, consideration should be given to the advisability of drafting default clauses, whether dealing with insolvency matters or a simple failure of timely payment, or other materially adverse events (such as the occurrence of a casualty) to take effect on a self-operative basis without notice in order to avoid the potential pitfalls of the automatic stay and the delays mandated by section 108(b). In weighing the disadvantages of self-operative default clauses, attention should be given to the possibility that such clauses may instantly trigger cross-defaults in other agreements of the debtor which both the debtor and the mortgagee would like to see maintained in good standing. Moreover, if the mortgagee does not seek to enforce its rights upon the occurrence of one or a series of automatic defaults, there may arise some question as to whether there has been a waiver of rights by the mortgagee and uncertainty as to the circumstances under which the mortgagee can thereafter place the mortgage in default. Of course, mortgagors are likely to resist many of these automatic defaults without grace because of the fear of an unintended forfeiture or acceleration in the event of a default that could have been easily cured.

Although drafting considerations will of course be governed by the circumstances affecting a particular transaction, including the mortgagor's preexisting contractual obligations to other lenders, a general approach may be suggested which takes into consideration: (1) the problems imposed by the automatic stay and section 108(b); (2) the relative importance of various covenants in a mortgage; and (3) the attendant likelihood that the mortgagee will waive enforcement of a particular covenant if the mortgage is automatically placed in default upon breach of the covenant.

Under this approach, payment defaults, whether for interest, principal or other charges, will almost always occur without notice or grace. If a payment provision contains a grace period, it is possible that section 108(b) will work to maintain an otherwise defaulted mortgage in good standing for as much as 60 days after a Bankruptcy Code filing by the mortgagor. If the mortgagee cannot rely on other prepetition defaults, it will be severely compromised in any effort to obtain relief from the automatic stay until the 60-day period has elapsed. Given the fundamental importance of a payment provision, it is highly unlikely that a mortgagee will permit a payment default to be waived by inaction. Moreover, if the parties intend to waive or otherwise deal with a payment default, in common practice this will ordinarily be accomplished by a written waiver or mortgage amendment that will define the continuing rights of the mortgagee.

Similar consideration should also be given to including a cross default provision in the underlying instrument that will result in a default without notice or grace in the event that the mortgagor defaults in the payment of amounts due under

other agreements between the mortgagor and the mortgagee. A common example would be a mortgagee which has numerous mortgages with a mortgagor, perhaps encompassing more than one property. In most circumstances, the default in payment to the mortgagee under any instrument will be of such fundamental importance to the lender/borrower relationship that it is unlikely the default would be waived by inaction and it is likely that any waiver would be addressed by a written waiver or amendment.

The default provisions should be drafted so that defaults relating to payments to be made to third parties, such as insurance premiums, real property taxes and amounts owing for labor or materials, will be deemed to occur without any notice or grace. Otherwise, such payments may be deferred for up to 60 days under section 108(b) with the mortgagee unable to even claim a default, which would create a risk that the mortgaged property would become subject to a tax lien by operation of law or to a mechanic's or materialman's lien, or that important insurance coverage might lapse by operation of the insurance contract. Similar consideration should be given to cross default provisions to payment defaults under other indebtedness of the mortgagor because of the risk that such other payment default would ultimately result in a judgment in favor of the holder of the other indebtedness or such creditor exercising remedies (subject, of course, to the effect of the automatic stay as against such creditor in the event that the mortgagor is a debtor in a bankruptcy proceeding) against the mortgagor of a type, or in a manner, that results in a materially adverse effect on the property or the mortgagor. Therefore, a mortgagee should be in a position to approach the bankruptcy court for permission to enforce these covenants or to take other appropriate steps under state law at the earliest possible time. As in the case of a payment default provision, it is unlikely that a mortgagee would permit this type of automatic default to be waived by inaction.

The default provisions should be drafted so that defaults relating to compliance with laws, governmental orders and regulations, to the use of the mortgaged property, to the maintenance and repair of the property and to other matters affecting the physical condition of the security, will be deemed to occur after notice by the mortgagee and passage of a cure period. Except in cases of extreme deterioration of the mortgaged property, a delay in the enforcement or attempted enforcement of such covenants resulting from the operation of section 108(b) is probably less prejudicial than a delay in the enforcement of the other types of covenants discussed above. Moreover, although such defaults may adversely affect the value of the mortgage security, a mortgagee may tend to be less vigorous in the enforcement of such covenants if the mortgagor is current in its payments. Accordingly, an automatic default clause relating to this type of covenant, together with the distinct possibility of nonenforcement, may give rise to an argument that the mortgagee has waived the breach and cannot assert the same as grounds for termination or modification of the automatic stay. Therefore, default clauses providing for notice and grace in these circumstances are preferable to automatic default provisions not only as a matter of traditional drafting but for purposes of the Bankruptcy Code as well.

As noted, above, mortgagees will generally bargain for tightly drawn default clauses with minimal notice and grace provisions. The Bankruptcy Code has given rise to additional considerations in the preparation of such provisions with a view towards reducing the delay, complexity and expense of bankruptcy court litigation.

[2] Mortgages--Bankruptcy Default Provisions

Section 365(e), which is applicable to executory contracts and unexpired leases, renders unenforceable bankruptcy default and *ipso facto* clauses.ⁿ⁸ Although there is no explicit counterpart in the Code to section 365(e) specifically applicable to mortgages, there is reason to question whether the single default of the commencement of a Bankruptcy Code case by or against a mortgagor will alone constitute an enforceable default under a mortgage and give rise to a viable claim that the automatic stay should be lifted or modified to permit the utilization of state law remedies. Under section 541(c)(1), mortgaged property becomes property of the estate notwithstanding a bankruptcy default clause in a mortgage.ⁿ⁹ Section 1124(1) provides that a class of claims is unimpaired under a chapter 11 plan that "leaves unaltered the legal, equitable, and contractual rights to which such claim ... entitles the holder of such claim" ⁿ¹⁰ Under section 1124(2), mortgage indebtedness that has been accelerated may be reinstated if the trustee cures all defaults under the mortgage other than defaults arising from: (1) the debtor's insolvency or financial condition at any time before

the closing of the case; (2) the commencement of a case under the Code; (3) the appointment or taking possession by a trustee in a Bankruptcy Code case or the appointment or taking possession by a custodian before such commencement; (4) the failure to satisfy any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations.ⁿ¹¹ Furthermore, under the cramdown provisions of section 1129(b)(2)(A), a defaulted mortgage may be reinstated with a new payment schedule engrafted thereon so long as the proposed plan treatment satisfies the "fair and equitable" standard set forth therein.ⁿ¹² In chapter 13 cases, defaults under mortgages may be cured in a plan complying with the provisions of section 1322 including the analogous cramdown provisions of section 1325(b)(5).ⁿ¹³

It therefore appears that the Code contemplates that mortgage defaults can be cured and mortgages reinstated as written (section 1124(2)) or as revised (section 1129(b)(2)(A)) pursuant to a plan confirmed under chapter 11 of the Code. If bankruptcy default clauses in mortgages were to be enforceable in cases under the Code, and if it is assumed that nearly all mortgages contain such clauses, then section 1124(1) would in the case of mortgages be a virtual nullity inasmuch as all mortgages would be in default whenever the mortgagor is a debtor under the Code, thereby rendering section 1124(1) inapplicable. Section 1124(2) expressly provides that bankruptcy defaults will not impede the deacceleration and reinstatement of a mortgage, and section 1129(b)(2)(A) obligates a mortgagee to accept a revised mortgage payment schedule without reference to the outstanding default under the bankruptcy clause of the mortgage. It therefore appears that bankruptcy default provisions in mortgages are unenforceable in the context of a Bankruptcy Code case of the mortgagor.ⁿ¹⁴

Another issue that has developed in the context of bankruptcy default clauses is whether the existence of a clause providing for automatic acceleration as a result of a bankruptcy filing would have the effect of eliminating the right of a mortgagee to collect a prepayment premium in the event that the mortgagor is able to repay the debt in full either during the bankruptcy case or on the effective date of a chapter 11 plan.^{n14a}

In view of the foregoing, it may be questioned whether there is any need to retain bankruptcy default clauses in mortgages. As in the case of executory contracts and unexpired leases,ⁿ¹⁵ however, it is suggested that these clauses be retained. The clauses are customarily written to encompass a broad range of "acts of bankruptcy" that may occur without the filing of a petition under the Bankruptcy Code. Thus, a mortgagor may be unable to pay its debts as they mature, make an assignment for the benefit of creditors, suffer the appointment of a receiver for a substantial part of its property, or engage in other acts that call into question its ability to continue performance of its obligations under the mortgage. In the absence of a traditional broadly written bankruptcy clause, these events will not constitute defaults under a mortgage.^{n15a}

In addition, the provisions of the Bankruptcy Code previously referred to,ⁿ¹⁶ which appear to render unenforceable bankruptcy clauses in mortgages, deal with matters involving the insolvency or financial condition of the debtor. Nothing in such sections renders unenforceable bankruptcy clauses dealing with the insolvency of a third party. Therefore, if there is a guarantor of the debtor's obligations under the mortgage, the bankruptcy default clause in the mortgage, if drafted with reference to the insolvency of the guarantor as well as of the debtor, should be effective upon the insolvency of the guarantor. If, as is often the case, the guarantor is a corporate parent or affiliate of the debtor, there is a substantial likelihood that the guarantor will be insolvent as well and that the bankruptcy default clause may be invoked.

Moreover, bankruptcy default clauses serve another useful purpose in that it is common for an agreement or instrument to have material provisions or rights that are effected by the presence or absence of a default under another agreement, such as a mortgage. For example, many letters of credit contain drawing conditions that require a certification from the beneficiary that there has been a default under an agreement between the beneficiary and the letter of credit account party/debtor. Although a bankruptcy court might be reluctant to enforce the exercise of remedies against a debtor as a result of the automatic stay, there is no reason why such default would not be valid as a triggering event under the independent letter of credit contract between the two nondebtors. Another example would be a loan agreement or

similar instrument between the mortgagee and a related nondebtor, such as an affiliate, which may have cross default provisions that make reference to a default under the mortgage, either directly by reference to the mortgage itself or by general reference to all loan documents between the mortgagee and the entity that is the bankruptcy debtor. Again, because the Bankruptcy Code should affect the enforceability of such clauses only as against a debtor, it would appear that the cross-default would be effective in defining the rights as between the mortgagee and a nondebtor.

Finally, in view of the need for judicial determination of the efficacy of bankruptcy default clauses in mortgages, and the apparent absence of any detriment arising from inclusion of such clauses, the prudent drafter will usually elect to retain these provisions.

With respect to the issue noted above, concerning whether a bankruptcy default clause may adversely affect the creditor's rights to a prepayment premium,^{n16b} it is suggested that such risk can be mitigated if not eliminated by providing explicitly in the documents (1) that any prepayment following any acceleration, including automatic acceleration upon a bankruptcy event, would entitle the mortgagee/lender to the premium and/or (2) that the mortgagee could voluntarily choose to reverse any such automatic acceleration. With respect to the latter suggestion, it is arguable that such a "deacceleration" does not come within the scope of any of the acts protected by the automatic stay of section 362.^{n16c} Even if the notice of deacceleration does implicate the automatic stay, a creditor may be able to obtain stay relief for "cause," and a court may have an inclination to grant the relief if the request is made at an early enough stage of the case so that there can be no claim by a debtor that it relied on the acceleration in formulating its chapter 11 plan.^{n16d}

Assuming, then, that bankruptcy default provisions will continue to be part of standard mortgage default clauses, certain modifications to the traditional versions of these clauses will be required to make them responsive to the concepts and terminology employed in the Bankruptcy Code. The Bankruptcy Code dispenses with the concept of "adjudication" of any person or entity as a bankrupt and refers to all such persons and entities as "debtors."ⁿ¹⁷ A case under any chapter of the Code, including a chapter 7 liquidation, is commenced by a "petition," and the commencement of a voluntary case "constitutes an order for relief."ⁿ¹⁸ In an involuntary case, a petition is filed by creditors and an order for relief may or may not be entered thereafter by the court.ⁿ¹⁹ The Code also introduces the term "custodian," which is defined in section 101(11) as: (1) a receiver or trustee of any of the debtor's property appointed in a case or proceeding other than under the Bankruptcy Code; (2) an assignee under a general assignment for the benefit of creditors; or (3) a trustee, receiver or agent appointed or authorized under applicable law or under a contract to take charge of property of the debtor in order to enforce a lien against such property "or for the purpose of general administration of such property for the benefit of the debtor's creditors."ⁿ²⁰ Thus, the entry of an order for relief and appointment of a custodian should be included within the events described in a bankruptcy default clause.

Although the Bankruptcy Code has eliminated the traditional "acts of bankruptcy" in respect of the filing of an involuntary petition, a properly drafted bankruptcy clause should reflect the events that are required for the entry of an order for relief in an involuntary case. These events are (1) that the debtor is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or (2) within 120 days before the filing of the petition, a custodian (other than a custodian of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property) was appointed or took possession of property of the debtor.ⁿ²¹

In addition to changes in terminology, consideration should be given to the effect of the automatic stay on the mortgagee's ability to send a notice of acceleration in the event of a default under the bankruptcy clause. Thus, in the case of a bankruptcy-related default, the customary notice requirement for acceleration should be eliminated, with acceleration to be self-operative upon the occurrence of the bankruptcy default. Also, consideration should be given to precisely defining the scope of the monetary obligations that are subject to such acceleration, to mitigate the risk that certain items, such as deferred payments that, by the terms of the contract, only become due upon the creditor initiating acts such as notice, will be treated as not due on the bankruptcy filing date. This may be an appropriate response to cases such as *In re Optel*, discussed above,^{n21a} that suggest that payment amounts that only become due upon the

taking of affirmative acts are not enforceable as part of the creditor's claim.

[3] Mortgages--Sample Default Clause

The following mortgage default clause reflects the drafting considerations discussed previously²² and employs in the bankruptcy default section the terminology of the Bankruptcy Code²³ as well as language traditionally employed in bankruptcy clauses. Thus, the payment default clause (subparagraph (a)) provides for an automatic default without notice or grace; there is a separate clause (subparagraph (b)) for defaults in the payment of obligations to third parties which likewise provides for an automatic default; a similar automatic default will occur upon a default in any other indebtedness of the mortgagor to the mortgagee or upon a payment default under other indebtedness of the mortgagor exceeding a threshold amount (subparagraph (d)); there is a basket default clause (subparagraph (c)) which provides for notice and grace and a cross default to other indebtedness which does not involve a payment default (subparagraph (e)); the insolvency of the mortgagor or a guarantor is made a default under the mortgage (subparagraphs (i) and (j)); and the acceleration clause (paragraph I) provides for automatic acceleration of the mortgage debt without notice upon the occurrence of a bankruptcy or insolvency-related event. In addition, the provision in the acceleration clause providing for the ability to rescind the effect of any event of default specifically references the bankruptcy events of default so as to address the recent reading by a court of the deacceleration clauses in a standard indenture as only applying to situations in which the original acceleration was triggered by the giving of notice rather than accelerations that were automatic.^{23a}

Sample Mortgage Default and Acceleration Clause:

If one or more of the following Events of Default shall occur:

- (a) if default shall be made in the payment of any installment of interest, principal, interest and principal, or in the payment of any premium, when any of the same shall become due and payable under the [Mortgage] Note, whether at maturity or by acceleration or as part of any prepayment or otherwise;
- (b) if default shall be made in the payment of any Tax [*defined*] to be paid by Mortgagor pursuant to Section, any insurance premium to be paid by Mortgagor pursuant to Section, or of any amounts payable for labor or materials to be paid by Mortgagor pursuant to Section
- (c) if default shall be made in the due observance or performance of any other term, covenant or condition on the part of Mortgagor in the Note or in this Mortgage contained, and such default shall have continued for a period of days after written notice specifying such default shall have been given to Mortgagor by Mortgagee;
- (d) if default shall be made in the payment of any principal, interest or other amount due under any other Indebtedness [*defined*] of Mortgagor to Mortgagee (whether by acceleration or otherwise), or under any other Indebtedness of Mortgagor if the amount of such Indebtedness has an outstanding principal amount in excess of \$..... or the amount of the defaulted payment shall exceed \$.....;
- (e) if default (other than a payment default described in clause (c) above) shall be made under any other Indebtedness of Mortgagor having an outstanding principal amount in excess of \$..... if the effect of such default would be to entitle the holder of such Indebtedness or a representative of such holder to declare the amount of such Indebtedness to become due (whether by the giving of notice, the lapse of time or both, or the occurrence of any other event) prior to its stated maturity, and such default under such other Indebtedness shall have continued for a period of days after written notice specifying such default shall have been given to the Mortgagor by the Mortgagee;^{23b}

(f) any financial report or statement, certificate, statement, representation or warranty at any time furnished or made by or on behalf of Mortgagor or any guarantor of any of Mortgagor's obligations hereunder, including, without limitation, any representation or warranty made by Mortgagor herein, proves to have been false or misleading in any material respect at the time as of which the facts therein set forth were stated or certified, or any such financial report or statement has omitted any material contingent or unliquidated liability or claim against Mortgagor or any such guarantor;

(g) any guarantor of any of Mortgagor's obligations hereunder shall fail to perform or observe any covenant, condition or agreement to be performed or observed by it under any guaranty agreement;

(h) Mortgagor or any guarantor of Mortgagor's obligations hereunder shall be in breach of or in default in the payment and performance of any obligation owing to Mortgagee, whether or not related to this Mortgage and howsoever arising, whether by operation of law or otherwise, present or future, contracted for or acquired, and whether joint, several, absolute, contingent, secured, unsecured, matured or unmatured;

(i) Mortgagor or any guarantor of any of Mortgagor's obligations hereunder shall cease doing business as a going concern, make an assignment for the benefit of creditors, generally not pay its debts as they become due or admit in writing its inability to pay its debts as they become due, file a petition commencing a voluntary case under any chapter of the Bankruptcy Code, *11 U.S.C. § 101 et seq.* (the "Bankruptcy Code"), be adjudicated an insolvent, file a petition seeking for itself any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar arrangement under the Bankruptcy Code or any other present or future statute, law, rule or regulation, or file an answer admitting the material allegations of a petition filed against it in any such proceeding, consent to the filing of such a petition or acquiesce in the appointment of a trustee, receiver, custodian or other similar official for it or of all or any substantial part of its assets or properties, or take any action looking to its dissolution or liquidation;

(j) a case, proceeding or other action shall be instituted against Mortgagor or any guarantor of any of Mortgagor's obligations hereunder, seeking the entry of an order for relief against Mortgagor or any such guarantor as a debtor, to adjudicate Mortgagor or any such guarantor as a bankrupt or insolvent, or seeking reorganization, arrangement, readjustment, liquidation, dissolution or similar relief against Mortgagor or any such guarantor under the Bankruptcy Code or other present or future statute, law, rule or regulation, which case, proceeding or other action either results in such entry, adjudication, or issuance or entry of any other order or judgment having a similar effect or remains undismissed for sixty (60) days, or within sixty (60) days after the appointment without Mortgagor's or such guarantor's consent or acquiescence of any trustee, receiver, custodian or other similar official for it or such guarantor or of all or any substantial part of its or such guarantor's assets and properties, such appointment shall not be vacated; or

(k) an order, judgment or decree shall be entered against Mortgagor by a court of competent jurisdiction which, together with other outstanding orders, judgments, and decrees against Mortgagor, exceed an aggregate of \$ (exclusive of amounts insured against by adequate liability insurance policies), and shall continue in effect for any period of ten (10) consecutive days without a stay of execution; then and in every such case:

I. During the continuance of any such Event of Default, the Mortgagee, by written notice to the Mortgagor, may declare the entire principal of the Note then outstanding (if not then due and payable), and all accrued and unpaid interest thereon, and all other payment amounts provided for in the [specify any other agreement containing a payment obligation, including any deferred payment obligations that are contemplated in the underlying transaction], to be due and payable

immediately, and upon any such declaration the principal of the Note and accrued and unpaid interest, the Prepayment Premium provided in section a hereof, and such other payment amounts, shall become and be immediately due and payable in full; provided, however, that upon the occurrence of any of the events specified in subparagraphs (i) and (j) above, all sums specified in this paragraph I shall be immediately due and payable without any notice or demand whatsoever; provided, further, that Mortgagee may, by written notice filed with a court of competent jurisdiction or provided to Mortgagor, rescind the effect of any such Event of Default (including pursuant to subparagraphs (i) and (j) above) pursuant to this paragraph I.

II. [Additional remedies in accordance with state law]

[4] Leasehold Mortgages and Mortgageable Leases--Generally

Section 365(h)(1) of the Bankruptcy Code provides that when an unexpired lease of real property under which the debtor is lessor is rejected, the lessee may elect either to (1) treat the lease as terminated if the rejection amounts to such a breach as would entitle the lessee to treat the lease as terminated under its terms, applicable nonbankruptcy law, or another agreement between the lessee and a third party, or (2) retain its rights under such lease that are in or appurtenant to the real property for the balance of the term and any renewals or extensions thereof if the option to renew or extend rests with the lessee.ⁿ²⁴ The Code says nothing more concerning the election of the lessee to treat the lease as terminated, but it appears that, upon making such election, the lessee will be required to surrender possession of the premises and will have an allowable claim for damages arising out of the rejection. Unlike a claim for damages on the part of a lessor arising out of the rejection of a real estate lease by a trustee of the lessee, the Code does not limit the allowable amount of a real estate lessee's claim arising out of rejection of the lease by the lessor's trustee.ⁿ²⁵

It should be noted that, as interpreted by a court of appeals decision, *In re Qualitech* ^{n25a} described *infra*, the protections of section 365(h) may be narrowly applied only to a formal rejection by a trustee or debtor-in-possession and not to other events which may materially and adversely affect the leasehold interest of a tenant and, by extension, the security interest of a leasehold mortgagee.

Prior to the Bankruptcy Reform Act of 1994 (the "1994 Act"),ⁿ²⁶ the Code provided very little guidance as to the nature of the ensuing tenancy when a nondebtor lessee does not elect to treat a rejected lease as terminated. Section 365(h)(1) as enacted in 1978 provided that upon the rejection of a real estate lease by the lessor's trustee the lessee under such lease could treat the lease as terminated or " ... remain in possession for the balance of the term including any term or terms which may be provided by otherwise enforceable options of renewal or extension."ⁿ²⁷ The Bankruptcy Amendments and Federal Judgeship Act of 1984 modified this language to provide that the lessee had the right to treat the lease as terminated or to "remain in possession of the leasehold" ⁿ²⁸ This language engendered litigation as to the meaning of the term "possession" where a lessor's trustee rejected a real estate lease under which the lessee had sublet to third parties all of the demised premises and therefore was not itself in actual physical possession of the leased premises. In these cases, the lessor's trustee would argue that in the absence of actual possession the lessee could not elect to "remain in possession" of the premises and therefore was compelled to treat the lease as terminated. Although there was a division of authority on the issue, the better view was that the term "possession of the leasehold" meant that as between the lessor and lessee, the lessee had the *right to possession* of the leasehold, and therefore could elect under section 365(h)(1) to maintain its right to possession.ⁿ²⁹

Another area of difficulty under section 365(h) prior to the enactment of the 1994 Act was the extent to which a nondebtor lessee retained, as against the lessor's trustee (and the postconfirmation entity) following rejection, the group of contractual rights provided for in the lease that did not arise solely by reason of the lessee's right to possession. Thus, in *In re Carlton Restaurant*,ⁿ³⁰ a bankruptcy court held that the rejection of a real property lease by a debtor-landlord terminated the lease, left the lessee only with a "personal right to possession," and thereby rendered the lessee's interest in the premises nonassignable. Certain other cases considered whether the provisions of 365(h)(2) (as in effect prior to

the 1994 Act), limiting the postrejection lessee's remedies against a nonperforming debtor-landlord to a rental offset for damages arising out of such nonperformance, precluded the lessee from obtaining affirmative relief to compel such performance.ⁿ³¹

The existence of issues relating to (1) the right of a nondebtor lessee to maintain its right to possession following a lease rejection by the lessor's trustee, (2) the continuation in effect of the lease following such rejection, (3) the loss of the lessee's right of assignment under the lease, and (4) the extent to which the lessee could enforce its rights against the lessor's trustee, all gave rise to grave concern on the part of real estate lenders that engaged in leasehold mortgage transactions. In the absence of other protections, the prospect that a lease could be terminated by a lessor's trustee or rendered nonassignable following rejection meant that a leasehold mortgagee could lose the leasehold that was the subject of its lien, or would be unable to transfer the lease upon foreclosure.

Many of these concerns were addressed by the amendments to section 365(h) made by the 1994 Act. Instead of speaking in terms of remaining in possession, the statute, since 1994, speaks of the tenant's ability to retain certain rights under the lease and specifies the nature of such rights retained. The revised section makes it clear that a lessee may enforce all of its rights in the lease that are in or appurtenant to the real property, and specifically lists subletting, assignment and hypothecation as protected rights. Furthermore, a new clause in section 365(h)(1) provides that the term "lessee" in such paragraph includes "any successor, assign, or mortgagee permitted under the terms of such lease,"ⁿ³² thereby providing that a leasehold mortgagee may step into the shoes of a nondebtor lessee and exercise whatever rights such lessee has under section 365(h)(1)(A). Significantly, the 1994 Act also amended section 365(h)(1) to provide that "the rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights ... does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance."ⁿ³³ The portion of the statute relating to the rights of a lessee when the debtor-lessor rejects a lease provides that:

(h)(1)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and--

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or

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

(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, use, exclusivity, or tenant mix or balance.

(D) In this paragraph, "lessee" includes any successor, assign, or mortgagee permitted under the terms of such lease.ⁿ³⁴

Although many significant issues have been resolved by the revisions to section 365(h)(1) effected by the 1994 Act, many questions remain as to the nature of the ensuing "tenancy," when a nondebtor lessee does not elect to treat a rejected lease as terminated. For example, although section 365(h)(1)(A)(ii) does not explicitly provide that a lease remains in existence following rejection by a lessor's trustee and the lessee's election to "retain its rights," no other interpretation of this section is as supportable as reading that the lease remains in effect, albeit in breach status on the part of the lessor. The nondebtor lessee is given the option to "retain its rights under such lease ... for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law."ⁿ³⁵ This language in effect provides that the nondebtor lessee is to retain its rights under the lease for the remainder of the stated term thereof and during any renewal or extension of the term provided for in the lease. Such retention of rights by the nondebtor lessee is inconsistent with any notion that the lease has been terminated or has been converted into a mere personal right of possession (such as a license).

However, section 365(h)(1)(A)(ii) also appears to set forth a limitation on the rights retained by the nondebtor lessee inasmuch as the rights so retained are solely those " ... that are in or appurtenant to the real property" The parenthetical provision in this section provides examples of, but not limitations on,ⁿ³⁶ provisions that are appurtenant to the real property. These provisions relate to the amount and timing of payment of rent and other amounts payable by the lessee, and any right of use, possession, quiet enjoyment, subletting, assignment or hypothecation. It appears that only in the most unusual circumstance will a provision in a lease be found not "appurtenant to the real property." Apart from the provisions expressly enumerated in the parenthetical clause of section 365(h)(1)(A)(ii), the typical panoply of provisions found in a commercial lease, dealing with matters such as casualty, condemnation, insurance requirements, maintenance and repair of the premises, real estate taxes and the like, seem to be closely related to the lessee's use and possession of the premises and therefore are "appurtenant" to the real property. On the other hand, matters that may have been inserted into a lease (and which could have been placed in a separate agreement), and that are wholly collateral to the use and possession of the real property, may be deemed excised from the group of rights retained by the nondebtor lessee under this section. Examples of such matters include provisions granting to the lessee a right of first negotiation for a lease of other real estate owned or controlled by the lessor, or the right to receive a loan from the lessor on an unsecured basis. Whether a purchase option or right of first refusal given to a lessee with respect to (or including) the real property demised under the lease constitutes a right in or appurtenant to the real property, and will be retained by the lessee after rejection of the lease by the lessor's trustee, may depend upon whether the granting of such right was an integral and material part of the leasing transaction.ⁿ³⁷

Section 365(h)(1)(C) provides that the rejection of a lease of real property in a shopping center with respect to which the lessee retains its rights under section 365(h)(1)(A)(ii) does not affect the enforceability under nonbankruptcy law of any provision in the lease relating to radius, use, exclusivity, or tenant mix or balance. This language, which is similar to language employed in section 365(b)(3) (dealing with assumption and assignment of shopping center leases), expressly preserves for shopping center tenants the enforceability of certain typical lease provisions that are often critical to the continued viability of a lessee's business conducted in a shopping center. For example, the operator of a small laundry and dry cleaning business in a shopping center will insist on an exclusivity provision in order to protect its effort and investment against the intrusion of a large discount operator, and may be unwilling to enter into a lease for space in the shopping center in the absence of such a provision. Similarly, the operator of a supermarket facility or movie theater will often demand in its lease both an exclusivity provision and a radius provision, with the radius provision limiting the lessor's right to enter into a leasing transaction with a competitor of the lessee within a specified radius of the shopping center. Although it may be argued that the placement of these provisions in section 365(h)(1)(C) rather than as part of section 365(h)(1)(A)(ii) indicates that these shopping center lease provisions are not "appurtenant to the real property" for the purposes of section 365(h)(1)(A)(ii), and therefore require separate and explicit treatment, these provisions are indeed an integral and appurtenant part of many shopping center leases. These provisions govern the relationships among the various lessees at a shopping center to preserve the mix of operators and uses that formed the original

inducement to a lessee to engage in business at a particular shopping center site.

Section 365(h)(1)(B) grants to a lessee that retains its rights under section 365(h)(1)(A)(ii) the right to offset against rent the value of any damage to the lessee caused by the debtor's nonperformance of any obligation under the lease following the date of rejection thereof by the lessor's trustee, and provides that "the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance." As noted above, some courts have held that the similar provisions of section 365(h)(2) as in effect prior to the 1994 Act do not preclude the grant to a nondebtor lessee of affirmative relief to compel performance by the trustee or its successor.ⁿ³⁸ This issue is particularly significant with respect to the enforcement by nondebtor lessees of the radius, use exclusivity and other provisions referred to in section 365(h)(1)(C), which often must be enforced by affirmative relief due to the difficulty of ascertaining monetary damages for breach of such provisions. It should be noted that section 365(h)(1)(A)(ii) speaks in terms of the nondebtor lessee's retention of certain rights under its lease, while section 365(h)(1)(C) speaks both in terms of such retention and in terms of the "enforceability under nonbankruptcy law" of the provisions described therein. It remains to be determined whether this language will be construed as providing for "enforceability" through the granting of affirmative relief, thereby overriding the limitation of remedies set forth in section 365(h)(1)(B).

There are additional questions under section 365(h) that remain unresolved notwithstanding the amendments enacted under the 1994 Act. If pursuant to section 365(h)(1)(B) the lessee commences after the closing of the case to offset its damage claim against the rent reserved in the lease, will state or federal law govern the measure of the offset and which court will have jurisdiction to decide the issue? If the lessee's offset is claimed by the trustee of the debtor-lessor to be excessive, will the lessee be subject to eviction or other dispossession proceedings?

Although many questions arising under section 365(h) remain open, the threshold issue, noted above, in the context of a lease rejection under section 365(h), is whether the lease continues in effect if the lessee elects to retain its rights under the lease. Section 365(h)(1) does not expressly relieve the trustee of the debtor-lessor from the performance of its affirmative obligations under the rejected lease if the lessee retains its rights under the lease. The section provides only that a rent offset will be available if the debtor-lessor's obligations are not performed.ⁿ³⁹ Moreover, section 365(g), which provides that the rejection of an executory contract or unexpired lease constitutes a breach thereof, is prefaced with the phrase, "Except as provided in subsections (h)(2) and (i)(2) of this section [365]," indicating that the rejection by the lessor's trustee may not terminate the lease.ⁿ⁴⁰ In addition, under section 365(h)(1), the lessee's alternatives upon rejection are to "treat the lease *as terminated*" (emphasis supplied) or to retain its rights under such lease, which implies that the lease is not terminated if the lessee elects to retain its rights under the lease.ⁿ⁴¹ It therefore appears that a lease will continue in effect notwithstanding rejection by the lessor's trustee if the lessee elects to remain in possession of the premises.ⁿ⁴² Nevertheless, it is useful to buttress this conclusion by adding to real estate leases a clause providing in substance that in the event of rejection of the lease by the lessor's trustee and the election under the Bankruptcy Code by the lessee to retain its rights under the lease, the rights and remedies of the parties will continue to be governed by the terms of the lease.ⁿ⁴³ It could be further provided that the lessee will have all the rights of a tenant under applicable state law, and that the parties agree to submit to the jurisdiction of the state courts for determination of these rights after the closing of the lessor's Bankruptcy Code case.

Moreover, under leases that provide for the payment of first proceeds of casualty insurance and condemnation awards to the lessor, it may be desirable to provide for the diversion of these awards first to the lessee to compensate it for rejection damages which it has not been able to recoup from rent. In some instances, a lessee with sufficient bargaining power may take a lien on the lessor's interest in the premises to secure all or a part of lessor's obligations under the lease. When the lease is being structured in contemplation of placement of a mortgage on the leasehold, a clause may be added to the effect that the rejection of the lease by the lessor's trustee will in no manner affect or impair the lien of the mortgage and the rights of the leasehold mortgagee under and in respect of the lease.ⁿ⁴⁴ The possibilities are as varied as are the differing versions of leases that are signed every day in the course of business transactions, and it is recommended that at least in the larger of these transactions drafters consider dealing with the ramifications of rejection

under the Bankruptcy Code by the lessor's trustee. There can be no assurance that a court in a Bankruptcy Code case will find such provisions enforceable under or consistent with the provisions of the Code; however, in view of the number of unresolved issues arising under section 365(h), the courts may be willing to honor the contract of the parties if it does not impair the benefits accorded to the lessor's estate arising out of rejection and provides a measure of clarity to the continuing relationship among the lessor, lessee and leasehold mortgagee.

In considering the rights granted under section 365(h) there remains the distinct possibility that the statute will be construed in a manner that limits its application to the situation where there is a formal rejection of the lease under section 365(a). A recent decision of the Court of Appeals for the Seventh Circuit suggests that there are significant limitations to the tenants rights under section 365(h), and suggests the need for heightened vigilance by both tenants and lenders under leasehold mortgages with respect to any action that affects the leasehold estate even if the action does not constitute a formal rejection by the debtor landlord under 365(a). In *In re Qualitech* n44a a tenant (Precision) had entered into a ten year lease for a warehouse with the debtor Qualitech. After Qualitech filed for bankruptcy, it ceased operation and moved to sell substantially all of its assets at auction, including the subject warehouse. The assets were ultimately sold to the debtor's prepetition lenders pursuant to a credit bid, and the order approving the sale provided that the assets were conveyed to the purchaser "free and clear of all liens, claims, encumbrances, and interests" pursuant to section 363(f) of the Bankruptcy Code. In addition to the subject warehouse, the sale order also provided the purchaser with the right to assume and assign leases and executory contracts. The tenant did not object to the sale. After the assets were later conveyed to a new entity formed by the prepetition lenders, Precision and the new owner (i.e., its landlord) were unable to agree to the terms and the lease was not assumed, albeit it was not formally rejected under section 365.n44b

After it was ultimately barred from the premises by the new owner, the tenant brought suit to enforce its purported right to remain in possession of the premises pursuant to the lease. The question squarely before the court was whether a sale free and clear of interests under section 363(f) trumps the tenants ability to retain its rights under the lease pursuant to section 365(h). After the bankruptcy court found in favor of the purchaser, the district court reversed in favor of Precision, essentially holding that although a leasehold interest is an interest of the type that may be extinguished under section 363(f), the more specific statutory rights in favor of tenants granted by section 365(h) should have precedence over the general provisions of the latter statute that could otherwise be construed in a manner that would divest the tenant of its leasehold interest.n44c

On appeal, the Seventh Circuit first found that the term "any interest" as used in section 363(f) was sufficiently broad to cover the possessory interest of a tenant under a lease. The court then squarely faced the seeming conflict between 363(f) and the tenants rights under section 365(h). In reversing the district court, the court of appeals first determined, as a matter of statutory construction, that the provisions contained no suggestion that one was intended to override the other, and found it notable that there was no cross reference in section 363(f) of the type found, for example, in section 363(d) and 365(a) that would suggest that 365(h) was a limitation on the trustee's right to sell assets free and clear of any interest.n44d

Second, the court also decided to interpret section 365(h) with a narrow scope, holding that it was only intended to cover the specific situation of a trustee or debtor-in-possession formally rejecting a lease pursuant to section 365(a), rather than the asset sale situation that actually occurred:

[T]he plain language of section 365(h)(1)(A) suggests that it has a limited scope. By its own terms, that subsection applies "if the trustee [or debtor-in-possession] *rejects* an unexpired lease of real property" (Emphasis supplied.) Here what occurred in the first instance was a sale of the property that Precision was leasing rather than a rejection of its lease. Granted, if the Sale Order operated to extinguish Precision's right to possess the property--as we conclude it did--then the effect of the sale might be understood as the equivalent of a repudiation of Precision's lease. See *Taylor*, 198 B.R. at 166 ("to allow a sale free and clear of a leasehold interest pursuant to § 363 ... would effectively provide a debtor with

means of dispossessing the lessee"). But nothing in the express terms of section 365(h) suggests that it applies to any and all events that threaten the lessee's possessory rights. Section 365(h) instead focuses on a specific type of event--the rejection of an executory contract by the trustee or debtor-in-possession--and spells out the rights of parties affected by that event. It says nothing at all about sales of estate property, which are the province of section 363. The two statutory provisions thus apply to distinct sets of circumstances. [citation omitted] see also *In re Stein*, 281 B.R. 845, 851 (Bankr. S.D.N.Y. 2002) ("The trustee is not seeking to assume or reject the lease for the [debtor's] apartment; he is attempting to sell the property of the estate under § 363(b). Thus, the effect of a theoretical rejection is immaterial."); cf. *In re Webber Lumber & Supply Co.*, 134 B.R. 76, 79-80 (Bankr. D. Mass. 1991) (§ 365(h) applies only to rejection of lease and does not limit "strongarm" power to avoid lease pursuant to 11 U.S.C. § 544(a)); *In re Sheets*, 277 B.R. 298, 306-07 (Bankr. N.D. Tex. 2002) (§ 365's provisions regarding executory contracts for purchase of property do not trump "strong-arm" authority bestowed by § 544(a) to avoid obligations).^{n44e}

Finally, the court stated that the protection available to a tenant in the sale context was not those provided under section 365(h), but rather the tenant's right, under section 363(e), to require that such sale be conditioned on the grant of adequate protection. The court noted that "adequate protection" in this context was not necessarily the retention of possession or some other right analogous to those under section 365(h), but, alternatively, such protection could be in the form of compensation from the proceeds of sale for the leasehold interest proposed to be terminated.^{n44f} In the case at bar, the court noted that Precision failed to object to the sale or otherwise seek adequate protection. Therefore, according to the court, because the tenant failed to assert the one statutory right otherwise available to protect its tenancy, the sale order was effective to extinguish its leasehold interest.^{n44g}

The reasoning of *Qualitech* has been followed by other courts facing a conflict between the rights of a lessee under 365(h) and the rights of a debtor to sell property free and clear of interests under 363(f). In one case, a bankruptcy court ruled that an approved sale of a property extinguished the rights of a lessee notwithstanding the lack of notice of the sale to the lessee because the lessee could, as a theoretical matter, have been compelled to accept a money satisfaction of its interest within the meaning of section 363(f)(5) by virtue of a buyout provision in the relevant lease.^{n44h}

Sales of assets under section 363(f) are quite common in today's bankruptcy environment. *Qualitech* and its progeny point out that, notwithstanding the arguable congressional intent to protect tenants pursuant to a comprehensive and specific provision like section 365(h), those rights may be limited in the sale context, and extra vigilance is required to monitor a bankruptcy case well in advance of a motion to formally reject a lease. Moreover, it remains to be seen if other courts will follow the lead of the *Qualitech* decision and hold that section 365(h) is to be narrowly construed in other situations that are not squarely within the four corners of the statute. For example, in many chapter 11 cases, a debtor in possession lender will often obtain a superpriority lien on the assets of a debtor under section 364(d).ⁿ⁴⁴ⁱ Section 364(d) permits a court, in certain circumstances, to authorize the obtaining of credit secured by a senior or equal lien on property of the estate that is subject to a lien. Does such a 364(d) lien, if ultimately enforced, give the lender the right to extinguish a tenant's leasehold interest? Arguably, it does, since the foreclosure by a lender to enforce such lien is different than a lease rejection by a trustee (or debtor-in-possession), which, under *Qualitech*, is the only kind of action that triggers the protection of section 365(h). Significantly, the term "lien" is defined in the Bankruptcy Code in terms of an "interest in property."^{n44j} Thus, it would appear that the interest in property provided by the bankruptcy court financing order could be deemed to prevail over the leasehold interest of a tenant. On the other hand, it is arguable that because of the focus in *Qualitech* on the broad scope of the term "interest," as distinguished from lien, and the fact that the interest encompassed by the Bankruptcy Code definition of lien is further circumscribed by the statutory requirement that such interest must secure a debt or other obligation,^{n44k} it is arguable that the senior "lien" granted under section 364(d) is not superior to the more expansive leasehold interest of a tenant. This and other issues will need to be settled by subsequent cases, but it points out the type of issues that are raised by the narrow construction of 365(h) adopted by the *Qualitech* court.^{n44l}

A trustee is authorized to sell property of the estate "after notice and hearing" under section 363(f). However, an entity that holds or asserts an interest in a property the trustee seeks to sell is entitled to receive notice of the trustee's intent to sell that property, particularly when the trustee seeks to sell the property free and clear of that entity's interest.

In *In re MMH Automotive Group, LLC*,^{n3a} after a final sale of the debtor's real estate, the purchaser of the property sought a determination that an unrecorded billboard lease had be terminated by such final sale. The lessee object, because even though the lease had not been recorded, the trustee had been aware of the lease and did not give the required notice. The court explored the interrelationship between sections 363(f) and 365(h) with respect to the transfer of property free and clear of leasehold interests.^{n3b} The court held that the interest under the unrecorded billboard lease must be recognized. "If a non-debtor's possessory rights are paramount, the priority of those rights should not be impacted by whether those possessory rights have already vested by virtue of rejection or assumption prior to an attempt to sell the underlying fee."^{n3c} However, section 365(h) did not enhance the lessee's rights beyond what existed outside of bankruptcy. "There is no law that would preclude [a] land owner from seeking relief under section 363(f) to the extent its provisions could be satisfied. In such instance, section 365 would not apply at all because the land owner would not be a party to the Billboard Lease, and the Billboard Lease would not be a lease of a debtor."^{n3d} Noting that "[t]here is nothing in section 365(h) that prohibits a debtor/landlord from selling property in which there is a tenant in possession, whether that tenant is in possession by virtue of a lease that has been assumed or by a lease that has been rejected,"^{n3e} the court concluded that the real property could be sold "free and clear" of the billboard lease under section 363(f)(5). The court then ordered that the billboard lessee be paid the agreed upon value of its leasehold interest.

[5] Leasehold Mortgages--Drafting Considerations Relating to Issues Arising Under Section 365(h) of the Bankruptcy Code

Although it appears that a real estate lease that is rejected under the Code by the trustee of a lessor will survive in the hands of a lessee who elects to retain its rights under the lease under section 365(h)(1),ⁿ⁴⁵ a leasehold mortgage should deal with the possibility that the lease does not survive in total and that the lessee's postrejection tenancy arises not from the lease but from a statutory "right of possession" created by the Bankruptcy Code. It may therefore be prudent to include in leasehold mortgages a clause extending the mortgage lien to the right of the lessee to retain its rights under the lease. The following is a suggested clause extending the lien of leasehold mortgage to the right of the lessee-mortgagor to retain its rights under the lease:

The lien of this mortgage attaches to all of Mortgagor's rights and remedies at any time arising under or pursuant to *Section 365(h) of the Bankruptcy Code, 11 U.S.C. § 365(h)*, including, without limitation, all of the rights provided for in *Section 365(h)(1)(A)(ii), 11 U.S.C. § 365(h)(1)(A)(ii)*.

It is of course of paramount importance that a leasehold mortgagee be empowered to assert control over the lessee's decision to retain its rights under the lease or to treat the lease as terminated. Indeed, concern had been voiced prior to enactment of the 1984 Amendments that section 365(h)(1) created a statutory right of election on the part of lessees under leases rejected by a lessor's trustee which may not be waived in favor of a third party such as a leasehold mortgagee.ⁿ⁴⁶ The 1984 Amendments added to section 365(h)(1) language to the effect that a lessee could not treat as terminated a real estate lease which had been rejected by the trustee of the debtor-lessor if prohibited from doing so in an agreement between the lessee and another party. This language was carried through in the 1994 Act. The legislative history for the 1984 Amendments states that the amendment "enables a sublessee or leasehold mortgagee to step in the position of the debtor's lessee in the event the lessee seeks to treat the trustee's rejection as a termination."ⁿ⁴⁷ Thus the Code recognizes and confirms the enforceability of a clause in a leasehold mortgage dealing with the leasehold mortgagee's right to control the lessee's section 365(h)(1)(A) election. The following is a suggested clause requiring a lessee-mortgagor to obtain the leasehold mortgagee's consent before electing to treat the lease as terminated:

Mortgagor shall not without Mortgagee's prior written consent elect to treat the lease as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*. In furtherance of the

foregoing, in the event that the lease is rejected by the lessor under the lease in a bankruptcy case involving the lessor, Mortgagor shall not, without Mortgagee's prior written consent, file a claim for damages arising from the rejection. Any such election or filing of a claim made without Mortgagee's prior written consent shall be void. This provision constitutes an "agreement made by the lessee" under the provisions of *Section 365(h)(1)(A)(i) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)(i)*.

Besides the inherent efficacy of a clause requiring mortgagee consent to a termination treatment of a rejected lease, such a clause should provide strong support to an argument on behalf of the mortgagee that cause exists for relief from the automatic stay under section 362(d)(1) in order to protect the mortgagee's interest in the leasehold in the event that the mortgagor sought to make an election under section 365(h)(1)(A) without consent.

If the choice is made to treat a rejected lease as terminated, consideration should be given to the inclusion in leasehold mortgages of a provision assigning to the leasehold mortgagee the claim for damages arising out of the rejection of the lease by the lessor's trustee. If enforceable under state law, this assignment should be a so-called "absolute assignment," as distinguished from a "collateral" or "conditional" assignment. Under an absolute assignment, a mortgagee is entitled to receive the rents and profits of a mortgaged property upon the occurrence of a mortgage default. Under a collateral or conditional assignment, a mortgagee is ordinarily entitled to such rents and profits after the occurrence of a mortgage default and after the mortgagee has taken possession of the property, obtained the appointment of a receiver, or obtained an order of sequestration for the rents and profits.⁴⁸ In the case of an assignment of the damage claim of a lessee-mortgagor against the rejecting trustee of the lessor, the rejection and lessee's election to treat the lease as terminated eliminates the mortgage *res*--the leasehold--and the requirements for sequestration and the like arguably should have no application. However, as noted above, the determination to use a particular form of assignment should be made with reference to applicable state law. The following is a suggested clause assigning to a leasehold mortgagee the damage claim of the lessee-mortgagor arising out of the rejection of the lease. This clause is in the form of an absolute assignment:

Mortgagor hereby unconditionally assigns, transfers and sets over to Mortgagee all of Mortgagor's claims and rights to the payment of damages arising from any rejection by lessor of the lease under the Bankruptcy Code, *11 U.S.C. § 101 et seq.* (the "Bankruptcy Code"). Mortgagee shall have the right to proceed in its own name or in the name of Mortgagor in respect of any claim, suit, action or proceeding relating to the rejection of the lease, including, without limitation, the right to file and prosecute, to the exclusion of Mortgagor, any proofs of claim, complaints, motions, applications, notices and other documents, in any case in respect of lessor under the Bankruptcy Code. This assignment constitutes a present, irrevocable and unconditional assignment of the foregoing claims, rights and remedies, and shall continue in effect until all of the indebtedness and obligations secured by this mortgage shall have been satisfied and discharged in full. Any amounts received by Mortgagee as damages arising out of the rejection of the lease as aforesaid shall be applied first to all costs and expenses of Mortgagee (including, without limitation, attorneys' fees) incurred in connection with the exercise of any of its rights or remedies under this paragraph and then in accordance with paragraph of this mortgage [application of proceeds clause].

Under section 365(h)(1)(B), if the lessee remains in possession under a lease rejected by the trustee of the lessor, the lessee may offset against rental any damages occurring after rejection caused by the nonperformance of any obligation of the lessor under the lease after such rejection.⁴⁹ For example, if the lessor under a rejected lease of an entire building was obligated under the lease to make all necessary repairs, the lessee may make the repairs and deduct the cost thereof from succeeding installments of rent. However, the exercise by the lessee of the rights conferred under section 365(h)(1)(B) may give rise to disputes with the debtor-lessor as to whether a particular obligation on the part of the lessor has in fact been performed, whether the lessee has been damaged by the lessor's nonperformance, and the extent and amount of any such damages. Indeed, the lessee's exercise of its section 365(h)(1)(B) rights may give rise to an unintended default under the lease, thereby placing in jeopardy the security of the leasehold mortgage. Accordingly,

consideration should be given to inclusion in leasehold mortgages of a provision conferring upon the leasehold mortgagee control over the amount of rent to be offset by the mortgagor-lessee under section 365(h)(1)(B). In evaluating the desirability of such a clause, consideration should be given to whether the leasehold mortgagee will be subject to liability if the offset is approved and is ultimately determined to be unjustified or excessive. The following suggested clause includes indemnification by the leasehold mortgagor covering any exposure of the leasehold mortgagee arising from the offset, and a sentence seeking to disclaim any responsibility on the part of the leasehold mortgagee in respect of the offset:

If pursuant to *Section 365(h)(1)(B) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(B)*, Mortgagor seeks to offset against the rent reserved in the lease the amount of any damages caused by the non-performance by the lessor of any of lessor's obligations under the lease after the rejection by lessor of the lease under the Bankruptcy Code, Mortgagor shall, prior to effecting such offset, notify the Mortgagee of its intent so to do, setting forth the amounts proposed to be so offset and the basis therefor. Mortgagee shall have the right to object to all or any part of such offset, and, in the event of such objection, Mortgagor shall not effect any offset of the amounts so objected to by Mortgagee. If Mortgagee has failed to object as aforesaid within days after notice from Mortgagor in accordance with the first sentence of this paragraph, Mortgagor may proceed to effect such offset in the amounts set forth in Mortgagor's notice. Neither Mortgagee's failure to object as aforesaid nor any objection or other communication between Mortgagee and Mortgagor relating to such offset shall constitute an approval of any such offset by Mortgagee. Mortgagor shall indemnify and save Mortgagee harmless from and against any and all claims, demands, actions, suits, proceedings, damages, losses, costs and expenses of every nature whatsoever (including, without limitation, attorneys' fees) arising from or relating to any offset by Mortgagor against the rent reserved in the lease. As employed herein, the term "Bankruptcy Code" shall mean *11 U.S.C. § 101 et. seq.*, as the same may from time to time be amended, modified or supplemented.

A similar concern relates to the right of the leasehold mortgagee to take control of any litigation affecting the lease which may arise during the Bankruptcy Code case of the lessor. Such litigation may involve issues relating to the right of the lessor's trustee to reject the lease, disputes relating to rental offsets taken by the lessee⁵⁰ or the claim for damages against the debtor-lessor if the lease is treated as terminated.⁵¹ In addition, in light of the court of appeals decision in *Qualitech*^{51a} and similar cases and the common practice of selling assets in bankruptcy cases free and clear of interests, there may be litigation regarding the right of a debtor/landlord to sell a property free and clear of the leasehold interest and, if such sale is to be permitted, the scope of adequate protection that the lessee should receive under section 363(e). The interests of the leasehold mortgagee will of course be affected by the outcome of such litigation, and therefore the leasehold mortgagee may want the option to control the proceedings. The following is a suggested clause granting to a leasehold mortgagee the option to control Bankruptcy Code litigation relating to the lease:

If any action, proceeding, motion or notice shall be commenced or filed in respect of the lessee or the mortgaged premises in connection with any case under the Bankruptcy Code, *11 U.S.C. § 101 et seq.*, including, without limitation, any action, proceeding or motion filed by the owner of the mortgaged premises, or a person acting on the owner's behalf, Mortgagee shall have the option, to the exclusion of Mortgagor, exercisable upon notice from Mortgagee to Mortgagor, to conduct and control any such litigation with counsel of Mortgagee's choice. Mortgagee may proceed in its own name or in the name of Mortgagor in connection with any such litigation, and Mortgagor agrees to execute any and all powers, authorizations, consents and other documents required by the Mortgagee in connection therewith. Mortgagor shall, upon demand, pay to Mortgagee all costs and expenses (including attorneys' fees) paid or incurred by Mortgagee in connection with the prosecution or conduct of any such proceedings. Any such costs or expenses not paid by Mortgagor as aforesaid shall be secured by the lien of this mortgage and shall be added to the principal amount of the indebtedness secured hereby. Mortgagor shall not

commence any action, suit, proceeding or case, or file any application or make any motion, in respect of the lease in any such case under the Bankruptcy Code without the prior written consent of Mortgagee.

In view of the importance of a lease as security for a leasehold mortgage and the uncertain status of the lease resulting from a Bankruptcy Code filing by or against the lessor, it may be advisable to provide in the leasehold mortgage for an accelerated notice procedure between the leasehold mortgagor and mortgagee in the event of such a filing. It is highly likely that the lessee will receive notice of the filing before the leasehold mortgagee, who does not have a direct financial relationship with the lessor. It is therefore imperative that the leasehold mortgagor be obligated to immediately advise the leasehold mortgagee of the filing affecting the lessor. The following is a suggested clause providing for prompt notice by a leasehold mortgagor to the leasehold mortgagee of the filing of a Bankruptcy Code petition by or against the lessor under the lease:

Mortgagor shall promptly after obtaining knowledge thereof notify Mortgagee orally of any filing by or against lessor of a petition under the Bankruptcy Code, *11 U.S.C. § 101 et seq.* [Insert mechanism for oral communications]. Mortgagor shall thereafter forthwith give written notice of such filing to Mortgagee, setting forth any information available to Mortgagor as to the date of such filing, the court in which such petition was filed, and the relief sought therein. Mortgagor shall promptly deliver to Mortgagee following receipt any and all notices, summonses, pleadings, applications and other documents received by Mortgagor in connection with any such petition and any proceedings relating thereto.

Although the leasehold mortgagee may become aware of the pendency of a bankruptcy case involving the lessor, either because of clauses such as the one above, or otherwise, it is possible that the leasehold mortgagor will be less than diligent in keeping the mortgagee informed of all developments relating to the premises, or that the mortgagee will have insufficient time to properly respond to a material motion that could adversely affect its mortgage interest because possibility of shortened notice that is common in bankruptcy proceedings. Therefore, it may be worthwhile for the mortgagee to file a notice of appearance in the bankruptcy case of the lessor promptly upon obtaining knowledge of the pendency of the case in order to receive notices directly from the bankruptcy court and parties in interest and otherwise to keep itself apprised of developments. A sample form of Notice of Appearance is included as an annex to this chapter.^{n51b}

[6] Mortgageable Leases--Drafting Considerations Relating to Issues Arising Under Section 365(h) of the Bankruptcy Code

It may be necessary to complement the previously suggested provisions for leasehold mortgagesⁿ⁵² with related provisions in leases which will be subject to leasehold mortgages.

One of the concerns of a leasehold mortgagee in connection with the rejection of a lease by the lessor's trustee is the assertion of control over the lessee's election to treat the lease as terminated or to retain its rights under the lease. It has already been suggested that leasehold mortgages include a provision granting to the leasehold mortgagee the power to control the election.ⁿ⁵³ However, additional comfort may be provided to the leasehold mortgagee if the lessor under the lease also expressly recognizes that the right of election has passed to the leasehold mortgagee. This recognition may be effected by an express clause to that effect in the lease. Although some question arises as to whether the trustee or debtor in possession may be bound by any prepetition lease provision agreed to by the lessor, the suggested clause may be viewed as being merely a recognition of a valid assignment of certain rights by the lessee to its mortgagee. In this context, the clause should not be viewed as an executory obligation of the lessor and, therefore, should not be rejectable by the lessor's trustee.ⁿ⁵⁴ In any event, the clause should at least serve to alert the trustee of the lessor that there may be an infirmity in the making of an election under section 365(h)(1)(A) if the leasehold mortgagee has not participated in the election process; if fully enforceable, the clause will allow control of the section 365(h)(1)(A) election to pass to the leasehold mortgagee.

The first of the following suggested clauses vests in the leasehold mortgagee full control over the section 365(h)(1)(A) election. This approach may be objectionable to the leasehold mortgagor inasmuch as it permits the leasehold mortgagee to elect to terminate the leasehold. The second of the suggested clauses provides in substance for an automatic election by the leasehold mortgagor to retain its rights under the lease.

Suggested clause limiting the right of a lessee that is also a leasehold mortgagor to exercise the section 365(h)(1)(A) election:

If the rights of the lessee under this lease are at any time pledged, hypothecated or otherwise subject to any mortgage, deed of trust or other security instrument, lessor agrees, for the benefit of the holder of or beneficiary under any such mortgage, deed of trust or other security instrument, that the right of election arising under *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*, shall be exercised by such holder or beneficiary and not by the lessee. Any exercise or attempted exercise by the lessee of such right of election in violation of the preceding sentence shall be void.

Suggested clause limiting the right of a lessee that is also a leasehold mortgagor to exercise the section 365(h)(1)(A) election--alternative:

If the rights of the lessee under this lease are any time pledged, hypothecated or otherwise subject to any mortgage, deed of trust or other security instrument, and if the lessor or any trustee of the lessor shall reject this lease pursuant to *Section 365(h) of the Bankruptcy Code, 11 U.S.C. § 365(h)*, (a) the lessee shall without further act or deed be deemed to have elected under *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*, to remain in possession of the leased premises for the balance of the term hereof and shall have the right to exercise any one or more of the extension options provided for in Article of this lease, and (b) any exercise or attempted exercise by the lessee of a right to treat this lease as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code* shall be void.

Although no amount of drafting may override a judicial interpretation of the Bankruptcy Code, it may be helpful to employ provisions that purport to fill in certain gaps in section 365(h). For example, the question whether a lease and mortgage lien thereon survive a section 365(h) rejection if the lessee elects to retain its rights under the lease appears to be answered in favor of survival⁵⁵ and this conclusion has been buttressed to the amendments under the 1994 Act, which specifically provide for the retention of rights that are in or appurtenant to the lease including the rights relating to the amount and timing of the payment of rent and other amounts and the rights of use, possession, quiet enjoyment, subletting, assignment and hypothecation.⁵⁶ However, section 365(h) is silent as to whether the postrejection relationship between lessor and lessee will continue to be governed by the lease terms--at least with respect to lease terms that relate to rights that are arguably not in or appurtenant to the real property--and does not deal with the effect of such rejection on a leasehold mortgage. The following suggested clause provides for survival of a lease rejected by a lessor's trustee under section 365(h), identifies the lease provisions that will remain in effect and also provides for the continuation of any mortgage on the lease. The clause seeks to fill gaps created by section 365(h), but may be viewed by a court as providing nothing more than a suggested interpretation of section 365(h) that may be adopted or rejected by the court:

Rejection of this lease by the lessor or any trustee of the lessor pursuant to *Section 365(h) of the Bankruptcy Code, 11 U.S.C. § 365(h)*, shall not terminate this lease unless the lessee elects pursuant to *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*, to treat this lease as terminated. If this lease shall not be treated as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code*, it shall continue in full force and effect in accordance with its terms, except that (a) the lessor shall have no obligation to perform the covenants on its part to be performed under Articles and hereof [list the provisions setting forth the lessor's affirmative obligations, if any, other than

the covenant of quiet enjoyment], and (b) the lessee shall have the rights conferred under *Section 365(h)(1)(B) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(B)*. If at the time of such rejection the rights of the lessee under this lease have been pledged, hypothecated or otherwise subject to any mortgage, deed of trust or other security instrument, and this lease shall not be treated as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code*, such mortgage, deed of trust or other security instrument shall not be affected or impaired by the rejection of this lease.

Another gap left in section 365(h)⁵⁷ that was not resolved by the Bankruptcy Reform Act of 1994 is the absence of any mechanism for resolving postrejection disputes relating to rental offsets taken by a lessee pursuant to section 365(h)(1)(B). The lessee and leasehold mortgage will desire to avoid an inadvertent default under the lease arising from an unjustified or excessive offset. Moreover, the parties require guidance as to the mechanism and forum for resolving such disputes both prior and subsequent to the closing of the lessor's Bankruptcy Code case. The following provision sets forth such a mechanism, and provides that the nondebtor lessee will not be in default unless a court determines that the offset was improper and the lessee thereafter fails to pay to the lessor the amount wrongfully offset:

If the lessee shall reduce the amount of any installment of fixed rental hereunder by the amount of any offset taken by the lessee pursuant to *Section 365(h)(1)(B) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(B)*, lessee shall, on the date on which such installment of fixed rental shall have become due hereunder, deliver to the lessor a notice setting forth the amount so offset, the reason or reasons for such offset and an itemization in reasonable detail of the damages suffered and costs incurred by lessee arising from the nonperformance by the lessor of the covenant in this lease which gave rise to such right of offset under *Section 365(h)(1)(B) of the Bankruptcy Code*. The lessor shall be deemed to have irrevocably accepted such offset unless, within ten days after lessee shall have given the notice provided for in the preceding sentence, the lessor shall give notice to the lessee (a) that it disputes the amount of the offset, (b) setting forth the reasons for such dispute and (c) setting forth the amount, if any, which lessor proposes to accept as a proper offset. If lessee fails to pay to lessor, within ten days after lessor shall have given notice provided for in the preceding sentence, an amount equal to the difference between the amount offset by the lessee and the amount proposed by the lessor as a proper offset, or if the lessor shall not have proposed such an amount, the entire amount so offset, the lessor may commence a proceeding in the United States Bankruptcy Court in which lessor's case under the Bankruptcy Code, *11 U.S.C. § 101 et seq.*, is then pending, or if such case has been closed, in any court of competent jurisdiction in the State of, to determine the amount, if any, which the lessee was and shall be entitled to offset pursuant to *Section 365(h)(1)(B) of the Bankruptcy Code*. If within ten days after the entry by such court of a final and on-appealable order or judgment declaring that the lessee is required to pay to the lessor any amounts theretofore offset, the lessee shall have failed to pay such amounts to the lessor, the lessor shall have all of the rights and remedies available to it under this lease or otherwise at law in respect of a default in the payment of fixed rental hereunder.

Section 365(h)(1)(B) provides in substance that the lessee's right of offset is the exclusive remedy against the estate to recover damages resulting from a rejecting lessor's nonperformance of any lease obligations.⁵⁸ Many mortgageable leases will provide that casualty insurance proceeds and condemnation awards not used for restoration will be paid to the lessee, who will apply such proceeds to the satisfaction of the leasehold mortgage. In the case of a lessee who elects to retain its rights under a rejected lease, consideration should be given to a provision for the payment of any insurance proceeds or condemnation award in excess of the leasehold mortgage balance to the lessee as compensation for any damages that have not been recovered by the rental offset. This provision may of course be attacked on the grounds that section 365(h)(1)(B) expressly provides for rental offset as the exclusive means of compensation for rejection damages. On the other hand, it may be argued that the lessor and lessee are free at the outset to contract for the allocation of such proceeds and awards, and that the lessee's right to offset unrecouped damages from such proceeds and awards represents merely an additional allocation provision that must be contractually recognized. It may be further asserted that such proceeds and awards as would have been allocated to the lessor but for the offset clause constitute another form of

rental under the lease as to which offset rights are recognized under section 365(h)(1)(B). In any event, the inclusion of such a clause in a real property lease does not appear to be detrimental and may conceivably be helpful to the lessee. The following clause is structured as a proviso to the clause directing distribution to the lessor of excess insurance proceeds and condemnation awards:

provided, however, that any amounts not recovered by lessee from lessor in accordance with Section 365(h)(1)(B) of the Bankruptcy Code, 11 U.S.C., § 365(h)(1)(B), shall be paid to lessee prior to distribution of any sums to lessor under this Section

[7] Leasehold Mortgages--Drafting Considerations Relating to Issues Arising Under Section 365(a) of the Bankruptcy Code

A leasehold mortgagee will of course be concerned not only with the lessor's rejection of a lease but also with the lessee's rights of rejection as a debtor under the Code.⁵⁹ This problem is frequently dealt with in a direct agreement between the leasehold mortgagee and the lessor, which may be part of a three-party agreement which includes the lessee-mortgagor. However, consideration may also be given to dealing with this issue in the leasehold mortgage as well.

It is highly unlikely that the lessee-mortgagor may execute in advance an enforceable agreement waiving its right to reject the lease in a Bankruptcy Code case.⁶⁰ However, the lessee-mortgagor may be able to execute an agreement to assign the lease to the leasehold mortgagee in lieu of rejection upon demand of the leasehold mortgagee and the agreement of the leasehold mortgagee to cure any defaults outstanding under the lease. This would leave the debtor-lessee in a better position than if its trustee had rejected the lease, inasmuch as there would be no claim by the lessor for past due sums or for damages arising out of the rejection of the lease. The clause would also leave the lessor in at least the same position as if the lease had been assumed by the lessee's trustee. The suggested clause may nevertheless be subject to the infirmity that it limits the trustee's statutory freedom of rejection. The question remains, however, whether the rejection power of a trustee for a lessee may be employed to destroy the lien of an otherwise enforceable leasehold mortgage.⁶¹ The following clause grants to a leasehold mortgagee the option to assume a lease in lieu of rejection of the lease by the trustee of the leasehold mortgagor:

If there shall be filed by or against the Mortgagor a petition under the Bankruptcy Code, 11 U.S.C. § 101 et seq. (the "Bankruptcy Code"), and the Mortgagor, as lessee under the lease [defined], shall determine to reject the lease pursuant to Section 365(a) of the Bankruptcy Code, the Mortgagor shall give the Mortgagee not less than ten days' prior notice of the date on which the Mortgagor shall apply to the bankruptcy court for authority to reject the lease. The Mortgagee shall have the right, but not the obligation, to serve upon the Mortgagor within such ten-day period a notice stating that (a) the Mortgagee demands that the Mortgagor assume and assign the lease to the Mortgagee pursuant to Section 365 of the Bankruptcy Code and (b) the Mortgagee covenants to cure or provide adequate assurance of prompt cure of all defaults and provide adequate assurance of future performance under the lease. If the Mortgagee serves upon the Mortgagor the notice described in the preceding sentence, the Mortgagor shall not seek to reject the lease and shall comply with the demand provided for in clause (a) of the preceding sentence within 30 days after the notice shall have been given, subject to the performance by the Mortgagee of the covenant provided for in clause (b) of the preceding sentence.

Section 365(d)(4), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), provides that an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall be required to immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of (i) the date that is 120 days after the date of the commencement of the bankruptcy case (entry of order for relief); or (ii) the date of the entry of an order confirming a plan. That 120 day deadline may be extended for an additional 90 days by the court for cause prior to the

expiration of the 120 day period, but the court cannot grant any additional extensions without the written consent of the lessor.ⁿ⁶² A leasehold mortgagee may be concerned that neither the trustee nor the lessor will seek an extension of the 120-day period, that the lease will be automatically rejected and that the lien of the leasehold mortgage will be destroyed.ⁿ⁶³ Moreover, the statute, as amended by the 2005 Act, provides for only a single 90-day extension of the initial 120-day period unless the "lessor" consents in writing. Section 365(d)(4) does not preclude parties other than the trustee and the lessor from applying to the court for an extension of the 120-day period, so that perhaps a leasehold mortgagor may in the leasehold mortgage "assign" to the leasehold mortgagee its rights as debtor under section 365(d)(4) to apply for an extension.ⁿ⁶⁴ There can be no assurance that such a provision would be binding upon the trustee of the leasehold mortgagor, but the following clause may at least provide a further signal to the court that it should be cognizant of the rights of a leasehold mortgagee in the context of an otherwise automatic lease rejection:

Effective upon the entry of an order for relief in respect of the Mortgagor under the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"), the Mortgagor hereby assigns and transfers to the Mortgagee a non-exclusive right to apply to the Bankruptcy Court under *Section 365(d)(4) of the Bankruptcy Code* for an order extending the period during which the lease [defined] may be rejected or assumed.

[8] Mortgageable Leases--Drafting Considerations Relating to Issues Arising Under Section 365(a) of the Bankruptcy Code

If in fact a leasehold mortgagor in a Bankruptcy Code case may reject the lease constituting the security for the leasehold mortgage, the leasehold mortgagee will seek the initial agreement of the lessor to recognize the leasehold mortgagee as a successor tenant under the lease notwithstanding the rejection. Section 365(g) provides that the rejection of an unexpired lease constitutes a breach of the lease.ⁿ⁶⁵ The section does not provide that rejection and breach result in the termination of the lease (although the debtor-lessee will certainly regard the lease as terminated for its own purposes). A leasehold mortgagee may accordingly consider the following provision for a lease to the effect that rejection by the lessee's trustee will not terminate the lease if the leasehold mortgagee assumes the lease and cures the outstanding defaults thereunder.ⁿ⁶⁶ The suggested clause also provides for the reassignment of the lease by the leasehold mortgagee to a new party and the release of the leasehold mortgagee from all ensuing liability thereunder:

If the lessee shall reject this lease pursuant to *Section 365(a) of the Bankruptcy Code, 11 U.S.C. § 365(a)*, or the lease is deemed rejected pursuant to *Section 365(d) of the Bankruptcy Code, 11 U.S.C. § 365(d)*, the lessor shall serve on the holder of the then existing leasehold mortgage written notice of such rejection, together with a statement of all sums at the time due under this lease (without giving effect to any acceleration), and of all other defaults under this lease then known to the lessor. The holder of the leasehold mortgage shall have the right, but not the obligation, to serve on the lessor within ten days after service of the notice provided for in the preceding sentence, a notice that the leasehold mortgagee elects to (a) assume this lease and (b) cure all defaults outstanding thereunder (x) concurrently with such assumption as to defaults in the payment of money, and (y) within sixty days after the date of such assumption as to other defaults except defaults of the type specified in *Section 365(b)(2) of the Bankruptcy Code, 11 U.S.C. § 365(b)(2)*. If such holder of the leasehold mortgage serves the notice provided for in the preceding sentence, then, as between the lessor and such leasehold mortgagee (1) the rejection of the lease by the lessee shall not constitute a termination of this lease, (2) the leasehold mortgagee may assume the obligations of the lessee under this lease without any instrument of assignment or transfer from the lessee, (3) the leasehold mortgagee's rights under this lease shall be free and clear of all rights, claims and encumbrances of or in respect of the lessee, and (4) the leasehold mortgagee shall consummate the assumption of the lease and the payment of the amounts payable by it to the lessor pursuant to this section at a closing to be held at the offices of the lessor at the address set forth at the head of this lease [insert other closing mechanism as desired] on the business day after the leasehold mortgagee shall have served the notice hereinabove provided for. The leasehold

mortgagee shall have the right to assign this lease pursuant to Section *[insert provision in lease dealing with assignment]* hereof and on an assignment of this lease by the leasehold mortgagee, the leasehold mortgagee shall be relieved of all obligations and liabilities arising from and after the date of such assignment.

An alternative and perhaps complementary clause which is employed in many mortgageable leases provides that upon a termination of the lease by reason of the lessee's breach, the lessor will enter into a new lease with the leasehold mortgagee upon the satisfaction of certain conditions. The disadvantage in the termination of the original lease and entry by the leasehold mortgagee into a new lease is that the new lease may be subordinate to liens and encumbrances on the fee which were junior to the original lease.ⁿ⁶⁷ It should be noted in this connection that permitted junior leasehold mortgages should provide for the continued priority of the senior leasehold mortgage in the case of a new lease.

[9] Mortgages--Mandatory Exercise of the Section 1111(b) Election

Section 506(a) provides in substance that a secured claim may be divided into two claims: a secured claim equal to the value of the creditor's interest in the collateral, and an unsecured claim for the balance. Under section 506(d), a lien securing a claim against a debtor is void to the extent of the deficiency on an undersecured nonrecourse obligation. Accordingly, section 506 operates to reduce the allowed secured claim of a nonrecourse secured creditor to the value of its collateral.

However, the provisions of section 506 are modified in chapter 11 cases through the operation of section 1111(b). Under section 1111(b)(1), an undersecured claim is treated as though the holder thereof had recourse against the debtor even if the governing instrument provides for a nonrecourse obligation. Under section 1111(b)(1)(A), the holder of the claim may elect not to receive recourse treatment if (1) the class of which such claim is a part elects, by vote of at least two-thirds in amount and more than half in number of allowed claims of such class, to be treated as claimants under section 1111(b)(2), or (2) the collateral is to be sold under section 363 or under the chapter 11 plan. If the class of claimants (which may consist of a single secured claimant) elects application of section 1111(b)(2), then the claim is allowed as a fully secured claim (without a deficiency claim that is unsecured), even though the value of the collateral may be less than the amount of the claim.ⁿ⁶⁸

The effect of electing fully secured status under section 1111(b)(2) is to protect the undersecured creditor in the case of a cramdown of a chapter 11 plan under section 1129(b). Under section 1129(b)(2)(A)(i)(I), the holders of secured claims in a class that a debtor seeks to cram down must retain the liens securing such claims to the extent of the allowed amount of such claims. Moreover, under section 1129(b)(2)(A)(i)(II), a secured creditor must receive under the plan on account of such claim a payment stream in a face amount at least equal to the full amount of the claim, having a present value, as of the effective date of the plan, of at least the value of the collateral.ⁿ⁶⁹ In other words, the present value (interest rate and term) of the payment stream must be equal to the value of the secured creditor's lien. Thus, in the case of a secured creditor making an election under section 1111(b)(2), because the full amount of the claim is treated as a secured claim (rather than a reduced amount based on the judicially determined value of the collateral as otherwise provided under section 506(a)), the cramdown requirements of section 1129(b) have the effect of providing that the secured creditor will retain its lien on the property until it receives principal payments equal to the full amount of the claim.

If following plan confirmation the reorganized debtor defaults under the restructured secured obligation, the secured creditor will have the right to recover from the collateral the full face amount of the outstanding indebtedness. If the secured creditor bids in the indebtedness and takes title to the collateral, the secured creditor and not the debtor will be entitled to the benefits of any subsequent appreciation in value of the collateral.

Another benefit of the section 1111(b)(2) election is that it provides leverage to the undersecured creditor when it is

anticipated that the debtor will sell or refinance the collateral after confirmation for an amount greater than the value determined by the court pursuant to *section 506 of the Bankruptcy Code*. As the face amount of the mortgage will equal the full amount of the claim if the section 1111(b)(2) election is made, the debtor must satisfy the full claim amount in order to release the creditor's lien in connection with any sale or refinancing. In the case of property that appreciates after confirmation of a chapter 11 plan, the leverage provided by the effect of the section 1111(b)(2) election will often enable the creditor to realize for itself a substantial portion of that appreciation.

Notwithstanding the benefits of the section 1111(b)(2) election, in certain circumstances an undersecured creditor may be better served by retaining a recourse claim for the deficiency. Usually, such circumstances will involve an estate which has substantial free and clear assets in addition to the collateral pledged to the undersecured creditor pursuant to the original nonrecourse secured transaction, thereby permitting an immediate sizable cash distribution to unsecured creditors. The unsecured claim may also be large enough to control, or constitute a blocking position with respect to, the vote of the unsecured creditor class and thus have a greater influence on plan terms and distribution. If the debtor does not have a group of unsecured creditors for which separate classification from the claim of the undersecured creditor is proper,^{n69a} then the size of the deficiency claim held by the undersecured creditor may be sufficient to prevent the debtor from satisfying the confirmation requirement of section 1129(a)(10) that at least one class of impaired claims has accepted a plan.

Also, it should be noted that while an election under 1111(b)(2) will have the effect of requiring that the total claim be paid in full if the debtor wishes to cause the release of the creditor's lien upon a subsequent sale, it does not mandate payment of the claim at any particular time prior to the plan imposed maturity date, including even upon a sale of the collateral, if the buyer of the property is willing to purchase the property subject to the encumbrance. Thus, the Seventh Circuit Court of Appeals has held that while section 1129(b)(2)(A) requires that the secured creditor retains its lien on the property, as security for the full amount of its secured claim (i.e., the full claim by virtue of the 1111(b)(2) election), terms of the original loan requiring payment on sale of the property did not continue as a term governing the retained lien.^{n69b} In many situations, the absence of an explicit due on sale clause in the cramdown created indebtedness will not have a practical effect on the lender's position because of the unlikelihood that a buyer of the property (or a new lender providing financing to the buyer) will be willing to have the lender's lien remain. However, in other situations, particularly where the cramdown interest rate on the debt is low, the buyer may be willing to live with the continued lien.

For this reason, the decision of an undersecured creditor to make an election should not be reflexive and should be made only upon careful consideration of the particulars of the bankruptcy case and the lender's evaluation of the future position of the property including the likelihood of a near term, post confirmation default and the debtor's intentions regarding a future disposition of the property.

Pursuant to Bankruptcy *Rule 3014*, a secured creditor must make the section 1111(b)(2) election "at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix." The secured creditor's decision can be changed after this time only if the plan is subsequently modified in a manner that is materially adverse to the creditor.ⁿ⁷⁰ Therefore, it is important for a secured creditor to consider as early as practicable the possible risks and benefits of the section 1111(b)(2) election.

The operation of section 1111(b)(1) in converting nonrecourse undersecured debt to recourse debt may adversely affect other lenders considering unsecured or recourse secured loans to a borrower in a nonbankruptcy transaction context, and may also adversely affect intercreditor relationships in the case of concurrent but separate loan transactions involving different assets of a prospective borrower. In such circumstances, consideration should be given to including in mortgage documents or in intercreditor agreements a provision for the waiver and relinquishment by a nonrecourse secured creditor (such as a real property mortgagee) of its right to recourse treatment under section 1111(b)(1). This may also be accomplished by such creditor's electing in the operative document, or agreeing in the event of a bankruptcy case to make such an election, to accept fully-secured status under section 1111(b)(2).

It cannot be said with complete certainty that a secured creditor's prepetition exercise of the section 1111(b)(2) election (or waiver of recourse treatment under section 1111(b)(1)) is enforceable by other creditors in a Bankruptcy Code case of the debtor. Nothing in section 1111(b) provides for a waiver of the right to recourse treatment under section 1111(b)(1) or for the election in advance for treatment as a fully secured creditor (notwithstanding the existence of a deficiency) under section 1111(b)(2). Nevertheless, such waiver or election appears to violate no policy underlying the Bankruptcy Code. Clearly, debtors may not waive most rights under the Bankruptcy Code including, of course, the right to file a petition. Nevertheless, a fully informed creditor should be able to waive rights as part of consensual transactions involving arrangements with other creditors and there seems to be no Bankruptcy Code policy that would favor disregarding those intercreditor agreements, at least in situations where the bankruptcy estate is not adversely affected in a manner any different than if the contracted for section 1111(b) election were made in such manner even without such agreement. Indeed, section 510(a) expressly recognizes the enforceability in Bankruptcy Code cases of subordination agreements among creditors to the same extent that such agreements are enforceable under applicable state law. A waiver of recourse treatment or advance election of fully secured treatment under section 1111(b)(2) bears a substantial resemblance to a contractual subordination agreement among creditors. Therefore, there are sound reasons for believing that the suggested section 1111(b) waiver or election provision would be upheld.

An example of a suggested clause in an intercreditor agreement or mortgage document in which a creditor (Second Lender) agrees to elect treatment as a nonrecourse secured creditor is as follows:

Second Lender hereby agrees for the benefit of First Lender, to the maximum extent permitted under applicable law, that, in the event of any bankruptcy, insolvency or other proceeding with respect to borrower, it will elect, with respect to all obligations of borrower under [*describe loan documents*] and pursuant to *Section 1111(b) of the Bankruptcy Code, 11 U.S.C. § 1111(b)*, or otherwise, to be treated as fully secured and as having no recourse against borrower or any assets of borrower other than [*describe collateral to which recourse is limited*].

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 362(a)(1)-(5).

(n2)Footnote 2. See *Elder-Beerman Stores Corp. v. Thomasville Furniture Indus. (In re Elder-Beerman Stores Corp.)*, 195 B.R. 1019 (Bankr. S.D. Ohio 1996); *Amoco Oil Co. v. Joyner (In re Joyner)*, 46 B.R. 130 (Bankr. M.D. Ga. 1985); *In re Hub of Military Circle, Inc.*, 13 B.R. 288, 289-90 (Bankr. E.D. Va. 1981); see *Wallingford's Fruit House v. City of Auburn (In re Wallingford's Fruit House)*, 8 C.B.C.2d 1138, 30 B.R. 654 (Bankr. D. Me. 1983); *In re R. S. Pinellas Motel Partnership Ramada Inns, Inc.*, 2 B.R. 113 (Bankr. M.D. Fla. 1979). *Contra In re Sixteen to One Mining Corp.*, 9 B.R. 636 (Bankr. D. Nev. 1981); cf. *In re Computer Communs.*, 824 F.2d 725 (9th Cir. 1987); *In re Texaco, Inc.*, 16 C.B.C.2d 1398, 73 B.R. 960 (Bankr. S.D.N.Y. 1987).

(n3)Footnote 3. 11 U.S.C. § 108(b); cf. *In re H&W Enterprises, Inc.*, 19 B.R. 582 (Bankr. N.D. Iowa 1982); *Moratzka v. Lanesboro State Bank (In re Johnson)*, 3 C.B.C.2d 569, 8 B.R. 371 (Bankr. D. Minn. 1981).

(n4)Footnote 4. 11 U.S.C. § 362(a)(3), (4), (6).

(n5)Footnote 5. See cases cited in note 2 *supra*. It should be noted that the automatic stay will not prevent the creditor from asserting a proof of claim for the full amount of the outstanding indebtedness, because the broad definition of "claim" in *section 101(5) of the Bankruptcy Code* is broad enough to encompass all amounts constituting rights to payment, whether or not due and payable at the time of the bankruptcy filing. 11 U.S.C. § 101(5); see *In re Manville Forest Products Corp.*, 43 B.R. 293 (Bankr. S.D.N.Y. 1984).

(n6)Footnote 6. 11 U.S.C. § 108(b); see *In re Margulis*, 323 B.R. 130 (S.D.N.Y. 2005) (section 108(b) could extend automatic grace period to cure default). This section also acts to extend mortgagor redemption periods. *In re*

Froehle, 286 B.R. 94 (B.A.P. 8th Cir. 2002) ; *In re Murray*, 276 B.R. 869 (Bankr. N.D. Ill. 2002) ; *In re Hollar*, 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995) .

(n7)Footnote 7. Under *Fed. R. Bankr. P. 4001(a)*, a request for relief from the automatic stay will take the form of a contested matter, commenced by a motion brought on under *Fed. R. Bankr. P. 9014*, rather than the form of an adversary proceeding governed by Part VII of the Bankruptcy Rules.

(n8)Footnote 7a. It should be noted, however, that the automatic stay will not toll, and section 108(b) will not extend, a default period that is running at the time of filing of a petition if the governing instrument provides for no right of cure during such period and automatic termination of the agreement at the expiration of the period. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 11 C.B.C.2d 1 (7th Cir.) , cert. denied, 469 U.S. 982, 105 S. Ct. 386, 83 L. Ed. 2d 321 (1984) ; *In re Margulis*, 323 B.R. 130 (S.D.N.Y. 2005) ; *In re Policy Realty Corp.*, 242 B.R. 121 (S.D.N.Y. 1999) . This type of provision is rarely found in traditional real estate mortgages, but may be employed in indentures as a final period before acceleration and after the debtor has failed to cure a noticed default.

(n9)Footnote 7b. 60 *Fed. Appx.* 390, 2003 U.S. App. LEXIS 5783 (3d Cir. Mar. 25, 2003) .

(n10)Footnote 7c. Specifically, the agreement provided:

The Deferred Payment shall be the joint and several obligation of both [TVMAX] and [OpTel] and shall become due and payable at [Nationwide's] request, which request may be made only following either (i) the conclusion of [TVMAX's] fifth or sixth full fiscal year following the Closing Date [January 11, 1995] (each a "Scheduled Triggering Date") or (ii) the date of sale or other disposition of a majority of the Assets or a majority of the outstanding voting capital stock of [TVMAX] to a third party who is not an affiliate of [TVMAX] (an "Asset Disposition").

If [TVMAX] or [OpTel] fails to make the Deferred Payment when it is payable pursuant to Sections 2(b)(i) and (ii) [which provide, respectively, when and how much payment is due] above, then [Nationwide] shall have the right, in lieu of any other remedy that would otherwise exist as a result of such failure, to demand that [TVMAX] execute and deliver to [Nationwide] a promissory note in the form of Exhibit "E" hereto (the "Note") in an amount equal to the greater of (X) \$10 million or (Y) the sum of the Deferred Payment calculated in accordance with Section 2(b)(ii) above plus \$3 million. The Note shall be guaranteed by [OpTel] pursuant to a guaranty in the form of Exhibit "F" hereto (the "Guaranty").

2003 U.S. App. LEXIS 5783, at *3-4 (quoting from applicable purchase/sale agreement).

(n11)Footnote 7d. *Id.* at *6-7 .

(n12)Footnote 7e. *Id.* at *13-14 (citation omitted).

(n13)Footnote 7f. *In re Solutia Inc.*, 379 B.R. 473, 487 (Bankr. S.D.N.Y. 2007) .

(n14)Footnote 7g. See, e.g., *In re St. Casimir Development Corp.*, 358 B.R. 24 (S.D.N.Y. 2007) (permitting debtor's assumption of partnership agreement where notice of termination of interest was not served exactly in accordance with agreement).

(n15)Footnote 8. 11 U.S.C. § 365(e); see *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 34 C.B.C.2d 1351 (1st Cir. 1995) .

(n16)Footnote 9. 11 U.S.C. § 541(c)(1).

(n17)Footnote 10. 11 U.S.C. § 1124(1).

(n18)Footnote 11. 11 U.S.C. § 1124(2). The latter requirement was added by the Bankruptcy Reform Act of 1994 and was subject to a technical amendment under the 2005 amendments to clarify that the reference to "provision" referred to penalty provisions. Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised); Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 12. 11 U.S.C. § 1129(b)(2)(A). Among other options, "fair and equitable" treatment of a secured claim requires that the holders of the secured claims retain their liens and that each claim holder receive deferred cash payments totaling at least the allowed amount of the claim and with a present value of at least the secured portion of the claim as determined under section 506. *Id.*

(n20)Footnote 13. 11 U.S.C. § 1322; *see P 1.12 supra.*

(n21)Footnote 14. *Accord Riggs Nat'l Bank v. Perry*, 729 F.2d 982 (4th Cir. 1984) (automobile installment sales contracts); *In re Zenith Labs., Inc.*, 104 B.R. 659, B.L.R. P 73,176 (Bankr. D.N.J. 1989) ; *In re Cassell*, 12 C.B.C.2d 769, 41 B.R. 737 (Bankr. E.D. Va. 1984) (same). However, for the purpose of filing claims in a Bankruptcy Code case, the filing of the debtor's petition is deemed to automatically accelerate the debt. *See* 11 U.S.C. § 502(b)(1). The distinction is between enforcement of the claim outside of the context of the Bankruptcy Code case and allowance of the claim in the case. *In re Manville Forest Prod. Corp.*, 11 C.B.C.2d 735, 43 B.R. 293 (Bankr. S.D.N.Y. 1984) .

(n22)Footnote 14a. This issue has been recently highly contested in connection with the chapter 11 cases of Calpine Corp., where a positive change in business fortunes and financing markets following Calpine's bankruptcy filing provided Calpine with the opportunity to prepay its secured debt in full in cash during the case over the objection of the debt holders who argued that they were entitled to their contractual prepayment premium. These circumstances resulted in two noteworthy decisions. *See, e.g., Law Debenture Trust Co. v. Calpine Corp. (In re Calpine Corp.)*, 356 B.R. 585 (S.D.N.Y. 2007) (district court decision affirming bankruptcy court decision permitting prepayment to holders of first lien debt, but deferring decision on entitlement of holders to prepayment premium); *In re Calpine Corp.*, 365 BR 392 (Bankr. S.D.N.Y. 2007) (bankruptcy court decision allowing holders of different debt issue damages for prepayment).

(n23)Footnote 15. *See P 3.06[9] infra.*

(n24)Footnote 15a. An insolvency clause in a license agreement, giving rise to an automatic default without notice, was held enforceable in *In re Gordon Car & Truck Rental Inc.*, 59 B.R. 956 (Bankr. N.D.N.Y. 1985) .

(n25)Footnote 16. *See* text accompanying notes 8-13 *supra.*

(n26)Footnote 16b. *See* text accompanying note 14a *supra.*

(n27)Footnote 16c. However, this argument was not accepted in a recent case in which the court specifically held that where the loan agreement provides for automatic acceleration upon a bankruptcy, any attempt at deacceleration would violate the automatic stay since it would represent a direct attempt to obtain more property from the debtor, either through a simple increase in the amount of its plan distribution or through recovery of a greater amount of collateral securing the claim. *In re Solutia Inc.*, 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007) .

(n28)Footnote 16d. In the *Solutia* case, 379 B.R. 473 , the court denied the secured creditor's oral motion for relief from the stay in order to send a notice of deacceleration because the debtor had already filed two plans of reorganization that contemplated payment of the amount due upon acceleration rather than a greater deferred amount. 379 B.R. 473, 484 n.7 .

(n29)Footnote 17. The drafters of the Code believed that there was less stigma associated with the term "debtor" than with the term "bankrupt." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 310 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n30)Footnote 18. *11 U.S.C. § 301.*

(n31)Footnote 19. *11 U.S.C. § 303.*

(n32)Footnote 20. *11 U.S.C. § 101(11).*

(n33)Footnote 21. *11 U.S.C. § 303(h).*

(n34)Footnote 21a. *See P 2.01[1]* and notes 7b-7e and accompanying text *supra*. As noted, the acceleration cause should include any prepayment provision or make-whole provision.

(n35)Footnote 22. *See P 2.01[1] supra.*

(n36)Footnote 23. *See P 2.01[2] supra.*

(n37)Footnote 23a. *In re Solutia Inc.*, 379 B.R. 473, 483-84 (Bankr. S.D.N.Y. 2007) .

(n38)Footnote 23b. An alternative or addition to this cross default clause could be language that results in a default under the Mortgage if the default under the other Indebtedness is not cured or waived by the holders of such Indebtedness within a set number of days following its occurrence.

(n39)Footnote 24. *11 U.S.C. § 365(h)(1)(A)*. If the lessor's covenants in a lease, other than the covenant of quiet enjoyment, are "independent" covenants which if breached would give rise to an action by the lessee for damages or affirmative relief but not a right of termination, and if under section 365(h)(1) a lessee may elect to retain its rights under such lease (and therefore the covenant of quiet enjoyment may not have been breached), a question may be raised under section 365(h)(1) as to when rejection by the lessor's trustee would ever give rise to a right of termination by the lessee under the lease or applicable law. A suggested form of election by a lessee to retain its rights under a lease pursuant to section 365(h) is included at the end of this chapter.

(n40)Footnote 25. Section 502(b)(6) sets forth a limitation on the allowable amount of damages arising from the rejection of a real estate lease by the *lessee's* trustee. *See P 3.03[2] infra.*

(n41)Footnote 25a. *In re Qualitech*, 327 F.3d 537 (7th Cir. 2003) .

(n42)Footnote 26. Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n43)Footnote 27. Pub. L. No. 95-598 (1978), *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th Ed. Revised).

(n44)Footnote 28. Pub. L. No. 98-353 (1984), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n45)Footnote 29. *Lee Rd. Partners v. F.W. Woolworth Co. (In re Lee Road Partners)*, 169 B.R. 507 (E.D.N.Y. 1994) (possession of the leasehold means the right to possession, notwithstanding that entire premises were sublet); *accord In re Stanley Station Assocs., L.P.*, 179 B.R. 682 (Bankr. D. Kan. 1996) (decided under statute as in effect prior to the enactment of the 1994 Act); *In re Sok Jun Kong*, 162 B.R. 86 (Bankr. E.D.N.Y. 1993) (*dictum*) (this case was decided by Judge Duberstein, the bankruptcy judge affirmed in *Lee Road*); *In re Harborview Dev. 1986 Ltd. Partnership*, 152 B.R. 897 (D.S.C. 1993) (actual possession required).

(n46)Footnote 30. 151 B.R. 353 (Bankr. E.D. Pa. 1993) .

(n47)Footnote 31. *Chestnut Ridge Plaza Assocs., L.P. v. Fox Grocery Co. (In re Chestnut Ridge Plaza Assocs., L.P.)*, 156 B.R. 477 (Bankr. E.D. Pa. 1993) ; *In re Arden & Howe Assocs., Ltd.*, 28 C.B.C.2d 1182, 152 B.R. 971 (Bankr. E.D. Cal. 1993) .

(n48)Footnote 32. 11 U.S.C. § 365(h)(1)(D).

(n49)Footnote 33. 11 U.S.C. § 365(h)(1)(C).

(n50)Footnote 34. 11 U.S.C. § 365(h)(1).

(n51)Footnote 35. 11 U.S.C. § 365(h)(1)(A)(ii).

(n52)Footnote 36. Section 102(3) provides that the term "including" is not limiting.

(n53)Footnote 37. Under common law, an easement appurtenant is a right arising by reason of ownership of a dominant estate in real property, and is assignable and inheritable as a part of such rights of ownership. An easement in gross is a right held independently of the ownership of real property, and is often deemed to be personal to the holder and not transferable. *See, e.g., Banach v. Home Gas Co.*, 23 Misc. 2d 556, 199 N.Y.S.2d 858, 12 O.&G.R. 1044 (Sup. Ct., Schuyler Co., 1960) .

(n54)Footnote 38. *Chestnut Ridge Plaza Assocs., L.P. v. Fox Grocery Co. (In re Chestnut Ridge Plaza Assocs., L.P.)*, 156 B.R. 477 (Bankr. E.D. Pa. 1993) ; *In re Arden & Howe Assocs., Ltd.*, 152 B.R. 971 (Bankr. E.D. Cal. 1993) .

(n55)Footnote 39. 11 U.S.C. § 365(h)(1)(B).

(n56)Footnote 40. 11 U.S.C. § 365(g). The amendments to section 365(h) by the Bankruptcy Reform Act of 1994 resulted in a renumbering of the paragraphs in that section such that the provisions which were formerly in section 365(h)(2) are now contained (as amended) in section 365(h)(1)(B). It appears that the failure to change the reference in section 365(g) was an oversight and that the section should be treated as if the preface read "Except as provided in subsections (h)(1)(B) and (i)(2) of this section ... "

(n57)Footnote 41. 11 U.S.C. § 365(h)(1).

(n58)Footnote 42. *Accord Megafoods Stores v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.)*, 60 F.3d 1031, 1034 (3d Cir. 1995) ; *Upland/Euclid, Ltd. v. Grace Rest. Co.*, 13 C.B.C.2d 898, 56 B.R. 250 (B.A.P. 9th Cir. 1985) ; *In re Stable Mews Assocs.*, 9 C.B.C.2d 976, 35 B.R. 603 (Bankr. S.D.N.Y. 1983) .

(n59)Footnote 43. *See PP 2.01[6], 2.01[7] infra* .

(n60)Footnote 44. *See PP 2.01[6], 2.01[7] infra* .

(n61)Footnote 44a. *In re Qualitech*, 327 F.3d 537 (7th Cir. 2003) .

(n62)Footnote 44b. The court of appeals described the lease as having been "de facto rejected" as a result of the nonassumption. 327 F.3d at 541 .

(n63)Footnote 44c. 327 F.3d at 542 .

(n64)Footnote 44d. 327 F.3d at 547 .

(n65)Footnote 44e. 327 F.3d at 545-46 .

(n66)Footnote 44f. 327 F.3d at 548 .

(n67)Footnote 44g. The holding in *Qualitech* is contrary to the results under similar fact patterns in *In re Taylor*, 198 B.R. 142, 167 (Bankr. D.S.C. 1996) ("[I]t appears to the Court that Congress intended § 365(h) to control the rights of the landlord and the tenant when a landlord files bankruptcy and that § 365(h) reflects a careful balance between the needs of the bankrupt's estate and the rights of a tenant to the estate to which the tenant bargained."), and an earlier decision by the Bankruptcy Court for the Northern District of Illinois, which has now, of course, been overruled by the Seventh Circuit's decision in *Qualitech*. See *In re Churchill Properties III, Ltd.*, 36 C.B.C.2d 664, 197 B.R. 283 (Bankr. N.D. Ill 1996) . A result similar to *Qualitech* was reached by a district court in the Southern District of New York, which held that the sale of a building was free and clear of all leasehold interests, including the rights to a statutory lease under the New York City rent stabilization laws. See *In re Downtown Athletic Club of N.Y. City*, 44 C.B.C.2d 342, 2000 U.S. Dist. LEXIS 7917 (S.D.N.Y. 2000) .

(n68)Footnote 44h. *South Motor Co. v. Carter-Pritchett-Hodges, Inc. (In re MMH Auto. Group, LLC)*, 385 B.R. 347, 371 (Bankr. S.D. Fla. 2008) . The court noted that "[t]here is nothing in section 365(h) that prohibits a debtor/landlord from selling property in which there is a tenant in possession, whether that tenant is in possession by virtue of a lease that has been assumed or by a lease that has been rejected."

(n69)Footnote 44i. 11 U.S.C. § 364(d). A bankruptcy court case from Massachusetts cited and discussed the *Qualitech* decision in the context of a section 363 sale, but came to a different conclusion by holding that because of the rights provided to lessees under section 365(h), the tenant could not be compelled to accept a money satisfaction of its leasehold interest within the meaning of section 363(f)(5) of the Code. *In re Haskell L.P.*, 321 B.R. 1, 9 (Bankr. D. Mass. 2005) ("[i]f the Court were to grant the Debtor's Sale Motion, the provisions of § 365(h) would be eviscerated. In other words, the Debtor would be doing indirectly what it could not do directly, namely, dispossessing [tenant]"). The *Haskell* court did not reject the adequate protection theory of *Qualitech* but held that because, in the case at hand, the proceeds of the sale were far below the amount of a first mortgage on the property, there would not be sufficient proceeds to compensate the tenant for its loss of tenancy and that the only adequate protection that could be provided was the continuation of the leasehold interest.

(n70)Footnote 44j. 11 U.S.C. § 101(37).

(n71)Footnote 44k. *Id.*

(n72)Footnote 44l. For a contrary, subsequent case from a different jurisdiction, see *In re Haskell L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005) , discussed in note 44i *supra*.

(n73)Footnote 3a. 385 B.R. 347 (Bankr. S.D. Fla. 2008) .

(n74)Footnote 3b. For additional discussion of this interrelationship, see *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 49 C.B.C.2d 1765 (7th Cir. 2003) .

(n75)Footnote 3c. 385 B.R. 347, 365 .

(n76)Footnote 3d. 385 B.R. 347, 366 .

(n77)Footnote 3e. *Id.*

(n78)Footnote 45. See P 2.01[4] *supra*.

(n79)Footnote 46. New York State Bar Association, Proceedings of the Real Property Law Section, January 1980, at 29-30.

(n80)Footnote 47. S. Rep. No. 98-65, 98th Cong., 1st Sess. 77 (1983). Even in the absence of protective language

in a leasehold mortgage, *In re Penn Cent. Transp. Co.*, 458 F. Supp. 1346 (E.D. Pa. 1978) and *Commercial Trading Co. v. Lansburgh (In re Garfinkle)*, 577 F.2d 901, 17 C.B.C. 635 (5th Cir. 1978) both indicate that a leasehold mortgagee's position would be protected against impairment by a rejecting debtor-lessor and a lessee which accepted the rejection. *Eastover Bank for Savings v. Sowashee Venture*, 19 F.3d 1077 (5th Cir. 1994) (Jones, J.), holds squarely that rejection of a ground lease by a debtor-tenant does not terminate the rights of a leasehold mortgagee, as against the lessor. See also Friedman, Leases, § 7.801, at 362-63 (2d ed. 1983).

(n81)Footnote 48. See P 2.03 *infra*.

(n82)Footnote 49. 11 U.S.C. § 365(h)(1)(B).

(n83)Footnote 50. See text following note 35 *supra*.

(n84)Footnote 51. Section 1109(b), applicable only in chapter 11 cases (including railroad reorganizations), provides that a party in interest may raise and may appear and be heard on any issue. *Fed. R. Bankr. P. 2018(a)*, applicable under all chapters of the Code, authorizes the court after a hearing on such notice as the court may direct and for cause shown to permit intervention by any interested entity generally or with respect to any specified matter. *Fed. R. Bankr. P. 7024* applies to adversary proceedings and incorporates by reference *Rule 24 of the Federal Rules of Civil Procedure* as governing intervention in adversary proceedings. Thus, *Fed. R. Bankr. P. 7024* will govern as to intervention in adversary proceedings in a case under any chapter of the Code, and *Fed. R. Bankr. P. 2018(a)* will govern as to intervention in all other matters, including contested matters, arising in a case under any chapter.

(n85)Footnote 51a. *In re Qualitech*, 327 F.3d 537 (7th Cir. 2003) , discussed *supra*.

(n86)Footnote 51b. See P 2.57 *supra*.

(n87)Footnote 52. See P 2.01[5] *supra*.

(n88)Footnote 53. See P 2.01[5] *supra*. A provision in section 365(h)(1), added by the Bankruptcy Amendments and Federal Judgeship Act of 1984, and retained in section 365(h)(1) as amended by the Bankruptcy Reform Act of 1994, prohibits the lessee from treating as terminated a real estate lease rejection by a trustee for a debtor-lessor if an agreement between the lessee and a third party prohibits such termination. The provision does not contemplate any limitation on the right of rejection in the hands of the trustee for the debtor-lessor.

(n89)Footnote 54. The rejection of a lease by the trustee for a debtor-lessor is generally viewed as a breach of the lessor's affirmative obligations under the lease. See P 2.01[4] *supra*.

(n90)Footnote 55. See P 2.01[4] *supra*.

(n91)Footnote 56. Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n92)Footnote 57. See P 2.01[5] *supra*.

(n93)Footnote 58. 11 U.S.C. § 365(h)(1)(B).

(n94)Footnote 59. 11 U.S.C. § 365(a).

(n95)Footnote 60. See cases cited in P 1.05 note 8 *supra* .

(n96)Footnote 61. *In re Austin Dev. Co.*, 19 F.3d 1077, 1083 (5th Cir. 1994) (suggesting that treating lease rejections as affecting a termination of the rights of a leasehold mortgagee would be "a capricious result that makes no bankruptcy sense"), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994) ; cf. *International Trade*

Admin. v. Rensselaer Polytechnic Inst., 936 F.2d 744 (2d Cir. 1991) (leasehold mortgagee has standing to oppose termination of a lease under section 365(d)(4)). See generally Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 Harv. L. Rev. 973 (1983). But see *In re Cobham Enter., Inc.*, 62 B.R. 191 (Bankr. S.D.N.Y. 1986), *aff'd*, 72 B.R. 779 (S.D.N.Y. 1987), holding that a creditor holding a security interest in a real estate leasehold is without standing to cure defaults under the lease and to compel assignment of the lease to the creditor.

(n97)Footnote 62. 11 U.S.C. § 365(d)(4). A monumental amendment was made to this section under the 2005 Act to remove the discretionary right of the court to grant unlimited further extensions for cause beyond an initial 60-day period. Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The legislative history makes clear that the amendment was intended "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected." See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), at 10-354 (Matthew Bender 15th Ed. Revised).

(n98)Footnote 63. See *In re Austin Dev. Co.*, 19 F.3d 1077 (5th Cir. 1994), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994), discussing cases and concluding that automatic rejection does not terminate interest of leasehold mortgagee.

(n99)Footnote 64. See *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744 (2d Cir. 1991).

(n100)Footnote 65. 11 U.S.C. § 365(g).

(n101)Footnote 66. In the absence of such provision in the lease, the leasehold mortgagee or collateral assignee has no standing under the lease or the Bankruptcy Code to cure lease defaults, and compel an actual assignment. *In re Cobham Enter., Inc.*, 62 B.R. 191 (Bankr. S.D.N.Y. 1986), *aff'd*, 72 B.R. 779 (S.D.N.Y. 1987). But see *Int'l Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744 (2d Cir. 1991).

(n102)Footnote 67. See generally Levitan, *Leasehold Mortgage Financing: Reliance on the "New Lease" Provision*, 15 Real Prop., Prob. & Tr. J. 413 (1980).

(n103)Footnote 68. See P 2.07[2] *infra*. See generally Carlson, *Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 Bankr. Dev. J. 253 (1989); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133 (1979).

(n104)Footnote 69. Substantial room for disagreement exists as to the proper choice of discount rate for purposes of calculating the present value of the payment stream. *E.g.*, *GMAC v. Jones*, 999 F.2d 63 (9th Cir. 1993); *In re McKean*, 178 B.R. 637 (Bankr. M.D. Pa. 1994); *In re Nite Lite Inns*, 6 C.B.C.2d 107, 114-15, 17 B.R. 367 (Bankr. S.D. Cal. 1982). In the chapter 13 context, the United States Supreme Court has required application of a "formula rate" approach, involving an upward adjustment to the national prime-rate of interest charged to credit-worthy borrower, based on the risk of default by the post-bankruptcy debtor. *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004); see P 2.07[2]. However, the *Till* Court suggested that in chapter 11 cases, it might be more appropriate to base the rate on an analysis of what an efficient market would produce, 541 U.S. 465, 477 n.14, and subsequent courts have been willing to impose a different rate where the court was able to determine a proxy for an efficient market rate of interest, such as the rate of the debtor's exit facility. *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239, 256 (Bankr. M.D. Fla. 2006); see also S. Fawkes & S. Hartmann, *Revisiting Till: Has a Consensus Emerged in Chapter 11s?*, Am. Bankr. Inst. J., July/August 2008, at 28.

(n105)Footnote 69a. See P 2.07[2] *infra*.

(n106)Footnote 69b. *Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.)*, 519 F.3d 640, 645 (7th Cir. 2008).

(n107)Footnote 70. *In re Elmwood, Inc.*, 182 B.R. 845, 853 (Bankr. D. Nev. 1995) .

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.02

P 2.02 Structuring of Mortgage Transactions

[1] Mortgage Supported by One or More Leases

A typical commercial mortgage transaction will take the form of a nonrecourse mortgage loan to a fee owner supported by one or more credit leases furnishing the income stream to service the debt. Under the former Bankruptcy Act, if the lessee under an important lease became a debtor in a bankruptcy case, the bankruptcy default clause in the lease, especially when coupled with a default in the payment of rent, would be sufficient to permit a termination of the lease by the lessor-mortgagor, or by a foreclosing mortgagee or receiver when the lease default had resulted in a mortgage default and ensuing foreclosure proceeding.ⁿ¹ If the mortgage foreclosure was carried through to foreclosure sale, the mortgagee could bid in its interest free of the lease, and, if not defeated by a higher bid, obtain title to the premises with the hope of appreciation of the value of the property.

Under the Bankruptcy Code, however, bankruptcy termination clauses are not enforceable, payment and other nonbankruptcy defaults may be cured and the debtor-lessee is therefore free to seek to assign its leasehold position.ⁿ² The proceeds of this assignment in the absence of a lien on the leasehold (and any proceeds thereof) will become part of the general assets of the estate. Although the fee mortgage may be brought current as the result of the assumption and assignment of the lease with the attendant cure of the lease defaults,ⁿ³ the fee mortgagee will have lost the opportunity to bid in the mortgage debt and to take title to the property. Instead, the equity appreciation in the property, if any, will have been given to the general creditors of the debtor-lessee through the distribution of the proceeds of the lease assignment. Through the operation of section 365, a successor lessee will be named under the lease who will be entitled to possession of the leased premises notwithstanding any contractual rights of the mortgagee to disapprove the tenancy. Moreover, during the pendency of the proceedings involving the assumption and assignment of the lease, the fee mortgagee may have been enjoined under the automatic stay from initiating or continuing any foreclosure proceedings which would cut off the lease.ⁿ⁴

It therefore appears that, whenever feasible, the mortgagee in the above-described form of transaction should take a lien on the lessee's interest in the leasehold as well as on the fee. A lien on the leasehold would (1) create the possibility that the proceeds of an assignment of the lease could be applied by the mortgagee to the prepayment of the mortgage, rather than having such proceeds paid to the debtor's estate, (2) perhaps discourage the debtor-lessee from seeking to assign the lease in the first instance, inasmuch as it would be deprived of the proceeds of the assignment, and (3) generally improve the mortgagee's bargaining position in the case. The mortgagee's opportunity to take a lien on the leasehold

generally will be available only if the mortgage financing and leasing transactions are occurring concurrently and consideration to the lessee for the grant of the lien may be established as part of the overall benefit to the fee mortgagor and the lessee of the financing provided by the mortgagee.

[2] Mortgage and Sale-Leaseback Compared

The determination of whether to finance a real estate asset by means of a straight mortgage or a sale-leaseback transaction ordinarily entails an evaluation involving cash flow, taxation, financial reporting and other economic and operating considerations. There are in addition certain creditors' rights consequences attendant upon each of these transaction structures that should also be considered in determining the best course for a given property and borrower.

The mortgage financing and sale-leaseback structures are similar in several respects.ⁿ⁵ In both transactions, the "borrower" retains possession of the property and is responsible for the maintenance and carrying costs thereof. A mortgage financing transaction necessarily entails the loaning of money to the mortgagor, and a sale-leaseback may be viewed as a "loan" of the fee owner's property to the lessee. The consideration paid in a mortgage financing transaction is denominated "interest," and the consideration in a leasing transaction is called "rent." At the expiration of the term of the mortgage financing transaction, the mortgagee receives the balance of the funds loaned to the mortgagor; at the expiration of the lease term, the lessor receives possession of the real property which had been leased. A lessor under a true lease of real property and a mortgagee in a mortgage loan transaction are both accorded recourse to the subject property (among other remedies) for satisfaction of the obligations owing to them.

Of course, a foreclosing mortgagee is relegated to the sale of the property and application of the proceeds to the satisfaction of the mortgage debt, and will become the owner of the mortgaged property only if it is compelled to bid in its debt or otherwise purchases the property upon foreclosure; a lessor exercising its remedies under a defaulted lease may repossess and deal with the leased premises as the owner. Nevertheless, the differences in treatment accorded under the Bankruptcy Code to a lessor in comparison to a mortgagee cannot in each instance be ascribed to the existence or absence of a reversionary interest in the property. These differences instead appear to arise from, among other things, the view that: (1) a lease is a form of executory contract which can be assumed or rejected in its entirety but not in part, while a mortgage is a lien instrument securing indebtedness which may be modified and rescheduled;ⁿ⁶ (2) for purposes of protecting the value of a mortgage lien, the value of a mortgagee's interest in the collateral should be measured by the value of the collateral,ⁿ⁷ but for purposes of protecting the value of a lessor's interest in leased property, the value of that interest is measured by the rental reserved in the lease;ⁿ⁸ and (3) while installments due under a mortgage constitute "indebtedness," installments of rent payable under a lease will be treated not as "indebtedness" but rather as payment for the contemporaneous benefits accorded by the lease.ⁿ⁹ The following discussion sets forth certain differences in the Bankruptcy Code's treatment of lessors and mortgagees arising from the distinctions noted above.

[a] Preferential Payments

Section 547(b) empowers the trustee to avoid transfers: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor; (3) made while the debtor was insolvent; (4) on or within 90 days before the filing of the petition; if the creditor was not an insider (or within one year before the filing of the petition if the creditor was an insider); (5) made between 90 days and one year before the filing date of the petition if the debtor was an insider; and (6) which enables the creditor to receive more than such creditor would receive in a chapter 7 liquidation under the Code.ⁿ¹⁰ Section 547(c) lists several exceptions to and limitations upon the definition of a preferential transfer, including transfers made for a contemporaneous exchange of new value.ⁿ¹¹

It appears that a lessor receiving timely payments under a lease on or within 90 days before the filing of a Bankruptcy Code petition by or against the lessee will not be deemed to have received preferential payments under section 547(b).ⁿ¹² This conclusion arises from the view that each rental period under a lease represents an interval during

which the debtor was receiving consideration in the form of its possession of the premises, so that the rental payment is part of a contemporaneous exchange for new value.ⁿ¹³ A second basis for the conclusion is that timely rental payments under a true lease come within the exception set forth in section 547(c)(2) for payments made in the ordinary course of the debtor's business or financial affairs.ⁿ¹⁴

In addition, in situations where the lease calls for rental payments to be made in advance of the applicable time period, such as in the case of leases requiring that each rent installment be paid on the first day of the covered period, it could be contended that the rental payments do not constitute a preference because, as the argument would go, the payments represents an advance--a form of security--by the tenant at the beginning of each month for the rental obligations over the following month, and are not on account of an antecedent debt as required by section 547(b)(2). In addition, when the rent is paid on the first day of the month, it can also be argued that the debtor's use of the premises for the rest of the month constitute new value under section 547(c)(4).

Finally, in situations where the lease is ultimately assumed, the payments cannot be avoided because the cure requirement of section 365(b) has been held to preclude a disgorgement obligation under section 547(b).^{n14a}

A mortgagee receiving timely payments within the 90-day period is deemed to be receiving payments on account of an antecedent debt which arose when the mortgage loan was first made.ⁿ¹⁵ If the value of the mortgaged property equals or exceeds the mortgage debt, such payments will nevertheless not be deemed preferential inasmuch as the fully secured mortgagee is not receiving an advantage (or preference) over unsecured creditors.ⁿ¹⁶ The advantage was obtained when the lien was validly granted to the mortgagee either outside the 90-day period or for the contemporaneous consideration of the mortgage loan. If on the other hand, the value of the property is less than the mortgage debt, the mortgagee will be regarded as an unsecured creditor to the extent of the deficiency and will be deemed to have received preferential payments as to the unsecured portion of the mortgage debt.ⁿ¹⁷

Accordingly, a lessor under a true lease cannot be subject to a valid claim of preference with respect to timely payments received during the 90 days before the entry of the order for relief, notwithstanding that the leased premises may have a current rental value below the rental reserved in the lease. A mortgagee, on the other hand, may be required to disgorge such payments or a portion thereof to the extent the mortgage is undersecured.

[b] Postpetition Payments

A lessor under a real estate lease is entitled to receive on a current basis postpetition payments on account of use and occupation of the premises by the trustee.ⁿ¹⁸ Under section 365(d)(3), the payments are to be in an amount equal to the rental and other charges provided for in the lease.ⁿ¹⁹

With respect to a real estate mortgage, postpetition interest and any reasonable, necessary costs or charges provided for under the mortgage will be allowed to the extent that the value of the property exceeds the amount of the secured claim.ⁿ²⁰ However, nothing in the Bankruptcy Code mandates the timing of such interest payment and the payment of postpetition interest can be delayed until the conclusion of the bankruptcy case.^{n20a} No postpetition interest will exist if the mortgage is undersecured, notwithstanding that the premises may have a particular value to the trustee.ⁿ²¹

If a mortgagee has sought relief from the automatic stay in order to foreclose against the mortgaged property, and has demanded adequate protection under section 362(d), the mortgagee may be entitled to receive payments to adequately protect the value of the mortgagee's interest in the collateral. The protection provided to the mortgagee may include compensation for deterioration or other decline in value of the property during the pendency of the automatic stay.ⁿ²² However, under the Supreme Court's holding in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, an undersecured mortgagee may not receive adequate protection in the form of compensation for the mortgagee's lost opportunity to realize on the collateral and to reinvest the proceeds occasioned by the delay resulting from the imposition of the stay.ⁿ²³ Although a lessor may also seek modification of the automatic stay for the purpose of

terminating a defaulted lease, and is therefore entitled under section 362(d) to adequate protection of its interest in the property if the stay is continued.ⁿ²⁴ there is uncertainty as to whether the lessor is entitled to protection of its interest beyond timely receipt of amounts equal to the rent and other charges provided for in the lease.ⁿ²⁵ Under the present state of the law it appears that the lessor will be deemed to be adequately protected if it is receiving such payments.ⁿ²⁶

If a mortgage is deaccelerated and reinstated pursuant to Section 1124(2), all outstanding defaults will be cured and all past due interest accordingly will be paid.ⁿ²⁷ If a mortgage is subject to a cramdown under section 1129(b)(2)(A),ⁿ²⁸ postpetition interest will probably be unavailable inasmuch as mortgage cramdowns will usually involve undersecured liens.

To summarize:

- (1) A lessor under a lease assumed by the trustee of the lessee will be made whole as to postpetition rent and will be paid in a timely manner;
- (2) Postpetition payments are equal to the rent and other charges provided in the lease;
- (3) The holder of an oversecured mortgage is entitled to postpetition interest, but the *timing of such payment can be delayed*;
- (4) The holder of an undersecured mortgage is not entitled to postpetition interest;
- (5) The holder of a mortgage may be entitled to adequate protection payments as compensation for decline in the value of the collateral but not as compensation for the loss of opportunity to reinvest the proceeds of a foreclosure which has been prevented by imposition of the automatic stay; and
- (6) The holder of a mortgage reinstated under section 1124(2) will receive postpetition interest at the rate provided for in the mortgage.

[c] Deficiency Claims

If a trustee rejects a lease of real property under which the debtor was lessee, the property will be surrendered to the lessor. Under section 502(b)(6), the lessor's claim for damages arising out of the rejection will be in an amount equal to the damages allowed under applicable state law, but in no event to exceed an amount equal to the rent reserved in the lease without acceleration for the greater of one year, or 15 percent of the remaining term of the lease, but not to exceed three years of the remaining term of the lease.ⁿ²⁹ The cap operates from the earlier of the petition filing date or the date on which the lessor repossessed or the lessee surrendered the property and the landlord has an additional claim for any unpaid rent due under the lease prior to the earlier of those dates.^{n29a} Notably, this statutory cap applies even where there would otherwise be sufficient assets in the estate to pay the lessor in full without such limitation, and it has been held that a capped claim which is paid in full is not "impaired" within the meaning of section 1124.^{n29b} Finally, this claim, as so limited, is a general unsecured claim.ⁿ³⁰ There are, therefore, three limitations on the lessor's recovery:

First, damages allowed by state law are ordinarily computed by deducting from the accelerated rental and enforcement costs an amount equal to the fair rental value of the property, and by discounting the resulting difference to present value;^{n30a}

Second, under section 502(b)(6), the lessor's allowable claim in the lessee's Bankruptcy Code case is limited in accordance with the formula set forth above and the lessor will be required to deduct the value of any security deposits from the capped allowed claim, rather than the state law damage amount;ⁿ³¹

Third, unless there is a 100-percent dividend for general creditors, the lessor's allowed claim, as so limited, will not be paid in full and even if there is a 100-percent dividend, it will be paid on the capped claim amount rather than the state law damage amount.

Accordingly, if a long-term lease is rejected by the lessee's trustee, the lessor cannot recover an amount in excess of three years' rent provided for in the lease, and will necessarily be required to absorb the deficiency. If there is a guarantor of the lessee's obligations under the lease who is also a debtor in a Bankruptcy Code case, the section 502(b)(6) limitation appears to also apply to the lessor's claim under the guarantee.ⁿ³² However, the limitation in section 502(b)(6) does not limit a lessor's claim against a guarantor who is not a debtor in a Bankruptcy Code case.^{n32a}

In the event that a long term-lease is assumed by the debtor during the case, but later rejected, the damages arising from such breach are entitled to administrative priority in an amount equal to all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises.^{n32b} This administrative claim is not subject to setoff or rejection for any reason whatsoever except for sums actually received from an entity other than the debtor.^{n32c} Any claim for remaining sums due for the balance of the term of the assumed lease is a claim under section 502(b)(6).^{n32d} This limitation on administrative claims arising from the rejection of a previously assumed lease was added to the Bankruptcy Code by the 2005 Act, effective in bankruptcy cases commenced on or after October 17, 2005.^{n32e} Previously, the Bankruptcy Code provided for an unlimited administrative claim in the case of a previously assumed lease, and the case law indicated that the same result applied to a lease entered into following the petition date.^{n32f} It is unclear whether the new administrative claim limitation in section 503(b)(7) applies to new leases entered into by a debtor during the post petition period, since the limitation, by its terms only refers to "a non residential real property lease previously assumed under section 365."^{n32g}

In the case of a real estate mortgage no limitation is imposed by the Bankruptcy Code on the amount of a mortgagee's deficiency claim. Indeed, under section 1111(b), a nonrecourse claim is generally treated as a recourse claim, thereby giving the mortgagee a claim against the general assets of the estate for the unsecured portion of its claim.ⁿ³³

[d] Transfer of the Property Without Consent of the Lessor or Mortgagee

The lessor under a real estate lease is subject to the Code's provisions rendering unenforceable lease clauses which prohibit or limit assignment by the lessee.ⁿ³⁴ If the trustee can cure existing lease defaults and provide adequate assurance of future performance under the lease, the lease may be assigned to a new lessee subject to the other enforceable provisions of the lease.ⁿ³⁵ The lessee and the trustee will be relieved of liability under the lease from the date of transfer.ⁿ³⁶ The lessor will be made whole as the result of the cure of outstanding defaults required for the assumption and assignment of the lease, but will be obligated to accept a new lessee not of its choosing.^{n36a}

In the case of mortgaged property, the collateral may be sold subject to or free and clear of the mortgage lien, with the lien to attach to the proceeds in the latter instance.ⁿ³⁷ In addition, the court is empowered under sections 361 and 1129(b)(2)(A) to lift the lien of the mortgage from the original collateral and to attach the lien to substitute security.

[e] Recourse to the Property During Case

Section 365(d)(4), as amended by the 2005 Act, provides that an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected if the trustee does not assume or reject the unexpired lease by the earlier of (1) the date that is 120 days after the date of the order for relief (which is the date of the filing of the petition in a voluntary case) or (2) the date of the entry of an order confirming a plan. That 120-day deadline may be extended for an additional 90 days by the court for cause prior to the expiration of the 120-day period, but the court cannot grant any additional extensions without the written consent of the lessor.ⁿ³⁸ If a lease is deemed rejected under section 365(d)(4), the trustee is required to immediately surrender the leased premises to the lessor.ⁿ³⁹ If the trustee of a debtor-tenant assumes a lease, then, under section 365(b)(1), it must cure or provide adequate assurance of prompt cure

of any outstanding defaults, except for a default that is a breach of provision relating to a satisfaction of any provision relating to a default arising from any failure to perform nonmonetary obligations, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption.ⁿ⁴⁰ This has the effect of relegating the lessor to a position equivalent to its position prior to the filing of the lessee's Bankruptcy Code petition and prior to the occurrence of any default under the lease. Thus, assumption of the lease by the trustee of the debtor-lessee will deny to the lessor any recourse to the property unless a new default arises under the lease.

If the trustee applies to the court under section 365(d)(4) for a 90-day extension of the 120-day period, and is, pursuant to section 365(d)(3), performing its postpetition lease obligations on a timely basis, it is unlikely that a court will compel rejection or assumption unless the lessor can demonstrate that the delay will result in substantial prejudice or that there is little chance for a successful rehabilitation (in a chapter 11 or 13 case).ⁿ⁴¹

The counterpart for real estate mortgages to section 365(d) appears to be section 554(b), which provides that "[o]n request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."ⁿ⁴² Presumably a real estate asset would be abandoned to the mortgagee if the value thereof is less than the mortgage debt and the property is not required for the debtor's business.ⁿ⁴³ In the absence of an abandonment, a mortgagee may reach the mortgaged property only through the successful prosecution of a contested matter seeking the lifting or modification of the automatic stay to permit foreclosure.ⁿ⁴⁴ If the debtor or trustee can satisfy the court that adequate protection of the mortgagee's interest in the property is being provided, it is unlikely that the court will modify the automatic stay to permit foreclosure.ⁿ⁴⁵

[f] Modification of the Governing Instrument

The Code does not provide for modification of a real estate lease or of the rental schedule provided for therein.ⁿ⁴⁶ The lease will be either rejected in whole or assumed in whole, with no modification of its terms.ⁿ⁴⁷ In the case of a mortgage, however, section 1129(b)(2)(A) in a chapter 11 case authorizes a cramdown under which the payment schedule may be modified to yield an amount having a present value equal to the value of the collateral.ⁿ⁴⁸

[g] Valuation Risks

The protections afforded to and the classification and treatment of claims held by a mortgagee under the Bankruptcy Code are related directly to the valuation of the mortgaged property. If the mortgagee and the trustee are unable to agree upon a value for the mortgaged property, value will be determined by the court following a valuation hearing. Under section 506(a), a mortgagee's claim will be divided into a secured claim to the extent of the value of the collateral and an unsecured claim for the remainder.ⁿ⁴⁹ For the purpose of determining whether a mortgagee has received any preferential payments prior to the filing of a petition, valuation of the collateral will be required to ascertain the extent, if any, to which the mortgagee is undersecured.ⁿ⁵⁰ This valuation will be particularly significant if the section 1111(b) election is unavailable to convert a dual claim created by operation of section 506(a) into one fully secured claim. Under section 1129(b)(2)(A), valuation is required to determine the present value of the payment stream imposed upon a mortgagee under a cramdown.ⁿ⁵¹

The valuation risk in the mortgage context is that value will be determined by the court based on testimony and reports of competing appraisers.ⁿ⁵² In view of the uncertainty of result, the trustee is in a position to effectuate a debtor-beneficial settlement of the valuation issue if the mortgagee is unwilling to accept the downside risks of the valuation hearing.

In the case of a leasing transaction, no valuation is required to determine the level of postpetition payments prior to rejection or assumption--such payments are to be in an amount equal to the rent and other charges provided for in the lease.ⁿ⁵³ Valuation is required to determine the fair rental value of the premises for the purpose of computing damages

under state law.ⁿ⁵⁴ In the case of a long-term lease that is rejected early in the term, there is room for slippage on the lessor's side inasmuch as the state law damage claim will always be subject to the ceiling imposed by section 502(b)(6).

[h] Conclusions

The following conclusions may be drawn as to the relative merits of the sale-leaseback and mortgage financing structures from the creditor's viewpoint. The conclusions assume that in the case of a leasing transaction the value of the premises has diminished since the inception of the transaction and that in the case of a mortgage financing transaction the value of the collateral is less than the amount of the debt.

(1) Preferences--The lessor's position is more favorable than that of the mortgagee inasmuch as the lessor is not required to return timely rental payments received within the 90-day period prior to the entry of the order for relief while the undersecured mortgagee may be required to return installments received during this period.ⁿ⁵⁶

(2) Postpetition Payments--The lessor's position is more favorable because there is a substantial likelihood that the lessor will receive payments on a timely basis in an amount equal to the rent provided for in the lease until the trustee rejects the lease. In the case of a mortgagee, there can be no postpetition interest payments if the mortgage debt exceeds the value of the collateral.ⁿ⁵⁷ Even in a situation where the mortgagee is oversecured, the postpetition interest may not be paid until the conclusion of the bankruptcy case. A mortgage that seeks adequate protection under the Code may receive payments as compensation for a diminution of collateral value but not for lost "opportunity value."ⁿ⁵⁸

(3) Deficiency Claims--The mortgagee's position is more favorable than that of the lessor inasmuch as the mortgagee's deficiency claim is not subject to statutory limitation while the lessor's damage claim is severely circumscribed. Therefore, in a credit-oriented real estate financing transaction, a mortgage structure is preferable to a sale-leaseback.ⁿ⁵⁹

(4) Transferability of the Property Without Consent of the Lessor or Mortgagee--The position of the lessor and the mortgagee are comparable.ⁿ⁶⁰

(5) Recourse to the Property--The position of the lessor and the mortgagee are comparable.ⁿ⁶¹

(6) Modification of the Governing Instrument--The lessor's position is more favorable than that of the mortgagee inasmuch as the rental schedule and other terms of a lease may not be modified by the court while a mortgage is subject to cramdown and revision of the payment terms.ⁿ⁶²

(7) Valuation Risks--The lessor's position is more favorable because under the Code there are fewer occasions for a property valuation in the case of leased property as opposed to property subject to a mortgage. In the case of a valuation for the purpose of computing state law damages arising out of a lease rejection, a low valuation may not materially affect the amount of the lessor's allowable claim inasmuch as the ceiling imposed by the Code on this type of claim severely limits the amount of the lessor's recovery in any event.ⁿ⁶³

[3] Mortgage and Sale-Leaseback Transactions--The Risk of Recharacterization

The differences between the Code's treatment of mortgagees and lessors give rise to the question whether a bankruptcy court will respect the parties' characterization of a sale-leaseback transaction or reclassify the relationship to the detriment of one or both parties.ⁿ⁶⁴ This issue is of heightened importance in view of the now substantial body of cases evidencing the willingness of bankruptcy and appellate courts to recharacterize sale-leaseback transactions as mortgages or other kinds of financing arrangements, generally to the detriment of the purchaser/lessor.ⁿ⁶⁵ The Code itself provides little guidance in distinguishing between a sale-leaseback and a mortgage or in defining the term "lease" or the

term "lease of nonresidential real property."n66 Section 365(m) provides that "for purposes of this section 365 and sections 541(b)(2) [leases expiring at the end of their term before or after the commencement of a case under the Code do not become, or cease to be, property of the estate] and 362(b)(10) [lessor under an expired lease may seek to obtain possession of the premises from the debtor without being subject to the section 362(a) automatic stay], leases of real property shall include any rental agreement to use real property." However, section 365(m) has not been viewed as significantly influencing the outcome of litigation dealing with lease recharacterization issues.n67

The issue has often arisen in cases in other contexts, and some courts analyzing real estate sale-leasebacks under the Code have found such cases to be analogous.n68 For example, the distinction between equipment leases and security agreements under the Code and the Uniform Commercial Code has been frequently litigated.n69 In addition, numerous cases have addressed the recharacterization of real estate sale-leasebacks in connection with usury litigation,n70 principles of state taxation and for federal income tax purposes.n71 It appears that the sale-leaseback and other lease recharacterization litigation that has arisen under the Bankruptcy Code is driven in many instances by the effects of sections 365(d)(3) and 365(d)(4). Section 365(d)(3) provides:

(3) 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 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.n72

Section 365(d)(4) provides:

(4)(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of--

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.n72a

Section 365(d)(3) was intended to eliminate the practice of debtor-lessees in large retail chapter 11 cases involving numerous leased locations of (1) vacating unwanted shopping center store locations, (2) refusing to promptly reject or assume the applicable lease, and leaving the location "dark" for a substantial period, (3) offering the lessor a small use and occupation payment for the premises in view of the minimal value thereof to the estate under section 503(b)(1),n72b and (4) demanding a payment in order to surrender the lease and the premises to the lessor.n73 Section 365(d)(3) was intended to require such debtors to make scheduled rental payments to their lessors in the postpetition period in a timely manner in accordance with the terms of the lease and to eliminate the use and occupation doctrine, thereby imposing a cost on any tactics involving delay in surrendering an unwanted leased location. Section 365(d)(4),

as originally drafted and as subsequently made more favorable to landlords by the 2005 Act, was intended to compel the expeditious assumption or rejection of nonresidential leases, again to curtail the practice of forcing lessors to pay for the surrender of unwanted leased locations by debtor-lessees.

Moreover, section 365(d)(3) has been viewed by some courts as creating a type of superpriority claim for nondebtor lessors of real property, and as placing such lessors in a position in the postpetition period not enjoyed by any other creditor.ⁿ⁷⁴

Section 365(d)(4) has proven to be even more problematic, inasmuch as counsel for the debtor in possession has at times failed to make the necessary motions in bankruptcy court within the initial period in order to obtain an order extending the time for rejection or assumption of a lease under which the debtor is the lessee. This failure of action, under the terms of section 365(d)(4), results in the automatic rejection of the lease and the requirement of immediate surrender of the leased premises to the lessor. When the debtor is a lessee under an important ground lease, or operates its business from only one or a small number of leased locations, the loss of a leasehold under section 365(d)(4) through inadvertence may result in the failure of the reorganization case.ⁿ⁷⁵

Accordingly, many of the lease recharacterization cases appear to be driven by a desire to avoid the perceived harsh consequences of section 365(d)(3) and particularly section 365(d)(4). By recharacterizing a leasing transaction as a financing arrangement, or even as a joint venture,ⁿ⁷⁶ the courts have sidestepped the difficulties involved in the application of *sections 365(d)(3) and 365(d)(4) of the Code*. Moreover, the inapplicability of section 365 generally to a recharacterized transaction will also mean that the debtor will not be required to assume an unexpired lease under section 365(a), and to cure any outstanding defaults thereunder as a condition to assumption under section 365(b). The requirement for cure under section 365(b), when viewed in the context of what may actually be a financing arrangement, is equivalent to a compulsory election to render a creditor unimpaired under section 1124. Here again, the courts view the characterization of a transaction as a leasing arrangement as giving rise to advantages for the nondebtor party not available under a financing characterization.ⁿ⁷⁷

It should be noted that the recharacterization of a lease as a financing instrument will favor the debtor-lessee and its estate when the value of the subject premises is less than the balance outstanding on the debt obligation. The estate will not be responsible for postpetition interest, and may be able to employ against the lessor/creditor the cramdown mechanisms available under the Code.ⁿ⁷⁸ On the other hand, if the value of the "collateral" is greater than the outstanding debt amount, the nondebtor party may be favored by a recharacterization inasmuch as (1) it will have the benefits and protections afforded under the Code to a fully secured creditor,ⁿ⁷⁹ and (2) will not be limited in the allowance of its claim by the provisions of section 502(b)(6) (which imposes certain limitations on the allowability of a lessor's claim against a debtor-lessee for damages arising out of the rejection of a lease of real property).ⁿ⁸⁰

The recharacterization area has produced a body of cases mandating the application of federal rather than state law to the characterization of sale-leaseback and other transactions denominated by the parties as leases.ⁿ⁸¹ These holdings often arise in the context of recharacterization of industrial revenue bond leases, which are often structured to provide a rental stream equal to interest and amortization on the related bonds, and which are often required to be denominated as leases under state or local industrial revenue bond enabling legislation. These holdings appear to be inconsistent with bankruptcy related decisions of the United States Supreme Court, which mandate that, absent an overriding federal interest, property rights in a debtor's estate are to be determined under applicable state law.ⁿ⁸²

Finally, the opinions recharacterizing leases as secured financing transactions either fail to address, or address in an *ad hoc* manner, whether the recharacterized secured transaction has been duly perfected under state law.ⁿ⁸³ For example, in certain jurisdictions a memorandum of lease may be recorded in one set of books in the appropriate recording office, while mortgage transactions are recorded elsewhere. The failure to record a memorandum of lease in the place required for the proper recordation of a mortgage could have an impact on the rights of the recharacterized secured creditor, but this issue has not been extensively treated in the recharacterization case law.

The following is a presentation of certain of the more significant recharacterization cases and a discussion of the issues raised thereby.

[a] The PCH Litigation

Among the most significant cases in the recharacterization area is *In re PCH Associates*, which was the subject of two opinions by the Court of Appeals for the Second Circuit.ⁿ⁸⁴ *In re PCH Assocs.* involved the sale and leaseback of a hotel. The seller/lessee, who initiated the transaction, had determined that the acquisition and renovation of the hotel would require a cash outlay of \$9 million. The seller/lessee invested \$4 million to purchase all of the interests in the partnership owning the hotel property. Concurrently therewith, the seller/lessee sold the land on which the hotel was situated, but not the hotel building, to the purchaser/lessor for \$5 million (designated as the "Landlord's Investment" in the documentation), and then leased it back under a net ground lease. The lease provided for an initial term of 33 years and options, exercisable by the seller/lessee, for four renewal terms of 33 years each. The seller/lessee owned and operated the hotel.

Upon the filing of a Bankruptcy Code petition by the seller/lessee, the purchaser/lessor sought an order under section 365(d)(3) and (d)(4) directing the seller/lessee to continue paying rent and compelling assumption or rejection of the ground lease. The seller/lessee, as debtor in possession, claimed that despite the documented sale-leaseback structure, the parties had always intended the transaction to be a financing arrangement and the purchaser/lessor's role to be that of a joint venturer or secured lender. The bankruptcy court and district courtⁿ⁸⁵ held in favor of the seller/lessee, each concluding that the transaction met the criteria of a joint venture under state law. The court of appeals affirmed the holding that the ground lease was not a true lease and that subsections (d)(3) and (d)(4) of section 365, therefore, were not applicable.ⁿ⁸⁶ The court endorsed the conclusion of the bankruptcy court that certain elements of the sale agreement for the land and the ground lease evidenced that the transaction was not a true sale and lease. Specifically, the following items were among those determined by the bankruptcy court to be unusual in an actual sale agreement:ⁿ⁸⁷

- (1) The amount of the purchase price was not related to the value of the land.ⁿ⁸⁸
- (2) Amounts recovered postclosing from the former hotel owners, as well as cost savings in the anticipated refurbishment of the hotel, would be shared by the purchaser/lessor and the seller/lessee pro-rata based upon their respective investments.
- (3) The agreement required the continued involvement in the project of the individual who controlled the seller/lessee.
- (4) The purchaser/lessor was required to pay one-half of the amount necessary to repay a preexisting mortgage on the land and building.ⁿ⁸⁹
- (5) No closing adjustments were made between the purchaser/lessor and seller/lessee.
- (6) The seller/lessee, contrary to local custom, paid all transfer taxes arising out of the transaction.
- (7) The seller/lessee was obligated to pay the premium for the purchaser/lessor's title insurance policy.

The bankruptcy court had found the following features of the ground lease to be uncharacteristic of a "true lease":ⁿ⁹⁰

- (1) The seller/lessee solicited the purchaser/lessor to invest in the tenant's property.
- (2) The term of the lease, if all renewal options were exercised, would have been 165 years.

(3) A minimum rent providing the purchaser/lessor with a 12% annual return was established for the first three years of the lease. Percentage rent would then be paid until the purchaser/lessor's investment was recovered. Thereafter, rent would be equal to one-half of the net profits of the hotel. In the bankruptcy court's view, rent determined in this manner bore no relationship to the value of the land, and the purchaser/lessor would be unable to recognize any benefit from appreciation in land value.

(4) Rent could be deferred under the lease provided that, when paid, the purchaser/lessor would realize at least a 12% annual return on its investment.

(5) The seller/lessee was required to insure the property.

(6) Condemnation awards would be shared on a pro-rata basis until the purchaser/lessor's investment had been recovered, rather than on the basis of the relative value of the land and building or the value of the unexpired portion of the lease term.

(7) The purchaser/lessor's position was subordinated to all existing and certain future mortgages on the property.

(8) The seller/lessee posted no security deposit with the purchaser/lessor, and was exculpated from any personal liability in connection with the ground lease.

Of these factors cited by the bankruptcy court, the court of appeals was most concerned that: (1) rent was not calculated to compensate the purchaser/lessor for the use of the property but was structured solely to ensure a return on the "Landlord's Investment"; (2) the purchase price paid by the purchaser/lessor for the land was not based on market value but was calculated as the amount necessary to finance the transaction; (3) the seller/lessee initiated the entire transaction; (4) the seller/lessee assumed many of the obligations associated with outright ownership of the property, including responsibility for paying taxes and insurance; and (5) the seller/lessee could prepay the "Landlord's Investment," leaving the purchaser/lessor only with an interest in the net profits of the hotel.ⁿ⁹¹

The court declined to characterize the arrangement as a joint venture, subordinated financing or other structure, holding only that it was not a bona fide sale-leaseback transaction. However, after a series of battles in the lower courts, the Court of Appeals for the Second Circuit was again presented with the question of the proper characterization of the transaction under applicable state law, in this case the law of Pennsylvania.ⁿ⁹² The court found the transaction to be one for secured financing because: (1) the ground lessor--Liona--had the right to share in gross revenues rather than net profits; (2) the control rights vested in Liona were more indicative of those customarily provided for in secured financings than in joint venture arrangements; (3) Liona did not retain any rights to control day-to-day management of the enterprise; and (4) Liona did not share in any losses of the enterprise nor did it hold itself out as a venturer conducting the business of the hotel in a manner that would give rise to a claim against it as a joint venture partner.ⁿ⁹³

The Court of Appeals for the Second Circuit asserted the right and power of a bankruptcy court to consider the "economic substance" of a transaction to determine whether the transaction involves a true lease or financing.ⁿ⁹⁴ Citing the Senate Reportⁿ⁹⁵ the court noted that Congress mandated a finding of a true lease as a requisite to the imposition under section 502(b)(6) of a limitation on the allowance of claims by lessors under real estate leases for damages arising out of the rejection of such a lease by a debtor-lessee. The court then determined that the "true lease" requirement under section 502(b)(6) was equally applicable to sections 365(d)(3) and 365(d)(4). The court stated:

We have no difficulty in applying the section 502(b)(6) requirement of a bona fide lease to section 365(d)(3), (4) because these sections, read together, are part of a total scheme designed to set forth the rights and obligations of landlords and tenants involved in bankruptcy proceedings... . [citations omitted]. When a debtor-tenant rejects a lease pursuant to section 365(3), (4) [sic], that rejection constitutes a breach of that lease under section 365(g), and brings section 502(b)(6) into effect [citation omitted]... .

We believe that reading a requirement of a true lease into section 365 is necessary to effectuate the purposes of that section. As a whole, section 365 allows a trustee, or in this case a debtor- in-possession, to reject or assume executory contracts and leases, based on a determination of whether they burden or benefit the bankrupt estate. Thus, executory contracts and leases that benefit the bankrupt are favored over contracts with other creditors. If security transactions, loans and other financing arrangements can be couched in lease terms, and can thereby be assumed by the bankrupt estate, the "lessor" gains a distinct advantage at the expense of other creditors without a concomitant benefit to the bankrupt estate. This is especially apparent in the case at bar. If successful, Liona would enjoy the benefit of its contract with PCH to the detriment of others having valid claims against the bankrupt's estate. However, if there is no true lease, Liona should not be permitted to escape the consequences of investor/creditor status by invoking the labels of "landlord" and "lease."ⁿ⁹⁶

In *PCH II*,ⁿ⁹⁷ the court affirmed the power of the bankruptcy court to recharacterize a transaction as follows:

It is well established that a bankruptcy court, as a court of equity, may look through form to substance when determining the true nature of a transaction as it relates to the rights of parties against a bankrupt's estate. *Pepper v. Litton*, 308 U.S. 295, 304, 60 S. Ct. 238, 244, 84 L. Ed. 281 (1939) . It is the economic substance of a transaction that should determine the rights and obligations of interested parties. See *Sun Oil Co. v. CIR*, 562 F.2d 258, 263 (3d Cir. 1977) ("We look to the economic realities of the leases and not to the labels applied by the parties."), *cert. denied*, 436 U.S. 944, 98 S. Ct. 2845, 56 L. Ed. 785 (1978) .ⁿ⁹⁸

[b] Application of Federal or State Law

The *PCH* court determined that it was empowered to effect a recharacterization of the sale-leaseback transaction (1) to fulfill the statutory objectives of *section 365 of the Bankruptcy Code*, as those objectives were ascertained by reference to the legislative history of section 502(b)(6), and (2) as a court of equity. As more fully discussed below,ⁿ⁹⁹ the process of statutory interpretation as it relates to the Bankruptcy Code in matters concerning state-created property interests gives rise to the question whether the characterization of a transaction (as a lease or otherwise) will be determined under federal, judge-made law, or by the laws of the state that govern the creation of the property interest that is before the court. With respect to the invocation of the equitable powers of a federal court adjudicating an issue in a case under the Bankruptcy Code, it is clear that the court will employ its own sense of fairness and equity to achieve the result it believes to be correct. The question in this circumstance is whether the court may literally read out of the Bankruptcy Code any provision (such as section 365 (d)(4)), that, if applied, would mandate a result contrary to the court's sense of the appropriate outcome.

There are certainly numerous examples in the bankruptcy field of a court refusing to apply statutory provisions that would result in a liquidation rather than a reorganization, or in a windfall to a nondebtor party. For example, in *Queens Blvd. Wine & Liquor Corp. v. Blum*,ⁿ¹⁰⁰ the Court of Appeals for the Second Circuit expressly refused to apply Section 70(b) of the former Bankruptcy Act to enforce a bankruptcy default clause in a real property lease, where enforcement would result in the failure of the Chapter XI case before it and the surrender of a below-market lease to the landlord. The court summarized its holding as follows:

Our decision does not deprive Section 70(b) of its statutory effect in those cases to which it is applicable. Bankruptcy forfeiture provisions are necessary for the protection of landlords and generally are enforceable. We hold only that, under the particular circumstances of this case, termination of Queens' lease would be grossly inequitable and contrary to the salutary purpose of Chapter XI.ⁿ¹⁰¹

Similarly, in an important bankruptcy court case involving the recharacterization of a contract for deed from executory contract status to that of a secured financing, the court stated:

In practical terms ... [failure to re-characterize a contract for deed] means that, absent assumption of the contract, vendor may enforce his remedy of forfeiture. Vendor, although in substance a mortgagee, [footnote omitted] may receive an advantage over other lienors, and the estate may be deprived of whatever equity exists in the property. The bankruptcy court, as a court of equity, regards substance over form, demands equality of treatment among creditors, and loathes a forfeiture. The contract should be treated as a lien; the vendor is thereby placed on a par with other lienors; forfeiture and the loss of equity are prevented. [footnote omitted.]ⁿ¹⁰²

The question is, of course, whether the equitable powers of a court adjudicating an issue in a case under the Code are sufficiently broad so as to permit (1) the refusal to apply a provision of the Code that, if applied, would, in the view of the court, produce an inequitable result,ⁿ¹⁰³ or (2) application of federal judge-made rules of equity, in lieu of otherwise applicable state law, to achieve an equitable result.ⁿ¹⁰⁴ As discussed below,ⁿ¹⁰⁵ these matters have been addressed by the Supreme Court in *Butner v. United States*.ⁿ¹⁰⁶ Nevertheless, the issue arises repeatedly in the recharacterization cases and is central to the outcome thereof.

Whether the recharacterization power of a bankruptcy court arises from the statutory scheme of the Code in sections 365 and 502(b)(6), or from the equitable powers of the court, nowhere in the *PCH* opinions is there a suggestion that the substantive law to be applied to resolve a recharacterization issue is anything other than the state law governing the transaction between or among the parties. Indeed, the *PCH* opinions clearly state that each of the courts adjudicating the matter have applied Pennsylvania law to determine, among other things (1) whether the *PCH* documentation was "ambiguous" so as to permit the introduction of parol evidence as to the actual intent of the parties, (2) whether the lease was or was not a true lease, (3) whether the transaction gave rise to a joint venture, and (4) whether the transaction was a secured financing.ⁿ¹⁰⁷

The question whether the bankruptcy courts are to apply a body of federal law to the recharacterization issues or apply state law is central to the outcome of the industrial revenue bond ("IRB") lease recharacterization cases.ⁿ¹⁰⁸ The typical pattern in these cases involves a chapter 11 debtor that is a lessee under an IRB lease. The debtor will have acquired a piece of property in order to build thereon an industrial or commercial asset, and will obtain low cost financing therefor by conveying the property to an IRB agency authorized by statute to issue tax exempt IRBs. The enabling legislation will often provide that the agency must own the asset involved in the transaction, thereby precluding the agency from simply holding a mortgage to secure the bonds. This will require that the user be a lessee of the property rather than an owner. The lease will be structured to provide for a rental stream equal to the interest and amortization requirements of the bonds, and will often contain a nominal price purchase option for the benefit of the lessee.ⁿ¹⁰⁹

In the context of the chapter 11 case of the IRB lessee, there may have been a failure to move for an extension of time within which to assume or reject the "lease" under section 365(d)(4), or the debtor may be unable to provide the funds necessary to cure any defaults required to be cured as a condition to assumption under section 365(b).ⁿ¹¹⁰ The question then arises as to whether the IRB lease is a true lease for the purposes of section 365(d)(4), or a financing agreement not subject to the provisions of section 365 generally.

If the bankruptcy court is compelled to apply state law, it may be constrained to characterize the agreement as a true lease inasmuch as the IRB legislation denominates the instrument as a lease. Bond counsel may have opined as to the *bona fides* of the transaction and investors may have acquired the bonds all in reliance upon the state law characterization of the lease instrument. However, an examination of the transaction would show that the lease functioned principally as the mechanism by which the lessee would pay the indebtedness arising under the bonds, and that title to the asset would revert to the lessee for nominal consideration upon the payment in full of the bonds. This would, of course, result in the characterization of the lease as a financing agreement and mortgage, with the IRB agency holding a mortgage lien on the asset rather than title. Under this characterization, section 365(d)(4) would be inapplicable and the debtor would be free to deal with the IRB agency as a secured creditor.

City of Olathe v. Kar Development Assocs., L.P. (In re Kar Development Assocs., L.P.),ⁿ¹¹¹ involved \$6 million in IRBs issued by the City of Olathe, Kansas, to finance a part of the construction of a hotel. The bonds were issued under the Kansas Economic Development Revenue Bond Act, which required that title to the asset be vested in the City.ⁿ¹¹² The property was deeded to the City and leased back to the debtor for a 24-year term, with rental payments equal to the installments of principal and interest on the bonds. The debtor defaulted under the lease, and filed a petition under chapter 11 of the Code. Representatives of the bondholders filed a motion for relief from the stay in order to evict the debtor from the property, and sought a declaration that the lease was subject to the provisions of section 365, including section 365(d)(4). The bankruptcy court held that (1) the IRB lease was a financing instrument, (2) the bondholders' claim was not for rent but instead for bond debt subject to the provisions of section 1129(b)(2)(A), (3) fee title to the hotel was the property of the estate, and (4) the hotel revenues were cash collateral subject to the security interest of the bondholders.ⁿ¹¹³

On appeal, the district court recognized that Kansas law characterized the lease as a true lease.ⁿ¹¹⁴ However, the court held that Kansas law did not apply to the recharacterization issue, stating:

After reviewing the Code's language and legislative history, this court is persuaded that Congress intended § 365(d)(4) to apply only to "true" or "bona fide" leases, and that the characterization is not controlled by state law. Given the relationship between sections 365(d)(4) and 502(b)(6), it is appropriate to look to the legislative history of § 502(b)(6) to interpret the meaning of "lease of nonresidential real property" found in § 365(d)(4). Nowhere in either the language of these Code sections or in the legislative history does Congress indicate that determining whether a transaction is to be considered a lease for purposes of § 365(d)(4) is controlled by state law. To the contrary, the legislative history sets forth a very specific standard to be used, based on the economic realities and the individual situation.ⁿ¹¹⁵

The court cited to the opinion in *PCH I*ⁿ¹¹⁶ to demonstrate the propriety of employing the legislative history of section 502(b)(6) to resolve characterization issues under section 365.ⁿ¹¹⁷ The court did not acknowledge that *PCH I* and *PCH II* employed Pennsylvania substantive law to resolve the recharacterization issues involved in that case, or that the *PCH* court viewed the legislative history of section 502(b)(6) as applicable to section 365 solely for the purpose of demonstrating the bankruptcy courts' power to recharacterize a transaction rather than to dictate the substantive resolution of the issue. The *Kar* court also cited to *In re Moreggia & Sons, Inc.*,ⁿ¹¹⁸ a 1988 Ninth Circuit Court of Appeals case, which held that federal law governs recharacterization issues under section 365(d)(4).

The *Kar* bondholders argued that the legislative history of section 101(51) (which defines the term "security interest") provides clearly that state or local law will govern the question whether a lease constitutes a security interest.ⁿ¹¹⁹ The court rejected this argument on the grounds that (1) the proper focus was on the term "lease of nonresidential real property" found in section 365(d)(4), and not on the definition of a "security interest," and that (2) no state court would reach the question of how to interpret section 365(d)(4).ⁿ¹²⁰

The court did not address the obvious rejoinder to its first contention; that is, that if the determination of whether a lease is to be characterized as a security interest (as defined in the Code) is to be governed by applicable state law, then state law should be applied to the characterization issues involving the term "lease" as employed in the phrase "lease of nonresidential real property" appearing in section 365(d)(4). Assuming, *arguendo*, the propriety of using legislative history for statutory interpretation purposes,ⁿ¹²¹ the guidance set forth in the legislative history of section 101(51) is more pointed and specific than the guidance set forth in the legislative history of section 502(b)(6). The legislative history of section 502(b)(6) indeed calls for the application of an "economic substance" test to resolve lease/financing transaction characterization issues, but does not address whether the economic substance test is to employ state or federal law standards. Of course, the absence of jurisdiction of a state court to administer a case under the Bankruptcy Code does not mean that a federal bankruptcy court should not apply state law in the appropriate circumstances. Moreover, although it is true that a state court ordinarily will not be called upon to construe section 365(d)(4) of the

Bankruptcy Code, it is also true that a state court may well be called upon to determine whether an instrument is a lease of real property or a financing agreement.

With respect to the court's contention that a state court would not be called upon to interpret section 365(d)(4), the absence of jurisdiction of a state court to administer a case under the Bankruptcy Code does not mean that a federal bankruptcy court should not apply state law in the appropriate circumstances.

The *Kar* bondholders also cited *Butner v. United States* n122 for the proposition that property rights in a bankrupt's estate are to be determined under applicable state law. *Butner* is a pre-Code case clearly holding that the federal courts are to apply state law in adjudicating property interests in bankruptcy cases. The specific holding of *Butner* is that state law, rather than a federal rule of equity, will govern the question whether a real property mortgagee holding an assignment of rents must take the steps required under state law to "perfect" its interest in rents notwithstanding the intervention of bankruptcy before those steps can be initiated or completed.ⁿ¹²³ In holding that state law applies to the assignment of rents "perfection" issue, the Court directed that the bankruptcy courts should entertain applications by mortgagees for the relief that would otherwise be available in state court (such as a motion for sequestration of rents) that would enable such mortgagees to perfect their rent assignments.ⁿ¹²⁴ The Court stated in the course of its opinion that:

Property interests are created and defined by state law. *Unless some federal interest requires a different result*, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." [citation omitted.] The justifications for application of state law are not limited to ownership interests: they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property. [footnote omitted.] The minority of courts which have rejected state law have not done so because of any congressional command, or because their approach serves any identifiable federal interest. Rather, they have adopted a uniform federal approach to the question of the mortgagee's interest in rents and profits because of their perception of the demands of equity. The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems. But undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt.ⁿ¹²⁵

For purposes of the choice of law issue in recharacterization cases, *Butner* yields two rules, *to wit*, (1) unless some federal interest requires otherwise, disputes involving property interests, including security interests, are to be resolved by reference to applicable state law, and (2) "undefined considerations of equity" provide no basis for establishing a federal rule of perfection in assignment of rents cases.

The bondholders in *Kar* also cited the Supreme Court cases of *Barnhill v. Johnson* n126 and *BFP v. Resolution Trust Corp.*,ⁿ¹²⁷ both of which were decided under the Bankruptcy Code. *Barnhill* held that state Uniform Commercial Code provisions will govern the determination of when a transfer of money by check is made within the 90-day period provided for in section 547(b). *BFP* held that a foreclosure sale conducted in accordance with state law requirements will necessarily yield reasonably equivalent value for the purposes of the Code's fraudulent transfer provisions set forth in section 548.

Nevertheless, the court in *Kar* determined that under the language of the *Butner* case, an adequate federal interest existed to override the general rule mandating the application of state law in bankruptcy cases to adjudicate disputes involving state-created property rights.ⁿ¹²⁸ The court stated that application of state law and the termination of the lease under 365(d)(4) would be antithetical to the purposes of chapter 11, which are to (1) restructure a business' debts

so that it may continue in operation, and (2) assure the equitable distribution of an estate's assets.ⁿ¹²⁹ The court found neither objective would be served if the IRB lease were terminated and the hotel ceased to operate.ⁿ¹³⁰ The court also cited for a second time the legislative history of section 502(b)(6), which it viewed as contemplating an "economic substance" test to determine the characterization of a lease.ⁿ¹³¹

The *Kar* decision may have been correct from the perspective of the general creditor body and perhaps of the persons who did not want to see a closed hotel in the affected municipality. However, this holding and others consistent with itⁿ¹³² appear to be incorrect as a matter of law. The Supreme Court has made it clear in several instances that applicable state law is to govern the adjudication of disputes involving state created property interests and security interests.ⁿ¹³³ The legislative history of section 101(51), discussed *infra*,ⁿ¹³⁴ states unequivocally that state law is to govern the question whether a lease constitutes a security interest, and is not limited to equipment leases. The legislative history of section 502(b)(6),^{n134a} in calling for the application of an economic substance test to determine whether an instrument is a true lease or financing agreement, does not address the question whether the economic substance test involves judge-made law on the federal level or the cases and statutes constituting the body of applicable state law. Finally, the notion that application of section 365(d)(4) to the IRB lease involved in *Kar* or in other IRB cases is inconsistent with the purposes of the Bankruptcy Code appears to support a selective nullification of the provisions of the Code that do not comport with a judge's view of what the outcome should be in a particular case.

In re Martin Brothers Toolmakers, Inc. ⁿ¹³⁵ provides a good example of a court advocating a pragmatic and result-oriented analysis of the applicability of section 365 to IRB leases. The case involved a debtor-lessee under an IRB lease providing for semi-annual rental installments equal to the principal and interest due on the related bonds. The rental obligation was to abate if the bonds were prepaid in full. There was a \$5,000 purchase option, or a \$15,000 annual rental for a renewal term, at the expiration of the initial term and the payment in full of the bonds. The total bond issue was \$500,000. The Alabama statutes governing the issue of the tax exempt bonds required the repayment of the bonds solely from the lease or sale of the subject property, and therefore the parties denominated the operative agreement as a lease. The debtor-lessee became a debtor under chapter 11 of the Code, and moved for an order declaring the agreement to constitute a mortgage. The bond trustee and industrial development board moved for an order directing assumption or rejection of the instrument as a lease under section 365.

The court held that the agreement would be characterized as a lease.ⁿ¹³⁶ The court stated that a contrary characterization of the instrument as a mortgage would result in the local Industrial Development Agency being denominated as a mortgagee, with a consequent loss of the tax-exempt status of the bonds. The court viewed this as destroying the IDA's capacity to provide low cost financing for businesses relocating to or expanding in the Huntsville, Alabama area. The court therefore found that recharacterization of the instrument as a mortgage would not be in the public interest.ⁿ¹³⁷

Although the result in *Martin Brothers* is at variance with that in *Kar*,ⁿ¹³⁸ the *Martin Brothers* court espoused a theory of recharacterization that may be viewed as consistent with the unwillingness of the *Kar* court to accept the arguments and substantial body of authority pointing to the application of state law rather than federal rules of equity in recharacterization cases. The court in *Martin Brothers* stated:

The determination in bankruptcy, however, of whether a particular agreement is in fact a lease or a security agreement for purposes of § 365 often depends on which characterization will best serve the interests of the estate. Section 365 enables the bankruptcy trustee to affirm or reject leases and executory contracts, and is based on the trustee's long-standing power to abandon obligations burdensome to the estate. [citation omitted.] Consequently, some courts have explicitly held that if a particular agreement is not unduly burdensome or is especially advantageous, it should not be construed as an agreement subject to § 365. See, e.g., *In re Becknell & Crace Coal Co., Inc.*, 761 F.2d 319, 86 O.&G.R. 482 (6th Cir. 1985) (construing lease-purchase agreement of coal field); *In re G-N Partners*, 48 B.R. 462 (Bkrtcy. D. Minn. 1985) (construing option to purchase reality); *In re Waldron*, 36 B.R. 633 (Bkrtcy. S.D. Fla.

1984) (same). As the Sixth Circuit has explained:

The key, it seems, to deciphering the meaning of [§ 365's lease-executory contract provision] is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, the [agreement] is not [a lease or executory contract] within the meaning of the Bankruptcy Act. 761 F.2d at 322 .n139

The Court of Appeals for the Ninth Circuit, in *In re Moreggia & Sons, Inc.*,ⁿ¹⁴⁰ clearly accepted a theory of equitable recharacterization substantially similar to that articulated by the Eleventh Circuit in *Martin Brothers*. *Moreggia* involved a terminal market lease between the City of San Francisco Market Corporation and the debtor providing for a 50-year term and rental payments that would cease upon retirement of the Corporation's bonds. The court determined that under state law the agreement would be characterized as a lease.ⁿ¹⁴¹ The Market Corporation contended that the debtor's failure to assume or reject the lease within the 60-day period provided for in section 365(d)(4) resulted in the automatic rejection and termination of the lease. The court of appeals rejected this contention, stating:

Thus, the purpose of Section 365(d)(4) is to protect lessors from delay and uncertainty by forcing the trustee or debtor-in-possession to act quickly to assume unexpired leases. [citation omitted]... Subjecting this agreement to the provisions of section 365(d)(4) would not further the legislative purposes underlying the section. The Market Corporation has suffered no delay, uncertainty, or other harm as a result of the failure to assume expressly the Lease with the 60-day period... The bankruptcy court properly invoked its equitable powers to look through the form to the substance of the transaction... . This is a case where the bankruptcy court's equitable considerations should govern

Moreover, after the Trustee was appointed, the Market Corporation cooperated with the Trustee's efforts to market the Lease. It offered the Trustee advice as to how to facilitate a sale and furnished the Trustee with lists of acceptable assignees. *Moreggia* has paid \$130,000 [in rental fees] and has fulfilled all of its material obligations under the agreement. In these circumstances, a forfeiture of the vested \$210,000 property interest [*Moreggia's* investment] would be grossly inequitable.ⁿ¹⁴²

The Supreme Court in *Butner* clearly directed that in the absence of a compelling federal interest, disputes involving property interests created by state law are to be governed in bankruptcy cases by state law and not under federal rules of equity. The Supreme Court in *Nobelman* may have reaffirmed but narrowed the holding of *Butner* to limit the circumstances of preemption of state property law by federal law to instances only where a specific federal rule of property exists.^{n142a} The rationale of the *Kar* case and the other IRB cases consistent with it appears to be that the application of state law in circumstances resulting in the termination of real property leases under section 365(d)(4) is antithetical to the reorganization imperatives of the Code. In the view of these courts, the policies embodied in chapter 11 of the Code fostering reorganization rather than liquidation constitute the federal interest to which the *Butner* court was alluding in the holding of that case. Under this view, the federal interest in reorganization is so compelling as to mandate the invocation of the *Butner* exception to nullify the effects of section 365(d)(4) of the Bankruptcy Code in order to prevent the occurrence of a liquidation. In sum, the federal interest protected by these courts entails the application of federal rules of contract recharacterization in order to avoid the application of a federal statutory provision that may result in a lease termination and the failure of a reorganization case.

If the *Kar* court was correct in applying the federal interest exception rule of *Butner*, then the application of state law in Bankruptcy Code cases to the resolution of any issue involving state-created property interests which would result in a liquidation rather than a reorganization, should justify the employment of a judge-created federal rule to foster a successful reorganization. Under this approach, the use of state law to determine when a transfer made by check is deemed to occur for the purposes of the 90-day rule of section 547(b) should be subject to the *Butner* federal interest exception, if application of state law would result in a liquidation. Similarly, the application of state law to determine

whether reasonably equivalent value was provided in connection with a mortgage foreclosure for the purposes of section 548 should not be permitted, if failure to avoid the foreclosure sale would result in a liquidation.

Of course, in the section 547(b) case, the Supreme Court in *Barnhill v. Johnson* decided, without reference to the Butner exception, that state law would govern the timing of the transfer.ⁿ¹⁴³ In the section 548 fraudulent transfer case, the Supreme Court, in *BFP v. Resolution Trust Corp.*, likewise decided that state procedural law would dictate the resolution of any issue involving the receipt by a debtor of reasonably equivalent value for the purposes of section 548, again without any exception for circumstances in which application of state law would result in the failure of a reorganization case.ⁿ¹⁴⁴ Finally, as noted above, the Supreme Court in *Nobelman* may have modified the Butner formulation to eliminate entirely the federal interest exception and to substitute therefore a rule that federal law preemption of state property law in Bankruptcy Code cases will occur only where federal law expressly overrides state property law.^{n144a}

[c] The Substantive Law

The resolution of the choice of law issue is most critical in the IRB recharacterization cases. It is, of course, also important to consider the substantive analyses employed by the courts in finding in favor of or against a party seeking recharacterization.

The *PCH* opinions,ⁿ¹⁴⁵ by reason of their completeness and of the breadth of the issues involved, appear to be the principal, but by no means the only, guiding precedent in the area. The courts that have cited to the *PCH* opinions have generally isolated five or six factors cited by the *PCH* court as warranting recharacterization of an agreement denominated as a lease. These factors are:

- (1) whether the rental payments compensate the lessor for the use of the land, as opposed to being structured for some other purpose, such as to ensure a particular return on investment;
- (2) whether the purchase price in a sale-leaseback transaction is related to the fair market value of the land, or calculated as the amount necessary to finance the transaction;
- (3) whether the property was purchased by the lessor specifically for the lessee's use;
- (4) whether the transaction is structured as a lease to secure certain tax advantages;
- (5) whether the lessee assumed many of the obligations normally associated with outright ownership, including the responsibility for paying property taxes and insurance; and
- (6) whether the lessee can acquire the property at the expiration of the lease term for nominal consideration.ⁿ¹⁴⁶

In *International Trade Admin. v. Rensselaer Polytechnic Inst.*,ⁿ¹⁴⁷ the Court of Appeals for the Second Circuit had the opportunity to apply the *PCH* recharacterization standards to another long term lease. This case, which did not involve a sale-leaseback, arose from the efforts of leasehold mortgagee to prevent the automatic rejection of a lease that was not timely assumed under section 365(d)(4).ⁿ¹⁴⁸ The lease was a 99-year, triple-net ground lease from an educational institution to a manufacturing company that would provide certain teaching and research opportunities to the school. The ground rent was fully payable and discharged within the first three years of the term, with the lessee thereafter obligated only to pay taxes and operating costs and to perform other typical net lease obligations. The court held that the transaction more closely resembled a sale rather than a leasing arrangement, and that section 365(d)(4) was therefore inapplicable.

The court considered two factors as critical to its analysis; the length of the term of the lease and the transfer to the lessee of obligations normally associated with ownership. The court noted that the lease involved in *PCH* had a potential term of 165 years, and found that the 99-year term of the lease before it, in combination with other factors, pointed to recharacterization.ⁿ¹⁴⁹ However, the court was careful to note that the 99-year term did not *per se* warrant recharacterization, stating that "[a]lthough an unusually long term, standing alone, does not automatically signal that an agreement is not a true lease for the purposes of § 365(d)(4) [citations omitted], we find that in combination with other factors, it may lead to such a conclusion."ⁿ¹⁵⁰ Similarly, in what may be construed as a retreat from the broad language of the *PCH* opinions, the court stated with respect to the triple-net nature of the lease:

Although we conclude that the indicia of ownership in the lessee are a factor in our decision, we caution that this factor, too, should not be viewed in isolation. To do so would be misleading because of the increasingly common use of "triple net" leases. In a typical triple net lease, the rent stated is "net" to the landlord because the tenant takes responsibility for taxes, operating expenses and the like. See *James v. Commissioner of Internal Revenue*, 899 F.2d 905, 906 (10th Cir. 1990) (in triple net lease, lessee is responsible for installation, maintenance, taxes, etc.). This arrangement assures the landlord that he will actually receive the lease's stated profits and that they will not be subject to any expenses other than typical income tax. It may appear in a typical triple net lease, then, that the lessee has assumed many of the responsibilities of ownership. This superficial shifting of costs in a triple net lease, taken alone, should not be interpreted to mean that an agreement is not a lease for purposes of § 365(d)(4). Rather, courts must be careful to look to "the economic substance of the transaction and not its form," *In re PCH*, 804 F.2d at 200, when considering this factor which, depending on the transaction, may be susceptible to different interpretations.ⁿ¹⁵¹

The court concluded that the subject agreement resembled a sale for a term of years, and not a lease, by reason of the 99-year term and the prepayment of the rent over only the first three years of the transaction.ⁿ¹⁵²

In *United Air Lines, Inc. v. HSC Bank USA*,^{n152a} the bankruptcy court applied the five factors set forth in *In re Hotel Syracuse, Inc.* ^{n152b} and *PCH* to four airport ground leases. In determining whether these leases were "true leases," the court divided them into those three that were leasebacks and the one that was not. The bankruptcy court held that the three leases that were leasebacks were not true leases, in that a bond-issuing agency received an interest in a leasehold held by the debtor and then leased that interest back to the debtor in exchange for rent. Finding that the leaseback transactions were the "economic equivalent of leasehold mortgages, a recognized real estate financing mechanism," the court noted that "unlike a true lessee--where the leased property reverts to the lessor at the end of the lease term with substantial value remaining, as to which the lessor takes the ownership risk--the leasebacks terminate with no property interest reverting to the bond-issuing agencies."^{n152c} Concluding that the fourth lease was a "true lease" and not subject to recharacterization, the court stated that the lessor owned the leased property, and at the conclusion of the lease term "would receive the return of the property, with a substantial part of its economic life remaining."^{n152d} The court then severed the true lease and recharacterized the other three.

Although the *RPI* case did hold in favor of a recharacterization, the court's opinion demonstrates that blind application of some of the factors identified in the *PCH* case as mandating recharacterization of a lease may lead to incorrect results.

The first factor is whether the rental payments compensate the lessor for the use of the land or are structured for some other purpose, such as ensuring a return on investment.ⁿ¹⁵³ It is axiomatic that the value of a piece of real property may vary widely depending on, among other things, (1) the financial strength of the owner and the effect of any financial compulsions to enter into a particular transaction; (2) prevailing market conditions; (3) the availability and cost of financing; (4) the tax position of the owner; (5) the financial objectives of the owner; and (6) the valuation methodology employed. There is no objectively correct figure that should be established as fairly compensating a lessor for the use of its real property. The best that can be said is that there is a range of values, taking into consideration the

prevailing circumstances.

The second factor is whether the purchase price in a sale-leaseback transaction is related to the fair market value of the land or to an amount financed by the lessee.ⁿ¹⁵⁴ This factor may be closely related to the first factor discussed above, and may depend on a proper valuation of the real estate. In addition, it is possible that a purchase price established on a financing rather than a full real estate value basis is consistent with a true leasing transaction. Where the lessor has a material residual interest in the asset following the expiration of the lease term, the genesis of the transaction as a financing arrangement does not necessarily mandate the recharacterization of the leasing instrument as a financing agreement.ⁿ¹⁵⁵

The third factor is whether the property was purchased by the lessor specifically for the lessee's use.ⁿ¹⁵⁶ Once again, the existence of structured transaction initiated by the lessee does not mean that the parties did not enter into a true lease. There are many transactions denominated as "build to suit" leases in which the property is developed for a specific use and user. There is nothing unusual in a company acquiring a parcel of property for a particular use and employing a leasing methodology to spread the costs of acquisition and development.

The fourth factor is whether the transaction is structured as a lease to secure certain tax advantages.ⁿ¹⁵⁷ Clearly, there are many different types of transactions that are structured in a manner that provides the most favorable tax treatment available to the parties. This is, of course, an important function of counsel in a transaction. The tax law motivation of the parties is irrelevant to the matter of recharacterization. What is relevant is the structure of the transaction and its relationship to accepted norms for transactions of a similar nature.

The fifth factor is whether the lessee has assumed many of the obligations associated with ownership, such as the responsibility for the payment of taxes and insurance premiums. This factor has been addressed above in connection with the RPI case.ⁿ¹⁵⁸ Triple net leases are extremely common and are designed to achieve an end that otherwise appears to be suspect under the *PCH* criteria--that is, the ensuring of a bargained for return to the lessor by eliminating the lessor's risk of operating and capital expense escalation. Such an arrangement is, of course, perfectly consistent with a true lease construct.

The sixth factor is whether the lessee can acquire the property at the end of the lease term for nominal consideration.ⁿ¹⁵⁹ This factor is highly significant inasmuch as a nominal price purchase option may indicate that the putative lessor has not actually retained a material interest in the residual value of the property. A nominal purchase price option may indicate that the rent payable under a lease actually represents installment payments of the purchase price of the property under an arrangement similar to a conditional sale or contract for deed.ⁿ¹⁶⁰ Under this arrangement, upon payment of all of the rental and the nominal purchase price of the asset, the residual value of the property will belong to the lessee.

There are also nominal purchase price arrangements under which the anticipated useful life of the asset is co-terminous with the term of the lease. In this circumstance, neither the lessor nor the lessee will have a material interest in the residual value of the asset. Such transactions may be structured with a nominal purchase price option, a fair market value purchase option (which in reality will be equivalent to a nominal price option),ⁿ¹⁶¹ or with no purchase option at all. Such transactions denominated as leases may well in fact be installment sales, although it is possible to conceive of a lease of an old building that is simply intended by the parties to constitute an ordinary leasing transaction.

[d] Recharacterization--Relief Denied

Certain bankruptcy court decisions upholding the real estate sale-leaseback structure have held that the intent of the parties, rather than the "economic substance" of the transaction, is the critical factor in determining whether recharacterization is appropriate.

Two cases decided under the former Bankruptcy Act cited the intent and sophistication of the parties as factors in rejecting the seller/lessee's request for recharacterization. In *In re San Francisco Indus. Park, Inc.*, n162 the court observed that the seller/lessee was "an experienced real estate investor [who] must have known that all the documents embodying the transaction called it a sale and leaseback, nowhere using the language of mortgage."n163 The court, in *In re Kassuba*, n164 also noted that the parties were "sophisticated in matters of real estate financing." In upholding the sale-leaseback structure, the court stated that "the substance of the transaction that a court of equity will examine is not its economic effect, which the parties determine by their agreement, but instead it is what their agreement is."n165

In re OMNE Partners II n166 is a more direct challenge to the line of cases favoring recharacterization. In that case, the purchaser/lessor was a pension fund that acquired land on which a shopping mall was to be constructed by the seller/lessee. The purchase price (including a portion of construction costs which the purchaser/lessor was obligated to fund) was \$2.7 million. Additional funding for the project was furnished by an industrial development grant and a construction loan in addition to contributions from the limited partners of the seller/lessee. The land was leased back to the seller/lessee under a 30-year net ground lease. After its filing of a Bankruptcy Code petition, the seller/lessee sought to classify the purchaser/lessor as a mortgagee for purposes of its reorganization plan. The court, in rejecting the request for recharacterization, placed the burden on the seller/lessee to show by "clear and convincing evidence" that the transaction should be deemed a mortgage. It focused on the intent of the parties as "factually the key issue in such cases" and concluded that because the structure had been heavily negotiated and arose from legitimate business motives, it should be respected.n167 The court also found it relevant that both the deed and lease were recorded and that creditors of the seller/lessee therefore could not be misled as to the nature of the purchaser/lessor's position. Finally, the court pointedly criticized those decisions in sale-leaseback cases which emphasize analysis of the economics of the transaction:

I am aware that some courts have downplayed the importance of the "intent factor" in these recharacterization situations. To some extent, it can be argued that it is logically inconsistent to say that the characterization of a commercial transaction depends upon the intent of the parties and yet also say that a court of equity can look through form to the economic substance of the transaction. I do not believe however that bankruptcy judges have a warrant from Congress to run roughshod over the economic landscape recharacterizing commercial transactions entered into by sophisticated parties--restating them in terms of their "economic substance" contrary to their negotiated and agreed form--in the absence of some triggering factor permitting such recharacterization, i.e., an actual ambiguity in the documentation, a substantial factual dispute as to the intent of the parties, or some "disguise" or "misleading" aspect to the transaction.n168

In *In re Lansing Clarion Ltd. Partnership*,n169 a bankruptcy court was confronted with a recharacterization argument with respect to a lease under which: (1) the rents were matched to the debt service payments on the mortgage encumbering the fee, other than the balloon payment; (2) the lessee was granted a purchase option, albeit at more than a nominal price; and (3) the lessee undertook to perform the usual triple-net lease obligations. The court refused to recharacterize the transaction as a financing agreement by reason of its analysis of the "economic substance" of the transaction.n170 The court stated that an instrument denominated as a lease "... is presumed to be a true lease absent compelling factors to the contrary [citing PCH]. This presumption is rebuttable."n171 In finding the instrument to be a true lease, the court noted that: (1) the rental payments, although matched to debt service, continued after the maturity date of the mortgage loan; (2) the exercise price under the purchase option in the lease was not nominal; and (3) the lessor retained a number of risks of ownership.n172

Recharacterization was also denied in *Barney's, Inc. v. Isetan Co Ltd. (In re Barney's Inc.)*,n173 a large retail chapter 11 case in the Southern District of New York. The debtors, together with the unsecured creditors' committee, moved for summary judgment declaring that the leases between Isetan, as lessor, and subsidiaries of Barney's Inc., as lessee, relating to stores in Chicago, Beverly Hills and New York City, were in fact joint venture agreements. The movants claimed, on the basis of a letter of intent, that the three stores were to be part of a global retailing partnership between

Isetan and Barney's, that the stores were intended to be equity contributions by Isetan to Barney's and belonged to Barney's (with Isetan holding an equity interest in Barney's), that the rental payments theretofore made to Isetan under the leases constituted a preferred return on equity to Isetan and should be recovered, and that approximately \$177 million in loans from Isetan to Barney's for construction of the three stores was part of the equity contribution by Isetan to Barney's.ⁿ¹⁷⁴

Isetan, of course, opposed the action for recharacterization, and also moved under section 365(d)(3) to compel the payment of postpetition rent. The estates had not accrued funds with which to pay postpetition rent for the three stores, and the court noted that the burden on the estates of such obligations would be "considerable, and possibly crippling..."ⁿ¹⁷⁵

The court stated that its determination as to recharacterization was to be made with reference to federal law, citing the *Kar* case,ⁿ¹⁷⁶ and that such determination was to be made under an "economic realities" test that was not governed by the transaction labels affixed by the parties, but rather looks to the substance of the transaction as it affects third parties.ⁿ¹⁷⁷

The movants relied primarily on the application of the *PCH* factorsⁿ¹⁷⁸ but were unable to convince the court that the leases before it warranted recharacterization. The movants alleged that (1) the rent provided for in the leases in fact provided the lessor with a 14% guaranteed return on its investment and did not constitute compensation for use of the premises, (2) the stores were purchased and constructed specifically for use by Barney's, (3) the terms of the leases were unusually long (the opinion is not clear as to the term of the leases), (4) Barney's, through a representative, solicited the lessor to develop the projects, (5) Barney's assumed all of the indicia of ownership under the triple-net provisions of the leases, and even paid ground rent directly to the ground lessors in Beverly Hills and Chicago and assumed other obligations normally associated with ownership, and (6) the right of first refusal for Barney's contained in the New York and Beverly Hills documentation showed that Barney's could prevent the transfer to any third party of the lessor's purported ownership rights.ⁿ¹⁷⁹

Isetan countered by claiming that (1) the so-called 14% preferred return was in fact an ordinary percentage rent clause found in many retail leasing transactions, was not guaranteed, and indeed had never been achieved, (2) the rent levels were related to market conditions, (3) it is not uncommon in retail lease transactions to have the facility constructed to the lessee's specifications, (4) the leases permitted the lessee to walk away from the tenancies after expiration of a relatively short initial term, leaving the lessor with the risk of reletting, (5) the triple-net provisions of the leases were common in commercial leasing transactions, and (6) the existence of a right of first refusal benefiting the lessee was not equivalent to a nominal price purchase option.ⁿ¹⁸⁰

In denying the motion for summary judgment, the court noted that the movants had alleged inconsistently that the four corners of the documents must be ignored in light of the letter of intent contemplating a global retailing partnership between the lessor and Barney's, but that within the same four corners the documents evidenced a joint venture rather than a leasing transaction.ⁿ¹⁸¹ More significantly, the court stated:

To be sure, analysis of the leases in accordance with the *PCH* Associates factors indicates that they contain terms and were entered into under circumstances that may not be commonly associated with true leases of real property. However, movants would have us mechanically apply those factors without considering evidence concerning either prevailing conditions in the retail leasing marketplace or changes in the way that those transactions are structured that may have taken place since our court of appeals rendered its decision. We are loathe to exercise such blind adherence. Moreover, it is particularly ill-advised in light of our court of appeals' subsequent decision in *Rensselaer Polytechnic Institute*, wherein it rejected the assertion that when a purported lease is "triple net", this factor should be conclusively established against the "true" lease nature of the transaction due to the increasingly common utilization of this feature in commercial leases.ⁿ¹⁸²

The court went on to deny the motion for summary judgment in view of the need to consider extrinsic evidence as to the intent of the parties, and the inability to find anything other than a true leasing transaction on the basis of the documentary record.ⁿ¹⁸³

Despite the potentially drastic consequences to the estates of finding in favor of a true lease characterization in a summary judgment context, the court very clearly disapproved of a blind or mechanical application of the *PCH* factorsⁿ¹⁸⁴ to leasing transactions in which the lessor and lessee have agreed upon a real estate acquisition program, a build-to-suit arrangement, a percentage rent arrangement, a substantial lease term, and a triple-net lease structure. As noted by the court, these arrangements are common in large retail-related real estate transactions, and should not in and of themselves be subject to a material risk of recharacterization. The court also noted the importance of understanding the actual retail business and real estate market environment in applying the *PCH* factors in order to avoid blind adherence to the words of *PCH*, which were written in the context of a highly unusual fact pattern involving an obviously forced transaction structure. Finally, the court appeared to acknowledge that the language of the *RPI* case, cautioning the courts in considering the effect of long lease terms and triple-net provisions, represents a step back from the more absolute language of the *PCH* opinion, which appeared to call for a more formalistic approach to recharacterization.

[e] The Perfection Issue

If a court recharacterizes a real estate lease as a secured financing agreement, or mortgage, then the question arises whether the instrument has been duly recorded and the lien properly perfected so as to withstand an avoidance action under the Bankruptcy Code. If the court is dealing with a real property lease that has not been recorded, there is a chance that a court may deem the recharacterized financing agreement unperfected. If the court is dealing with a lease that has been recorded, the perfection issue may turn upon the requirements of local law relating to the proper recordation of mortgage instruments, the payment of any required mortgage recording tax, and the effect of nonpayment of the tax at the time of recordation.ⁿ¹⁸⁵

It is common in equipment lease transactions intended to be true leases to make protective filings of UCC-1 financing statements in contemplation of the possibility of the recharacterization of the transaction as a secured financing. The filing of UCC financing statements in true lease transactions may give rise to the risk that a court will seize upon the filing as evidence of intent to enter into a secured transaction rather than a true lease.^{n185a} Accordingly, these filings often recite that they are for protective purposes only, and do not constitute an admission that the transaction constitutes a secured loan transaction. Similarly, in the area of off-balance sheet real estate financing known as "synthetic leasing,"ⁿ¹⁸⁶ the parties often will record a memorandum of lease in the real property records intended for the recordation of mortgages. The memorandum will set forth the grant by the lessee to the lessor of a mortgage lien and security interest in the real property, and contain traditional mortgage covenants.ⁿ¹⁸⁷ Where required, mortgage recording tax will be paid.ⁿ¹⁸⁸

There is surprising little case law in the recharacterization area dealing with the effect of nonrecordation or other perfection failures in the context of a lease recharacterized as a mortgage. In *In re Independence Village, Inc.*,ⁿ¹⁸⁹ where the court recharacterized an IRB lease as a security agreement giving the local economic development agency an equitable mortgage on the subject premises, the court found that the document labeled as a lease purchase contract had been recorded in the appropriate place for filing mortgages, and concluded that there was no issue as to the perfection of the agency's security interest in the real property.ⁿ¹⁹⁰ⁿ¹⁹¹⁻¹⁹²

It may be inferred from the opinion in *Independence Village* that a failure to perfect would have given rise to the question whether the recharacterized lessors should be relegated to unsecured creditor status. The outcome of this issue may depend upon the view of each court as to the result of a finding in favor of recharacterization. If a real estate lease is found to actually constitute an "equitable mortgage,"ⁿ¹⁹³ then perhaps for the purposes of the bankruptcy case of the

lessee/debtor, the recharacterized lease is deemed to be a duly perfected mortgage lien not subject to an avoidance action under section 544. This holding would be consistent with the long line of cases finding deeds given as security to constitute equitable mortgages.ⁿ¹⁹⁴ If, however, a real estate lease is found to constitute merely a financing instrument, or a loan agreement, then a question may remain as to whether the agreement (1) is effective to grant a lien and security interest, and (2) was perfected.

[f] Collateral Effects of Recharacterization

It is clear that the recharacterization cases reviewed above are dealing with the treatment of an instrument under the Bankruptcy Code, and generally relate to the question whether an agreement denominated as a lease will subject the putative debtor-lessee thereunder to the requirements of sections 365(d)(3) and 365(d)(4).ⁿ¹⁹⁵ However, the question remains whether the recharacterization of a lease for Bankruptcy Code purposes will have collateral effects on the debtor and its creditors. Will the recharacterization of a lease as a debt instrument calling for payments of principal and interestⁿ¹⁹⁶ require restatement of the debtor's past income tax returns to reduce its deductions for rent expense to only the interest component of the installment payments made to the lessor/creditor? Will the debtor's prior financial statements need to be restated to reflect the existence of a debt obligation rather than an off-balance sheet lease expense? In the case of an IRB lease recharacterized as a mortgage, will the decision result in loss of tax-exempt status of the related bonds, and give rise to issues concerning liability of bond counsel and accountants?

It appears that the only cases that have examined these questions in some depth are certain of the IRB decisions. The Court of Appeals for the Eleventh Circuit, in *In re Martin Brothers Toolmakers, Inc.*,ⁿ¹⁹⁷ refused to recharacterize the IRB lease before it on policy grounds relating to the effect of recharacterization on the tax-exempt bond program in the affected jurisdiction. The court stated:

Were we to find for appellant and deem the agreement a mortgage, IDB would assume the forbidden status of a mortgagee and the state tax exemption would be lost. With it would go much of IDB's leverage in attracting new industry to Huntsville, for the tax-exemption diminishes IDB's cost of borrowing and construction, automatically resulting in lower rent and operating costs for potential lessees. [footnote omitted].ⁿ¹⁹⁸

A bankruptcy court in Kansas, also dealing with an IRB lease recharacterization issue, was extremely forthright, stating:

Debtor urges this Court to look beyond the black letter expressions of legislative intent and public policy contained in the [Kansas Economic Development Revenue] Act in order to examine the true nature of the transaction by applying various provisions of the UCC. Were we to do so, we would most surely find that the Leases in question are, in fact, mortgages

Were we to deem the Leases mortgages, the City of McPherson would assume the status of mortgagee, in direct violation of the Act's provisions. [citation omitted] The state tax exemptions provided by the Act would be lost and the City of McPherson, as well as other cities in Kansas issuing IRBs under the Act, would lose much of their power in attracting new industry to Kansas ... In sum, the City must not become or be deemed a mortgagee of property constructed with proceeds of a bond issuance simply because, for reasons of public policy, it is forbidden to do so.ⁿ¹⁹⁹

The clear implication of these decisions is that recharacterization as mortgages of the IRB leases before these courts, for the purposes of the Bankruptcy Code, would result in the same recharacterization of the leases for purposes of the applicable industrial revenue bond statute, and destroy the tax exempt status of the bonds issued in connection with the leases. However, at least one other court has taken the view that recharacterization for Bankruptcy Code purposes does not necessarily constitute recharacterization for IRB purposes. In *In re Hotel Syracuse, Inc.*,ⁿ²⁰⁰ the court recharacterized an IRB lease as a financing agreement in the face of the assertion by the issuing agency that such a holding would impair the agency's ability to function. The court justified its holding in favor of recharacterization on the

grounds that (1) the agency must bear the responsibility of entering into a transaction beyond the scope of its authority, and (2) in any event, recharacterization for purposes of the Code would not necessarily affect the status of the transaction under state law.ⁿ²⁰¹ The court stated:

SIDA also contends that the Lease must be construed as a true lease because SIDA is not authorized to make a loan of bond proceeds. SIDA reasons, therefore, that because it lacks statutory authority to assume the status of a mortgagee, the parties intended to create a true lease. SIDA may not bootstrap its argument in this fashion. Thus, if SIDA acted outside the scope of its authority, the SIDA and not the estate should be made to bear the responsibility for such an ultra vires act.

However, the Court's determination that the Lease falls outside of the scope of *Code § 365(d)(4)* does not inescapably lead to the conclusion that SIDA has assumed the "forbidden" status of mortgagee. Rather, the Court's determination is limited solely to the finding that *Code § 365(d)(4)* is not applicable to the transaction at bar. [citations omitted].ⁿ²⁰²

The concept of treatment of the same agreement or transaction differently for different purposes is certainly not new to the law. Perhaps the most graphic example of this is the area of "synthetic leasing," which involves real estate leases constituting operating leases for financial accounting purposes, but also as loan transactions for federal and state income tax, bankruptcy and commercial law purposes.ⁿ²⁰³ These leases are not debt liabilities on a lessee's balance sheet, and rental payments thereunder are expensed.ⁿ²⁰⁴ However, for tax purposes, the lessee is treated as the owner of the property, may realize the appreciation on the property, may take depreciation deductions, and may treat the rental payments as payments of interest and principal.ⁿ²⁰⁵ As noted above, in these transactions, the lessor and lessee will often record in the mortgage records a memorandum of lease setting forth the grant by the lessee to the lessor of a mortgage lien and containing typical mortgage covenants.ⁿ²⁰⁶ Mortgage recording tax will be paid where required.ⁿ²⁰⁷

The view that recharacterization of a lease as a financing agreement for the purposes of section 365(d)(4) will not affect the transaction for state law or other purposes, is perhaps most supportable under the decisions that hold federal rather than state law governs the resolution of recharacterization issues for Code purposes.ⁿ²⁰⁸ These decisions simply disregard the transaction characterizations mandated by applicable state law, and therefore do not affect such characterizations. The IRB decisions that utilize state law to govern recharacterization issues generally find against recharacterization under state law, as well as on policy grounds.ⁿ²⁰⁹ As illustrated above,ⁿ²¹⁰ the statement of policy grounds of these courts assume that recharacterization of a lease under state law, through application of Uniform Commercial Code or similar standards, would adversely affect the IRB program involved in such cases. These courts therefor find that the arrangements before them, which clearly constitute financing transactions under most legal standards, nevertheless must be characterized as true leases, inasmuch as the applicable IRB statutes dictate that the instruments are to be called leases. There remains open the question whether state law would permit a lease characterization for IRB purposes, while calling for a financing transaction characterization under Uniform Commercial Code or real property law standards, in the context of a Bankruptcy Code case of the lessee.

[g] Conclusions

The courts have taken two divergent approaches in attempting to distinguish between sale-leasebacks and mortgages under the Code. The cases emphasizing "economic substance" have identified certain elements of the transaction as indices of whether the risk of ownership has in fact passed to the purchaser/lessor under the sale agreement and lease. The cases applying an intent test have questioned the propriety of economic analysis and suggest that the sale-leaseback form will be upheld absent clear evidence that the structure is a sham.

Both tests, as applied by the courts, are subject to question. To say that the intent of the parties should be determinative and that the structure of the transaction is conclusive evidence of that intent places an undue reliance on form and is

inconsistent with judicial approaches taken in other areas of the law.ⁿ²¹¹ The key issue for purposes of the Code should be to accurately classify the economic relationship between the purchaser/lessor and the seller/lessee. The intent test employed in *In re OMNE Partners* and its predecessors does not adequately address that issue.

On the other hand, if a court undertakes a financial analysis of a real estate sale-leaseback transaction, it should consider only those factors relevant to the issue of ownership of the property. The courts that have adopted the economic substance approach have placed excessive emphasis on provisions in the sale agreement and lease which merely allocate certain costs and risks between the parties and are unrelated to whether the asset has effectively been conveyed. The courts in *PCH* and *Nite Lite* ⁿ²¹² each cited as a basis for recharacterization that the seller/lessee bore the costs of taxes, insurance and maintenance under the terms of the lease. *PCH* expressed the further concern that the seller/lessee paid the transfer taxes and title insurance premiums in connection with the sale and that no closing adjustments were made between the parties. These elements, however, are common in net lease transactions and are presumably reflected in a rent less than that which would be charged if such items were paid by the purchaser/lessor. A net lease that shifts the burden of certain expenses to the seller/lessee does not necessarily allocate to the lessee the essential characteristics of ownership.ⁿ²¹³ This fact has been recognized in tax cases analyzing real estate sale-leasebacksⁿ²¹⁴ and should be recognized in the bankruptcy context as well.

In addition, excessive emphasis has been placed on the manner in which rent has been fixed in cases where the rental is expressed as a rate of return. Although in an unregulated commercial real estate environment, rental is a function of supply and demand, rental is also viewed by landlords as providing a certain rate of return on investment. Accordingly, the mere recitation in a lease of a rate of return does not itself mean that the transaction is a disguised financing.

Finally, it should be noted that a characterization decision based upon a determination as to the relationship between the purchase price paid by the purchaser/lessor and the "value" of the real property requires a valuation judgment by the court. This decision-making process, which is often based on competing appraisal reports and testimony, gives rise to the possibility that the court will override the parties' initial judgement as to the fairness of a sale price and rate of return with respect to a particular piece of property.

The following factors should be considered as evidence that a true lease does not exist and that recharacterization is warranted:

- (1) The term of the lease, assuming the exercise of all renewal options, exceeds the useful life of the property, thereby depriving the purchaser/lessor of any interest in the residual value in the property. The impact of extensive renewal options may be ameliorated if the renewal terms are at fair market rental. If the property consists of land only and therefore has unlimited useful life, the test should be whether the term is so long that the residual interest has virtually no present value.

- (2) The rent under the lease is calculated exclusively as an interest in profits (with no guaranteed minimum rent) for all or a significant portion of the lease term. This suggests that the purchaser/lessor is a joint venturer rather than the owner of the property.

- (3) The seller/lessee is granted a repurchase option at a fixed, below-market price. This is another mechanism which denies the purchaser/lessor the benefit of appreciation of the property. An option permitting the seller/lessee to purchase the property at fair market value is strong evidence that a "true lease" exists.

- (4) The purchase price paid by the purchaser/lessor is clearly unrelated to the market value of the property. However, if the price paid by the purchaser/lessor is within the range of reasonable values for the property at the time of sale (as determined by the court), the parties' initial characterization of the transaction should be respected.

An important development in the equipment leasing area reflects a commendable awareness that the lease/security interest distinction should be made more consistent with modern commercial practices. A new Article 2A to the Uniform Commercial Code, entitled "Leases," was approved by the National Conference of Commissioners on Uniform State Laws in 1986 and by the American Law Institute in October, 1987. As of May 1, 1997, the Article had been adopted by forty-seven states and the District of Columbia.ⁿ²¹⁵ Accompanying Article 2A is an amended version of *U.C.C. § 1-201(37)* redefining the term "security interest." This new definition, although strictly applicable only to personal property leasing, could have implications on the sale/leaseback recharacterization issue in bankruptcy.

The prior Official Text of *U.C.C. § 1-201(37)* defined a security interest, in part, as follows:

Unless a lease ... is intended as security, reservation of title thereunder is not a "security interest" Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

The amended definition of "security interest" in *U.C.C. § 1-207(37)* makes several significant changes. Generally, it eliminates intent as a factor in distinguishing between leases and security interests and focuses instead on the economics of the transaction. The new section, like the old, provides that "[w]hether a transaction is a security interest is determined by the facts of each case." However, it gives important new guidance in making this determination.

The amended *U.C.C.* section provides that a transaction creates a security interest if the lessee's obligation to pay rent is an obligation for the term of the lease not subject to termination by the lessee and either: (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) the lessee is bound to renew the lease for the remaining economic life of the goods or become the owner of the goods; (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal consideration; or (4) the lessee has a purchase option for no additional consideration or for nominal consideration. Additional consideration is not nominal if the renewal or purchase option requires the payment of fair market rent (in the case of a renewal) or fair market value (in the case of a purchase) at the time of exercise of the option.

Significantly, the amended new definition further provides that a transaction is not a security interest merely because: (1) the present value of the rent payable by the lessee is equal to or greater than the fair market value of the leased goods at the time of the lease; (2) the lessee assumes risk of loss of the goods or agrees to pay taxes, insurance, filing, recording or registration fees or service or maintenance costs with respect to the goods (indicating that a net lease can be a true lease); (3) the lessee has an option to renew the lease or become the owner of the goods; (4) the lessee has a renewal option for a fixed rent greater than the fair market rent for the goods at the time of exercise; or (5) the lessee has a purchase option at a price greater than the fair market value of the goods at the time of exercise.

The amended section clearly emphasizes the lessor's expectation of a meaningful residual as the key to the lease/security interest distinction. If the lessor has no reasonable expectation that the goods will have any remaining useful life at the expiration of the lease term, the transaction is a secured transaction. If the lessor retains a meaningful residual, the transaction is a true lease.

FOOTNOTES:

(n1)Footnote 1. Section 70b of the former Bankruptcy Act.

(n2)Footnote 2. *11 U.S.C. § 365(b), (e), (f); see P 3.01[7] infra.*

(n3)Footnote 3. *11 U.S.C. § 365(b)(1)(A).*

(n4)Footnote 4. *Roslyn Sav. Bank v. Comcoach Corp. (In re Comcoach Corp.)*, 19 B.R. 231, 8 B.C.D. 1077 (Bankr. S.D.N.Y. 1982), *aff'd*, 698 F.2d 571, 7 C.B.C.2d 1191 (2d Cir. 1983); *contra In re Juneau's Builders Center Inc.*, 14 C.B.C.2d 540, 57 B.R. 254 (Bankr. M.D. La. 1986).

(n5)Footnote 5. The similarities between true leases and installment sales in the equipment leasing context are discussed in Coogan, *Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?*, 56 N.Y.U. L. Rev. 1036 (1981), and in Kripke, *Book Review*, 37 Bus. Law. 723 (1982).

(n6)Footnote 6. *E.g.*, *Hurley v. Atchison, Topeka & Santa Fe R.R. Co.*, 213 U.S. 126, 29 S. Ct. 466, 53 L. Ed. 729 (1909); *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951); *Blue Cross v. Monsour Med. Ctr. (In re Monsour Med. Ctr.)*, 11 B.R. 1014 (W.D. Pa. 1981); 11 U.S.C. § 1129(b)(2)(A).

(n7)Footnote 7. *Bankers Life Ins. Co. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.)*, 4 C.B.C.2d 1066, 12 B.R. 803 (Bankr. D. Utah 1981).

(n8)Footnote 8. 11 U.S.C. § 365(d)(3).

(n9)Footnote 9. *In re Thomas W. Garland, Inc.*, 28 B.R. 87 (Bankr. E.D. Mo. 1983); *In re Mindy's, Inc.*, (Bankr. S.D. Ohio 1982), 17 B.R. 177.

(n10)Footnote 10. 11 U.S.C. § 547(b); *see Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee)*, 530 F.3d 458 (6th Cir. 2008), in which a court held a new mortgage to be a preferential transfer because the trustee met its burden on all elements under section 547(b). The court reasoned that because the new mortgage was not recorded and perfected for more than two months after the initial mortgage, the perfection did not relate back to the initial transfer pursuant to section 547(e)(2)(B).

(n11)Footnote 11. 11 U.S.C. § 547(c)(1). The circuits are split over whether "substantially contemporaneous" requires a case-by-case analysis or instead is tied to the 30-day relation-back period of section 547(e)(2)(A). *Collins v. Greater Atlantic Mortgage Corp. (In re Lazarus)*, 478 F.3d 12, 57 C.B.C.2d 400 (1st Cir. 2007), interpreted the term "substantially contemporaneous" as requiring the exchange to occur within the 30-day relation-back period under section 547(e)(2)(A). However, the Sixth, Eighth and Ninth Circuits have held that determining whether or not an exchange is "substantially contemporaneous" must be determined on a case-by-case basis. *See Ray v. Security Mutual Finance Corp. (In re Arnett)*, 731 F.2d 358, 10 C.B.C.2d 533 (6th Cir. 1984); *see also Lindquist v. Dorholt, Inc. (In re Dorholt Inc.)*, 224 F.3d 871 (8th Cir. 2000); *Dye v. Rivera (In re Marino)*, 35 C.B.C.2d 757, 193 B.R. 907 (B.A.P. 9th Cir. 1996), *aff'd*, 117 F.3d 1425 (9th Cir. 1997). In 2008, the Eleventh Circuit joined the Sixth, Eighth and Ninth Circuits, holding that unlike the bright-line rule of section 547(e)(2)(A), the "substantially contemporaneous" rule of section 547(c)(1)(B) requires an examination of all the facts and circumstances. *Gordon v. Novastar Mortgage, Inc. (In re Hedrick)*, 524 F.3d 1175 (11th Cir.), *cert. denied*, 29 S. Ct. 631, 172 L. Ed. 2d 610 (2008).

(n12)Footnote 12. *Bernstein v. RJL Leasing (In re White River Corp.)*, 799 F.2d 631, 15 C.B.C.2d 617 (10th Cir. 1986); *In re Clothes, Inc.*, 45 B.R. 419 (Bankr. D.N.D. 1984); *Carmack v. Zell (In re Mindy's Inc.)* C.B.C.2d 1451, 17 B.R. 177 (Bankr. S.D. Ohio 1982). However, if the lessee is not in possession of the property, the rental payments may be found to be preferential. *In re Jet Fla. Sys., Inc.*, 841 F.2d 1082 (11th Cir. 1988). The rental payments will also be preferential if made under a settlement stipulation between the lessee and lessor. *In re Advertising Assocs., Inc.*, 95 B.R. 849 (Bankr. S.D. Fla. 1989).

(n13)Footnote 13. *Id.*; Friedman, *Leases*, § 5.101 n.1 (2d ed. 1983).

(n14)Footnote 14. See the cases cited in note 9 *supra*. It has also been established that scheduled interest payments made on a timely basis under a long-term debt agreement may be transfers in the ordinary course of business within the meaning of section 547(c)(2). *Union Bank v. Estate of Wolas*, 502 U.S. 151, 112 S. Ct. 527, 116 L. Ed. 2d 514, 25 C.B.C.2d 1011 (1991). The long-term nature of the debt does not automatically mean that payments thereon are not in

the ordinary course of business.

(n15)Footnote 14a. See *In re Superior Toy & Mfg., Inc.*, 78 F.3d 1169 (7th Cir. 1995) ; *In re LCO Enters.*, 12 F.3d 938, 30 C.B.C.2d 624 (9th Cir. 1993) .

(n16)Footnote 15. E.g., *Iowa Premium Serv. Co. v. First Nat'l Bank (In re Iowa Premium Serv. Co.)*, 676 F.2d 1220, 6 C.B.C.2d 709 (8th Cir. 1982) , *rev'd en banc on other grounds*, 695 F.2d 1109, 8 C.B.C.2d 34 (8th Cir. 1982) ; *Grant v. Jacksonville Postal Credit Union (In re Anders)*, 20 B.R. 468 (Bankr. M.D. Fla. 1982) .

(n17)Footnote 16. E.g., *Barash v. Public Fin. Corp.*, 658 F.2d 504, 4 C.B.C.2d 1548 (7th Cir. 1981) ; *Kapela v. Newman*, 649 F.2d 887, 24 C.B.C. 297 (1st Cir. 1981) .

(n18)Footnote 17. *Barash v. Public Fin. Corp.*, 658 F.2d 504, 4 C.B.C.2d 1548 (7th Cir. 1981) ; *Kapela v. Newman*, 649 F.2d 887, 24 C.B.C. 297 (1st Cir. 1981) ; *contra In re Smith-Douglass, Inc.*, 842 F.2d 729, 18 C.B.C.2d 736 (4th Cir. 1988) , holding that regularly scheduled interest installments are incurred as they become due and are therefore not paid on account of antecedent debt.

(n19)Footnote 18. E.g., *Philadelphia Co. v. Dipple*, 312 U.S. 168, 61 S. Ct. 538, 85 L. Ed. 651 (1941) ; *In re Lane Foods, Inc.*, 213 F. Supp. 133 (S.D.N.Y. 1963) .

(n20)Footnote 19. 11 U.S.C. § 365(d)(3). The statute permits the court to extend, for cause, the time for payment of any obligation that arises within 60 days after the date of the order for relief, but the time for performance cannot be extended beyond such 60 day period.

(n21)Footnote 20. 11 U.S.C. § 506(b). The rate of postpetition interest is not necessarily the contract rate, and may be established by the court. *United States v. Ron Pair Enters.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989) ; *In re Laymon*, 117 B.R. 856 (Bankr. W.D. Tex. 1990) .

(n22)Footnote 20a. *In re Delta Resources, Inc.*, 54 F.3d 722 (11th Cir. 1995) .

(n23)Footnote 21. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) , 11 U.S.C. § 502(b)(2); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977) ("House Report"), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n24)Footnote 22. 11 U.S.C. § 361(1).

(n25)Footnote 23. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) . The *Timbers* decision resolved a conflict among the circuits. See *In re Briggs Transp. Co.*, 780 F.2d 1339, 13 C.B.C.2d 1289 (8th Cir. 1985) (whether lost opportunity costs are required should be decided on a case by case basis); *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 12 C.B.C.2d 264 (4th Cir. 1985) (lost opportunity costs granted); *In re American Mariner Indus.*, 734 F.2d 426 (9th Cir. 1984) (same). *Contra United Savings Ass'n of Texas v. Timbers of Inwood Forest, Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 808 F.2d 363, 16 C.B.C.2d 1 (5th Cir. 1987) , *en banc*, affirming the panel decision, 793 F.2d 1380, 15 C.B.C.2d 509 (5th Cir. 1986) holding that lost opportunity costs are not required as adequate protection, thus creating an intercircuit conflict with *American Mariner* and *Grundy*, *supra*.

(n26)Footnote 24. 11 U.S.C. § 362(d); *In re Inn at Longshore, Inc.*, (Bankr. D. Conn. 1983), 32 B.R. 942 ; *contra In re Attorneys Mgmt., Inc.*, 29 B.R. 96 (Bankr. C.D. Cal. 1983) .

(n27)Footnote 25. See *Bankers Life Ins. Co. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.)*, 4 C.B.C.2d 1066, 12 B.R. 803 n.5 (Bankr. D. Utah 1981) ; 11 U.S.C. § 365(d)(3).

(n28)Footnote 26. *See P 3.02[1] infra.*

(n29)Footnote 27. *11 U.S.C. § 1124(2).*

(n30)Footnote 28. *11 U.S.C. § 1129(b)(2)(A).*

(n31)Footnote 29. *11 U.S.C. § 502(b)(6).* *In re Winston Mills, Inc.*, 2 C.B.C.2d 1267, 6 B.R. 587 (Bankr. S.D.N.Y. 1980) , holds that the section 502(b)(6) limitation will not be recognized where a true lease was designed to support the payments required to be made by the lessor under an issue of industrial revenue bonds. As of the date of the opinion, the section 502(b)(6) limitation was set forth in section 502(b)(7).

(n32)Footnote 29a. *11 U.S.C. § 502(b)(6)(B) and (C).*

(n33)Footnote 29b. *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003) ; *In re Farley, Inc.*, 146 BR 739 (Bankr. N.D. Ill. 1992) ; *In re Federated Dep't Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991) .

(n34)Footnote 30. *11 U.S.C. §§ 365(g)(1) and 502(g).*

(n35)Footnote 30a. It is worth noting that courts generally have held that postpetition rentals received by the landlord after rejection from a new tenant are to be deducted from the state law damage claim rather than the cap under section 502(b)(6). *See, e.g., In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 208 n.17 (3d Cir. 2003) ; *In re All for a Dollar, Inc.*, 35 C.B.C.2d 190, 191 B.R. 262 (Bankr. D. Mass. 1996) ; *In re Financial News Network, Inc.*, 28 C.B.C.2d 384, 149 B.R. 348 (Bankr. S.D.N.Y. 1993) ; *In re Atlantic Container Corp.*, 133 B.R. 980, 26 C.B.C.2d 597 (Bankr. N.D. Ill. 1991) . *Contra In re Stewart's Props., Inc.*, 41 B.R. 353 (Bankr. D. Haw. 1984) .

(n36)Footnote 31. A good discussion of the computation of a damage claim of a lessor arising from the rejection of a real estate lease is set forth in *Third Nat'l Bank v. Winner Corp.*, 29 B.R. 383 (M.D. Tenn. 1982) (former Bankruptcy Act). The limitation relating to security deposits arises from the seminal case of *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944) , in which the court held that a landlord was required to deduct a rent security deposit from the statutory cap rather than the state law damage claim. The legislative history accompanying section 502(b)(6) expressly extends the *Oldden* holding to Bankruptcy Code cases. *See H. Rep. No. 95-595*, 95th Cong. 1st Sess. 393-54 (1977), *reprinted in Vol C Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); *see also In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 210 (3d Cir. 2003) (applying *Oldden* to letter of credit intended as security); *In re Handy Andy Home Improvement Centers, Inc.*, 222 B.R. 571 (Bankr. N.D. Ill. 1998) (following *Oldden*).

(n37)Footnote 32. *See P 3.03[3] infra*, and to the the claim amount for application of any security deposit held by the landlord. *In re Arden*, 176 F.3d 1226, 1227 (9th Cir. 1999) ; *In re Clements*, 185 B.R. 895 (Bankr. M.D. Fla. 1995) . *Fisher v. Lee Bros. Value World, Inc. (In re Lee Bros. Value World, Inc.)*, 486 F.2d 1037 (9th Cir. 1973) ; *Hippodrome Bldg. Co. v. Irving Trust Co. (In re Radio-Keith-Orpheum Corp.)*, 91 F.2d 753 (2d Cir.) , *cert. denied*, 302 U.S. 748, 58 S. Ct. 265, 59 S. Ct. 265, 82 L. Ed. 578 (1937) ; *In re Rodman*, 60 B.R. 334 (Bankr. W.D. Okla. 1986) .

(n38)Footnote 32a. *In re Modern Textile, Inc.*, 900 F.2d 1184 (8th Cir. 1990) .

(n39)Footnote 32b. *11 U.S.C. § 503(b)(7).*

(n40)Footnote 32c. *Id.*

(n41)Footnote 32d. *Id.*

(n42)Footnote 32e. *11 U.S.C. § 503(b)(7)*, added by Pub. L. No. 109-8, § 445 (2005), *reprinted in Vol. E-2 Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n43)Footnote 32f. *In re Klein Sleep Prods., Inc.*, 78 F.3d 18, 24 (2d. Cir. 1996) .

(n44)Footnote 32g. *In re Goody's Family Clothing, Inc.*, 401 B.R. 656 (D. Del. 2009) ; *In re Merry-Go-Round Enters., Inc.*, 180 F.3d 149 (3d Cir. 1999) .

(n45)Footnote 33. 11 U.S.C. § 1111(b). The recourse claim resulting from a section 1111(b) election will not survive the sale of the collateral under section 363, a foreclosure sale, or the abandonment of the property, because in these circumstances the secured creditor is given the opportunity to obtain possession of the collateral through purchase or abandonment. *In re DRW Prop. Co.*, 14 C.B.C.2d 1032, 57 B.R. 987 (Bankr. N.D. Texas 1986) . See P 2.01 [9] *supra* for a discussion of contractual waivers of lenders' rights of election under section 1111(b).

(n46)Footnote 34. 11 U.S.C. § 365(f).

(n47)Footnote 35. 11 U.S.C. § 365(b), (f); see cases cited in note 6 *supra*.

(n48)Footnote 36. 11 U.S.C. § 365(k).

(n49)Footnote 36a. However, the Code permits the lessor of the property to require a deposit or other security for the performance of the debtor's obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant. 11 U.S.C. § 365(l).

(n50)Footnote 37. 11 U.S.C. § 363(f), (k); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 345-46 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n51)Footnote 38. 11 U.S.C. § 365(d)(4), as amended by Pub. L. No. 109-8, § 404 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n52)Footnote 39. 11 U.S.C. § 365(d)(4).

(n53)Footnote 40. 11 U.S.C. § 365(b)(1). The exception for defaults relating to the failure to perform nonmonetary obligations was added to the Code by the 2005 Act.

(n54)Footnote 41. See *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.), *aff'd*, 681 F.2d 102 (2d Cir. 1982) ; *In re Northwood Indus., Inc.*, 25 B.R. 210 (Bankr. W.D. Wis. 1982) ; *In re The Lionel Corp.*, 23 B.R. 224 (Bankr. S.D.N.Y. 1982) ; *1535 Chestnut Corp. v. Horn & Hardart Baking Co. (In re Horn & Hardart Baking Co.)*, 19 B.R. 597 (Bankr. E.D. Pa. 1982) ; *COR Route 5 Company, LLC v Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 59 C.B.C.2d 1205 (2d Cir. 2008) ; see also P 3.01[3][b][iii] *infra*.

(n55)Footnote 42. 11 U.S.C. § 554(b).

(n56)Footnote 43. Property may be abandoned to any party with a possessory interest in it. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 377 (1977) *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 95-989, 95th Cong., 2d Sess. 92 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised). The procedure for abandonment at the behest of the trustee or a party in interest is governed by *Fed. R. Bankr. P. 6007*.

(n57)Footnote 44. See P 2.06 *infra*.

(n58)Footnote 45. See P 2.06 *infra*.

(n59)Footnote 46. 11 U.S.C. § 365(d)(3).

(n60)Footnote 47. See, e.g., *In re Klein Sleep Prods., Inc.*, 78 F.3d 18, 24 (2d. Cir. 1996) ; *In re Plitt Amusement*

Co., 233 B.R. 837 (Bankr. C.D. Cal. 1999) ; *In re Matter of Village of Rathskeller, Inc.*, 147 B.R. 665, 667 (Bankr. S.D.N.Y. 1992) .

(n61)Footnote 48. 11 U.S.C. § 1129(b)(2)(A).

(n62)Footnote 49. 11 U.S.C. § 506(a).

(n63)Footnote 50. See P 2.02[2][a] *supra*.

(n64)Footnote 51. 11 U.S.C. § 1129(b)(2)(A). See generally Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061 (1985).

(n65)Footnote 52. See, e.g., *In re Castle Ranch of Ramona, Inc.*, 3 B.R. 45 (Bankr. S.D. Cal. 1980) .

(n66)Footnote 53. 11 U.S.C. § 365(d)(3).

(n67)Footnote 54. *Third Nat'l Bank v. Winner Corp.*, 29 B.R. 383 (M.D. Tenn. 1982) .

(n68)Footnote 56. See P 2.02[2][a] *supra*.

(n69)Footnote 57. See P 2.02[2][b] *supra*.

(n70)Footnote 58. *United States Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n71)Footnote 59. See P 2.02[2][c] *supra*.

(n72)Footnote 60. See P 2.02[2][d] *supra*.

(n73)Footnote 61. See P 2.02[2][e] *supra*.

(n74)Footnote 62. See P 2.02[2][f] *supra*.

(n75)Footnote 63. See P 2.02[2][g] *supra*.

(n76)Footnote 64. The debtor in the real estate sale-leaseback cases is most frequently the seller/lessee. See Homburger, et al., *Unresolved Questions in Sale- Leaseback Transactions: A Look at Real Estate, Tax and Bankruptcy Law Issues*, 19 *Real Prop., Prob. and Tr. J.* 941, 979 n.127 (1984). Recharacterization is generally sought by the seller/lessee to avoid the application of subsections 365(d)(3) and (d)(4). See, e.g., *In re PCH Assocs.*, 804 F.2d 193 (2d Cir. 1986) . However, in some cases, the purchaser/lessor claims mortgagee status to avoid section 502(b)(6) limitations on a lessor's claim for damages. See, e.g., *In re Picnic 'N Chicken, Inc.*, (Bankr. S.D. Cal. 1986), 58 B.R. 523 .

(n77)Footnote 65. See cases cited in P 2.02[3][a] *infra* . These cases find support in earlier holdings that an assignment by a tenant of its interest in a lease coupled with a right of the tenant to sublease the premises back or reacquire its transferred leasehold interest is a financing arrangement. *In re 716 Third Ave. Holding Corp.*, 340 F.2d 42 (2d Cir. 1964) , cert. denied, 381 U.S. 913, 85 S. Ct. 1535, 14 L. Ed. 2d 434 (1965) ; *First Nat'l Bank v. Irving Trust Co.*, 74 F.2d 263 (2d Cir. 1934) . See generally Homburger & Andre, *Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 *Real Prop., Prob. and Tr. J.* 95 (1989).

(n78)Footnote 66. The term "lease" is not defined in the Code. The legislative history to the Bankruptcy Act indicates that the section 502(b)(6) limitations on a landlord's claim for damages apply only to true leases and not to financing leases intended as security, and attempts to distinguish between the two. The legislative history states that:

[W]hether a "lease" is a true or bona fide lease or, in the alternative, a financing "lease" or a lease

intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease." The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased premises for no additional consideration indicates that the transaction is a financing lease or lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal interest either on a loan secured by the leased real property or on the purchase of the leased real property.

S. Rep. No. 95-989, 95th Cong., 2d Sess. 64 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised); *see also* 4 Collier on Bankruptcy, P 502.LH[3][d] (Matthew Bender 15th Ed. Revised). The distinction made in the section 502(b)(6) legislative history has been held to be relevant to the definition of the term "lease of nonresidential real property" for purposes of subsections 365(d)(3) and (d)(4). *In re PCH Assocs.*, 804 F.2d 193, 199-200 (2d Cir. 1986) .

(n79)Footnote 67. *See Baker v. Harris Pine Mills*, 862 F.2d 217, 219-20 (9th Cir. 1988) ; *Hotel Syracuse Inc. v. City of Syracuse Ind. Dev. Agcy (In re Hotel Syracuse, Inc.)*, 155 B.R. 824, 831 (Bankr. N.D.N.Y. 1993) .

(n80)Footnote 68. *See, e.g., In re Nite Lite Inns*, 5 C.B.C.2d 1, 9, 13 B.R. 900, 907 (Bankr. S.D. Cal. 1981) (court placed "substantial reliance" on approach taken in federal tax cases).

(n81)Footnote 69. Courts have held that whether an equipment lease is a true lease for purposes of the Bankruptcy Code is a question governed by the applicable state version of *Section 1-201(37) of the Uniform Commercial Code*, defining a "security interest." The most important factor in this determination is generally whether the purchase option under the lease provides for a "nominal" option price (indicating a security agreement) or an option price at fair market value (indicating a true lease). *See, e.g., In re Puckett*, 60 B.R. 223 (Bankr. M.D. Tenn. 1986) ; *In re Cook*, 52 B.R. 558 (Bankr. D.N.D. 1985) ; *In re Mesa Refining Inc.*, 52 B.R. 359 (Bankr. D. Colo. 1985) ; *The Bank of New York v. Olympia & York Fla. Equity Corp. (In re Holywell Corp.)*, 51 B.R. 56 (Bankr. S.D. Fla. 1985) ; *see also* White & Summers, *Handbook of Law Under the Uniform Commercial Code*, § 22-3 (2d ed. 1980); Jones, *Lease or Secured Transaction--The Saga Continues Under the Bankruptcy Act*, 90 Com. L.J. 281 (1985).

(n82)Footnote 70. *See, e.g., Golden State Lanes v. Fox*, 232 Cal. App. 2d 135, 42 Cal. Rptr. 568 (1965) .

(n83)Footnote 71. The test emerging from the tax decisions indicates that a sale-leaseback will not be recharacterized if the transaction (1) was entered into for a "business purpose" other than simply obtaining tax benefits and (2) has "economic substance" (*i.e.*, the possibility of profit without regard to tax considerations). *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978) ; *Falsetti v. Commissioner*, 85 T.C. 332 (1985) ; *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985) ; *Sanderson v. Commissioner*, 50 T.C.M. (CCH) 1033 (1985) ; *West v. Commissioner*, 48 T.C.M. (CCH) 796 (1984) ; *see also* Maller, *Structuring a Sale-Leaseback Transaction*, 15 Real Est. L.J. 291 (1987); Steele, *Sham in Substance: The Tax Court's Emerging Standard for Testing Sale-Leasebacks*, 14 J. of Real Estate Tax'n 3 (1986); Burstein, *Distinguishing True Leases From Conditional Sales and Financing Arrangements*, 63 Taxes 395 (1985).

(n84)Footnote 72. 11 U.S.C. § 365(d)(3). This provisions was enacted as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984 and were prepared by representatives of the International Council of Shopping Centers. *See generally* Shopping Center Bankruptcy, Hearing before the Subcommittee on Monopolies and Commercial Law of the Committee on the Judiciary, House of Representatives, H.R. 2377 and H.R. 5187 98th Cong., 2d Sess. (1984).

(n85)Footnote 72a. 11 U.S.C. § 365(d)(4), as amended by Pub. L. No. 109-8, § 404 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Prior to the amendments to such subsection by the 2005 Act, which applies to bankruptcy cases commenced on or after October 17, 2005, section 365(d)(4) provided for an initial 60-day period after which the lease would be deemed rejected, but allowed the court to grant potentially unlimited extensions for cause within such initial 60-day period. In practice, prior to the 2005 Act, it was somewhat routine for bankruptcy courts to find "cause" and grant such extensions of the period. This practice likely will be eviscerated by the new statutory absolute deadline of 210 days (initial 120 period, plus one 90-day extension for cause) unless the lessor consents in writing.

(n86)Footnote 72b. 11 U.S.C. § 503(b)(1) (permitting as an administrative expense the actual, necessary costs and expenses of preserving the estate).

(n87)Footnote 73. The agreements between lessors and debtor-lessees providing for the surrender of the premises to the lessor and the receipt by the estate of consideration therefor become known as "Pick-Off" Agreements. *See* PP 3.01[b][I][B] and 3.02 *infra* .

(n88)Footnote 74. *See In re Rare Coin Galleries, Inc.*, 72 B.R. 415 (D. Mass. 1987) ; *cf. In re Sullivan Machinery Co.*, 79 B.R. 523 (Bankr. D. Conn. 1987) ; *In re Orvco, Inc.*, 95 B.R. 724 (B.A.P. 9th Cir. 1989) (section 365(d)(3) payments have administrative priority status *pro rata* with all other regular administrative claims and payments on account of postrejection possession are to reflect the reasonable value of the premises to the estate); *In re Four Star Pizza, Inc.*, 135 B.R. 498, 500 (Bankr. W.D. Pa. 1992) (section 365(d)(3) claim is to be paid immediately unless substantial doubt exists as to the availability of funds to pay all administrative costs).

(n89)Footnote 75. *See City of Olathe v. Kar Dev. Assocs. (In re Kar Dev. Assocs.)*, 180 B.R. 629, 638 (D. Kan. 1995) , *stay denied*, *In re Kar Dev. Assocs.* 182 B.R. 870 (D. Kan. 1995) ; *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 746, 24 C.B.C.2d 2123 (2d Cir. 1991) .

(n90)Footnote 76. *See In re PCH Assocs.*, 804 F.2d 193 (2d Cir. 1986) ; *Barney's, Inc. v. Isetan Co. Ltd. (In re Barney's, Inc.)*, 206 B.R. 328 (Bankr. S.D.N.Y. 1997) .

(n91)Footnote 77. *In re PCH Assocs.*, 949 F.2d 585, 598, 25 C.B.C.2d 1393 (2d. Cir. 1991) .

(n92)Footnote 78. *See In re Independence Vill., Inc.*, 13 C.B.C.2d 476, 52 B.R. 715 (Bankr. E.D. Mich 1985) .

(n93)Footnote 79. *See* 11. U.S.C. § 506(b) (oversecured creditor entitled to postpetition interest).

(n94)Footnote 80. *See* P 3.03[2] *infra*.

(n95)Footnote 81. *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744 (2d Cir. 1991) ; *In re Moreggia & Sons, Inc.* 852 F.2d 1179, 19 C.B.C.2d 949 (9th Cir. 1988) ; *Barney's, Inc. v. Isetan Co. (In re Barney's, Inc.)*, 206 B.R. 328 (Bankr. S.D.N.Y. 1997) ; *City of Olathe v. Kar Dev. Assocs. (In re Kar Dev. Assocs.)*, 180 B.R. 629, 638 (D. Kan. 1995) , *stay denied*, 182 B.R. 870 (D. Kan. 1995) ; *Hotel Syracuse, Inc. v. City of Syracuse Indus. Dev. Agency*, 155 B.R. 824 (Bankr. N.D.N.Y. 1993) . The following cases applied state law to the determination: *In re Wilcox*, 201 B.R. 334 (Bankr. N.D.N.Y. 1996) ; *In re Taylor*, 130. B.R. 849 (Bankr. E.D. Ark. 1991) ; *In re Wingspread Corp.*, 24 C.B.C.2d 244, 116 B.R. 915 (Bankr. S.D.N.Y. 1990) ; *In re Petroleum Prods, Inc.* 72 B.R. 739 (Bankr. D. Kan. 1987) , *aff'd*, 150 B.R. 270 (D. Kan. 1993) ; *In re Harris Pine Mills*, 79 B.R. 919 (D. Or. 1987) (logging agreements).

(n96)Footnote 82. *See Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) ; the *Butner* decision and other Supreme Court holdings are discussed at P 2.02[3][b] *infra*.

(n97)Footnote 83. *See* P 2.02[3][e] *infra*.

(n98)Footnote 84. 804 F.2d 193 (2d Cir. 1986) ("PCH I"). The Court of Appeals for the Second Circuit determined that the recharacterized lease was in fact a secured financing transaction in *In re PCH Assocs.*, 949 F.2d 585, 25 C.B.C.2d 1393 (2d Cir. 1991) ("PCH II").

(N99)Footnote 85. 55 B.R. 273 (Bankr. S.D.N.Y. 1985) ; 60 B.R. 870 (S.D.N.Y. 1986) .

(n100)Footnote 86. The court concluded that the distinction between true leases and financing transactions made in the legislative history of section 502(b)(6) applied to subsections 365(d)(3) and (d)(4) as well. See note 66 *supra*.

(n101)Footnote 87. 55 B.R. 273, 276 .

(n102)Footnote 88. The bankruptcy court did not indicate whether it believed that the value of the land was higher or lower than the \$5 million purchase price.

(n103)Footnote 89. The mortgage apparently encumbered both the land and the hotel, so it is not illogical that the purchaser/lessor, as fee owner of the land, would be responsible for satisfying a portion of it. The bankruptcy court may have been concerned that the obligation was not in proportion to the relative value of the land and hotel property.

(n104)Footnote 90. 55 B.R. 273, 277 .

(n105)Footnote 91. 804 F.2d 193, 200-01 .

(n106)Footnote 92. *In re PCH Assocs.*, 949 F.2d 585, 25 C.B.C.2d 1393 (2d Cir. 1991) .

(n107)Footnote 93. *In re PCH Assocs.*, 949 F.2d 585, 601-03, 25 C.B.C.2d 1393, 1412 (2d Cir. 1991) .

(n108)Footnote 94. *In re PCH Assocs.*, 804 F.2d 193, 198 (2d Cir. 1986) .

(n109)Footnote 95. Discussed in note 66 *supra*.

(n110)Footnote 96. *In re PCH Assocs.*, 804 F.2d 193, 199-200 (2d Cir. 1986) .

(n111)Footnote 97. *In re PCH Assocs.*, 949 F.2d 585, 25 C.B.C.2d 1393 (2d Cir 1991) .

(n112)Footnote 98. *In re PCH Assocs.*, 949 F.2d 585, 597, 25 C.B.C.2d 1393 (2d Cir 1991) . The power to recharacterize a transaction was deemed inherent to the bankruptcy court in *United States v. Colorado Invesco*, 902 F. Supp. 1339, 1342 (D. Colo. 1995) ; see also *In re American Eagle Coatings, Inc.*, 353 B.R. 656 (Bankr. W.D. Mo. 2006) ; *In re Best Products Co.*, 157 B.R. 222, 230 (Bankr. S.D.N.Y. 1993) (real estate sublease recharacterized as financing transaction, court is empowered to effect a recharacterization where rights of third parties are affected in Bankruptcy Code case).

(n113)Footnote 99. See P 2.02[3][b] *infra*.

(n114)Footnote 100. 503 F. 2d 202 (2d Cir. 1974) .

(n115)Footnote 101. 503 F. 2d 202, 207 .

(n116)Footnote 102. *In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982) (Mabey, J.).

(n117)Footnote 103. See *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1185-86 (9th Cir 1988) .

(n118)Footnote 104. 852 F. 2d 1179, 1185-86, 19 C.B.C.2d 949, 956-57 (9th Cir 1988) .

(n119)Footnote 105. See text accompanying notes 20-29 *infra*.

(n120)Footnote 106. 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) ; see also *Nobelman v. American Sav. Bank*, 508 U.S. 324, 329, 113 S. Ct. 2106, 2110, 124 L. Ed. 2d 228, 28 C.B.C.2d 977, 981 (1993) .

(n121)Footnote 107. 804 F.2d 193, 196-198 ; 949 F. 2d 585, 598-600 .

(n122)Footnote 108. *Two Trees v. Builders Transport, Inc. (In re Builders Transport, Inc.)*, 471 F.3d 1178 (11th Cir. 2006) , cert. denied, 550 U.S. 904, 127 S. Ct. 2112, 167 L. Ed. 2d 814 (2007) ; *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1185-86, 19 C.B.C.2d 949 (9th Cir 1988) ; *In re Martin Bros. Toolmakers, Inc.*, 796 F.2d 1435 (11th Cir. 1986) ; *City of Olathe v. Kar Dev. Assocs. (In re Kar Dev. Assocs.)*, 180 B.R. 629 (D. Kan. 1995) , stay denied, 182 B.R. 870 (D. Kan. 1995) ; *Hotel Syracuse, Inc. v. City of Syracuse Ind. Dev. Agency (In re Hotel Syracuse, Inc.)*, 155 B.R. 824 (Bankr. N.D.N.Y. 1993) ; *First Alabama Bank v. Shelby Motel Group (In re Shelby Motel Group)*, 101 B.R. 285 (Bankr. N.D. Ala. 1989) , aff'd, 914 F. 2d 227 (11th Cir. 1990) , vacated 925 F. 2d 1583 (11th Cir. 1991) (case settled).

(n123)Footnote 109. See, e.g., *In re Martin Bros. Toolmakers*, 796 F. 2d 1435 (11th Cir. 1986) .

(n124)Footnote 110. *In re Shelby Motel Group, Inc.*, 101 B.R. 285, 287 (Bankr. N.D. Ala. 1989) , aff'd, 914 F. 2d 227 (11th Cir. 1990) , vacated, 925 F. 2d 1583 (11th Cir. 1991) (case settled).

(n125)Footnote 111. 180 B.R. 629 (D. Kan. 1995) , stay denied, 182 B.R. 870 (D. Kan.1995) .

(n126)Footnote 112. 180 B.R. 629, 631 .

(n127)Footnote 113. 180 B.R. 629, 632 .

(n128)Footnote 114. 180 B.R. 629, 635 .

(n129)Footnote 115. 180 B.R. 629, 636 .

(n130)Footnote 116. *In re PCH Assocs.*, 804 F.2d 193, 198 (2d Cir. 1986) .

(n131)Footnote 117. 180 B.R. 629, 635 .

(n132)Footnote 118. 852 F. 2d 1179, 19 C.B.C.2d 949 (9th Cir 1988) cited at 180 B.R. 629, 635 .

(n133)Footnote 119. H.R. Rep. No. 595, 95th Cong., 2d Sess. 314 (1978), cited in *Kar* at 180 B.R. 629, 635 .

(n134)Footnote 120. 180 B.R 629 at 635, 636 .

(n135)Footnote 121. *Dewsnup v. Timm*, 502 U.S. 410, 433-34, 112 S. Ct. 773, 786-87, 116 L. Ed. 2d 903, 921-22, 25 C.B.C.2d 1297, 1312-13 (1992) (Scalia, J.).

(n136)Footnote 122. 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) , cited in *Kar* at 180 B.R. 629, 636 .

(n137)Footnote 123. See P 2.03[1][b] note 2 *infra*.

(n138)Footnote 124. See P 2.03[1][c][i] *infra*.

(n139)Footnote 125. 440 U.S. 48, 55, 99 S. Ct. 914, 917, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) (emphasis supplied). *Butner* appears to have been reaffirmed in *Nobelman v. American Sav. Bank*, note 106 *supra* , which dealt with the bifurcation under section 506(a) of an undersecured mortgage claim in a chapter 13 case. The Court in *Nobelman* stated:

In the absence of a controlling federal rule, we generally assume that Congress has "left the determination of property rights in the assets of a bankrupt's estate to state law," since such [p]roperty interests are created and defined by state law." [citing *Butner*]. See also *Barnhill v. Johnson*, 503 U.S. 393, 398, 112 S. Ct. 1386, 1389, 118 L. Ed. 2d 39, 26 C.B.C.2d 323 (1992) . Moreover we have specifically recognized that "[t]he justifications for application of state law are not limited to ownership interests, "but apply with equal force to security interests, including the interest of a mortgagee." *Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136 .

(n140)Footnote 126. 503 U.S. 393, 112 S. Ct. 1386, 118 L. Ed. 2d 39, 26 C.B.C.2d 323 (1992) .

(n141)Footnote 127. 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) .

(n142)Footnote 128. 180 B.R. 629, 637-38 . It should be noted that the Supreme Court in *Nobelman*, note 106 *supra* , did not employ the *Butner* terminology of an overriding "federal interest," (see quoted language on p. 2-66 *supra*), but instead mandated the application of state law to the determination of property rights "[I]n the absence of a controlling federal rule." (n.125 *supra*). The reference in *Nobelman* to a controlling federal rule, in contrast to the *Butner* formulation of an overriding federal interest, may signal that federal preemption of state property law in the context of cases under the Bankruptcy Code may only occur where there is a specific federal rule that alters state law. See, for example, section 552(b)(2), dealing with the perfection of assignments of rent [P 2.03[1][c] *infra*].

(n143)Footnote 129. 180 B.R. 629, 637-38 .

(n144)Footnote 130. 180 B.R. 629, 638 .

(n145)Footnote 131. 180 B.R. 629, 638 .

(n146)Footnote 132. *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 19 C.B.C.2d 949 (9th Cir. 1988) ; *In re Hotel Syracuse, Inc.*, 155 B.R. 824 (Bankr. N.D.N.Y. 1993) ; *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 24 C.B.C.2d 2123 (2d Cir. 1991) .

(n147)Footnote 133. See cases cited in ns.106, 126-27 *supra*. State law is applied in non-IRB cases where there no policy issue is articulated. See *Dunes Hotel Assocs. v. Hyatt Corp.* (*In re Dunes Hotel Assocs.*), 212 B.R. 110, 119-20 (Bankr. D.S.C. 1997) (characterization issue of hotel management agreement or real property lease); *In re Gasoil, Inc.*, 14 C.B.C.2d 556, 59 B.R. 804 (Bankr. N.D. Ohio 1986) (oil and gas leases characterized as real property leases for purposes of section 365(d)(4).

(n148)Footnote 134. See text accompanying note 119 *supra*.

(n149)Footnote 134a. 124 Cong. Rec. H 11,047-117 (Sept. 28, 1978); S 17,403-34 (Oct. 6, 1978) *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(d)-(f) (Matthew Bender 15th Ed. Revised).

(n150)Footnote 135. 796 F. 2d 1435 (11th Cir. 1986) .

(n151)Footnote 136. 796 F.2d 1435, 1439-40 .

(n152)Footnote 137. 796 F. 2d 1435, 1440 .

(n153)Footnote 138. *City of Olathe v. Kar Dev. Assocs.* (*In re Kar Dev. Assocs.*), 180 B.R. 629 (D. Kan. 1995) , *stay denied*, 182 B.R. 870 (D. Kan. 1995) .

(n154)Footnote 139. 796 F. 2d 1435, 1439 .

(n155)Footnote 140. 852 F.2d 1179, 19 C.B.C.2d 949 (9th Cir. 1988) .

(n156)Footnote 141. 852 F.2d 1179, 1182, 19 C.B.C.2d 949 .

(n157)Footnote 142. 852 F.2d 1179, 1186, 19 C.B.C.2d 949 .

(n158)Footnote 142a. 180 B.R. 629, 637-38 . It should be noted that the Supreme Court in *Nobelman*, note 106 *supra* , did not employ the *Butner* terminology of an overriding "federal interest," (see quoted language on p. 2-66 *supra*), but instead mandated the application of state law to the determination of property rights "[I]n the absence of a controlling federal rule." (n.125 *supra*). The reference in *Nobelman* to a controlling federal rule, in contrast to the *Butner* formulation of an overriding federal interest, may signal that federal preemption of state property law in the context of cases under the Bankruptcy Code may only occur where there is a specific federal rule that alters state law. See, for example, section 552(b)(2), dealing with the perfection of assignments of rent [P 2.03[1][c] *infra*].

(n159)Footnote 143. 503 U.S. 393, 112 S. Ct. 1386, 118 L. Ed. 2d 39, 26 C.B.C.2d 323 (1992) .

(n160)Footnote 144. 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) . Other IRB cases not discussed herein include *In re Wingspread Corp.*, 24 C.B.C.2d 244, 116 B.R. 915 (Bankr. S.D.N.Y. 1990) ; *In re Opelika Mfg. Corp.*, 67 B.R. 169 (Bankr. N.D. Ill. 1986) ; *In re Central Foundry Co.*, 48 B.R. 895 (Bankr. N.D. Ala. 1985) .

(n161)Footnote 144a. 180 B.R. 629, 637-38 . It should be noted that the Supreme Court in *Nobelman*, note 106 *supra* , did not employ the *Butner* terminology of an overriding "federal interest," (see quoted language on p. 2-66 *supra*), but instead mandated the application of state law to the determination of property rights "[I]n the absence of a controlling federal rule." (n.125 *supra*). The reference in *Nobelman* to a controlling federal rule, in contrast to the *Butner* formulation of an overriding federal interest, may signal that federal preemption of state property law in the context of cases under the Bankruptcy Code may only occur where there is a specific federal rule that alters state law. See, for example, section 552(b)(2), dealing with the perfection of assignments of rent [P 2.03[1][c] *infra*].

(n162)Footnote 145. 804 F.2d 193 (2d Cir. 1986) . The facts and holdings in *PCH* are set forth in P 2.02[3][a] *supra* .

(n163)Footnote 146. See *In re Hotel Syracuse, Inc.*, 155 B.R. 824, 839-40 (Bankr. N.D.N.Y. 1993) ; *In re Challa*, 186 B.R. 750, 757 (Bankr. M.D. Fla. 1995) ; see also *United Air Lines, Inc. v. HSC Bank USA*, 307 B.R. 618 (Bankr. N.D. Ill. 2004) , *rev'd*, 317 B.R. 335 (N.D. Ill. 2004) , *rev'd*, 416 F.3d 609 (7th Cir. 2005) , *cert. denied*, 547 U.S. 1003, 126 S. Ct. 1465, 164 L. Ed. 2d 247 (2006) ; *In re Dena Corp.*, 312 B.R. 162 (Bankr. N.D. Ill. 2004) ; *In re Big Buck Brewery & Steakhouse, Inc.*, 54 C.B.C.2d 326, 2005 U.S. Dist. LEXIS 10754 (E.D. Mich. 2005) .

(n164)Footnote 147. 936 F.2d 744, 24 C.B.C.2d 2123 (2nd Cir. 1991) .

(n165)Footnote 148. 936 F.2d 744, 746, 24 C.B.C.2d 2123 .

(n166)Footnote 149. 936 F.2d 744, 750, 24 C.B.C.2d 2123 .

(n167)Footnote 150. 936 F. 2d 744, 749 .

(n168)Footnote 151. 936 F. 2d 744, 751 .

(n169)Footnote 152. 936 F. 2d 744 .

(n170)Footnote 152a. 307 B.R. 618 (Bankr. N.D. Ill.2004) , *rev'd*, 317 B.R. 335 (N.D. Ill. 2004) , *rev'd*, 416 F.3d 609 (7th Cir. 2005) , *cert. denied*, 547 U.S. 1003, 126 S. Ct. 1465, 164 L. Ed. 2d 247 (2006) .

(n171)Footnote 152b. 155 B.R. 824 (*Bankr. N.D.N.Y.*1993) .

(n172)Footnote 152c. 307 B.R. 618, 632 .

(n173)Footnote 152d. 307 B.R. 618, 635 .

(n174)Footnote 153. *In re PCH Assocs.*, 804 F.2d 193, 200-01 ; see also *Barney's, Inc. v. Isetan Co. (In re Barney's, Inc.)*, 206 B.R. 328, 334 (*Bankr. S.D.N.Y.* 1997) .

(n175)Footnote 154. *In re PCH Assocs.*, 804 F.2d 193 .

(n176)Footnote 155. *Id.*

(n177)Footnote 156. *Id.*

(n178)Footnote 157. *Id.*

(n179)Footnote 158. See text accompanying note 147-152 *supra*. In *In re Chateaugay Corp.*, 21 C.B.C.2d 135, 102 B.R. 335 (*Bankr. S.D.N.Y.* 1989) , the court found a failure to transfer to the putative lessor sufficient indicia of ownership to constitute a true sale-leaseback transaction. The agreements involved were tax benefit transfer agreements, which were engendered by a short-lived provision of the Internal Revenue Code (*I.R.C. § 168(f)(8)*) enacted as part of the Economic Recovery Tax Act of 1981. The court found that the governing agreement was neither a true lease nor an executory contract.

(n180)Footnote 159. *Barney's, Inc. v. Isetan Co. (In re Barney's, Inc.)*, 206 B.R. 328, 334 (*Bankr. S.D.N.Y.* 1997) .

(n181)Footnote 160. See, e.g., *In re Winston Mills, Inc.*, 2 C.B.C.2d 1267 (*Bankr. S.D.N.Y.* 1980) .

(n182)Footnote 161. 2 C.B.C.2d 1267, 6 B.R. 587, 597 (*Bankr. S.D.N.Y.* 1980) .

(n183)Footnote 162. 307 F. Supp. 271 (*N.D. Cal.* 1969) .

(n184)Footnote 163. 307 F. Supp. 271, 274 (*N.D. Cal.* 1969) .

(n185)Footnote 164. 562 F.2d 511 (7th Cir. 1977) .

(n186)Footnote 165. 562 F.2d 511, 514 (7th Cir. 1977) .

(n187)Footnote 166. 67 B.R. 793 (*Bankr. D.N.H.* 1986) .

(n188)Footnote 167. The purchaser/lessor desired a sale-leaseback structure rather than a construction loan due to a pending dispute with the U.S. Department of Labor over its construction lending practices.

(n189)Footnote 168. 67 B.R. 793, 796-97 .

(n190)Footnote 169. 132 B.R. 845 (*Bankr. W.D. Mich.* 1991) .

(n191)Footnote 170. 132 B.R. 845, 850 .

(n192)Footnote 171. 132 B.R. 845, 850 .

(n193)Footnote 172. 132 B.R. 845, 851 .

(n194)Footnote 173. 206 B.R. 328 (*Bankr. S.D.N.Y.* 1997) .

(n195)Footnote 174. 206 B.R. 328, 329 .

(n196)Footnote 175. 206 B.R. 328, 332 .

(n197)Footnote 176. 206 B.R. 328 .

(n198)Footnote 177. 206 B.R. 328, 332 .

(n199)Footnote 178. 206 B.R. 328, 334 , discussed in P 2.02[3][c] *supra*.

(n200)Footnote 179. 206 B.R. 328, 334 .

(n201)Footnote 180. 206 B.R. 328, 334-35 .

(n202)Footnote 181. 206 B.R. 328, 336 .

(n203)Footnote 182. 206 B.R. 328, 336 (citation omitted).

(n204)Footnote 183. 206 B.R. 328, 336 .

(n205)Footnote 184. See P 2.02[3][c] *supra*.

(n206)Footnote 185. See generally Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 *Real Prop., Prob. & Tr. J.* 193 (1997).

(n207)Footnote 185a. Section 505(a) of Revised Article 9 of the Uniform Commercial Code permits the filing of a financing statement for leases intended as true leases, but states that "the filing ... is not of itself a factor in determining whether the collateral secures an obligation." This principal is the same as under section 9-408 of the former Article 9.

(n208)Footnote 186. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 *Real Prop., Prob. & Tr. J.* 193 at 227 (1997).

(n209)Footnote 187. *Id.* at 242-53.

(n210)Footnote 188. *Id.* at 227.

(n211)Footnote 189. 13 C.B.C.2d 476, 52 B.R. 715 (*Bankr. E.D. Mich.* 1985) .

(n212)Footnote 190. 52 B.R. 715, 720 .

(n213)Footnote 191-192. [Reserved]

(n214)Footnote 193. See e.g., *In re Independence Village, Inc.*, 52 B.R. 715, 720, 13 C.B.C.2d 476 (*Bankr. E.D. Mich.* 1985) .

(n215)Footnote 194. See 4B *Real Estate Financing*, § 3E.01[2] (Matthew Bender 1988) (citing Nelson and Whitman, *Real Estate Finance Law* 44 (2d ed. 1985)).

(n216)Footnote 195. See P 2.02[3] *supra*.

(n217)Footnote 196. See e.g., *In re Independence Vill., Inc.*, 13 C.B.C.2d 476, 52 B.R. 715 (*Bankr. E.D. Mich.* 1985) .

(n218)Footnote 197. 796 F. 2d 1435 (11th Cir. 1986) .

(n219)Footnote 198. 796 F. 2d 1435, 1440 .

(n220)Footnote 199. *In re Petroleum Prods., Inc.*, 72 B.R. 739, 746 (Bankr. D. Kan. 1987) .

(n221)Footnote 200. 155 B.R. 824 (Bankr. N.D.N.Y. 1993) .

(n222)Footnote 201. 155 B.R. 824, 842 ; see also *United Air Lines, Inc. v. HSC Bank USA*, 307 B.R. 618 (Bankr. N.D. Ill.2004) , rev'd, 317 B.R. 335 (N.D. Ill. 2004) , rev'd, 416 F.3d 609 (7th Cir. 2005) , cert. denied, 547 U.S. 1003, 126 S. Ct. 1465, 164 L. Ed. 2d 247 (2006) .

(n223)Footnote 202. 155 B.R. 824, 842 .

(n224)Footnote 203. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 *Real Prop., Prob. & Tr. J.* 193, 196-98 (1997).

(n225)Footnote 204. *Id.* at 196-98.

(n226)Footnote 205. *Id.*

(n227)Footnote 206. *Id.* at 227.

(n228)Footnote 207. *Id.*

(n229)Footnote 208. See cases cited note 81 *supra*.

(n230)Footnote 209. See text accompanying notes 197-99 *supra*.

(n231)Footnote 210. See text accompanying notes 197-99 *supra*.

(n232)Footnote 211. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550, 573 (1978) (the "objective economic realities of a transaction" rather than its form will be determinative for tax purposes). An example of an analysis considering both the intent of the parties and the economic realities of the transaction is found in *Victoria Hardwood Lumber Co. v. Cecil I. Walker Mach. Co.* (*In re Victoria Hardwood Lumber Co.*), 95 B.R. 954 (Bankr. S.D. Ohio 1988) .

(n233)Footnote 212. *Nite Lite Inns*, 5 C.B.C.2d 1, 13 B.R. 900 (Bankr. S.D. Cal. 1981) .

(n234)Footnote 213. Certain other factors cited by the bankruptcy court in *PCH*, such as the initiation of the transaction by the seller/lessee, the subordination of the purchaser/lessor's fee interest to financing, the exculpation of the seller/lessee from personal liability and the lack of a security deposit are also typical of net lease transactions and should not be relevant to the question of whether the lease is a true lease.

(n235)Footnote 214. See e.g., *Sanderson v. Commissioner*, 50 T.C.M. (CCH) 1033, 1040 n.12 (1985) ("the existence of a net lease that shifts some economic burdens away from the owner of property is a neutral factor in determining the validity of a sale-leaseback transaction").

(n236)Footnote 215. 1B U.L.A. 149 (Supp. 1996). As of May 1, 1997, the three states that had not adopted Article 2A were Connecticut, Louisiana, and South Carolina. Equipment Leasing, ch.3 supp. app. (Matthew Bender).

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.03

P 2.03 Assignments of Rent

[1] The Mortgagor as Debtor Under the Code

[a] Introduction

In most real estate mortgage transactions involving rent-producing assets, the documentation will include an assignment of rents, or an assignment of rents and leases, from the mortgagor to the mortgagee. Although the assignment typically is set forth in the granting clause of the mortgage, it is quite often also set forth in a separate instrument, which may include additional provisions governing the mortgagor's entry into, and modification and termination of, leases of space in the mortgaged premises. The mortgage gives to the lender a lien on the land and improvements of the borrower; the assignment of rents, whether set forth separately or in a mortgage, grants to the lender a lien on the going-concern value of the real property in the form of the rental stream generated thereby.ⁿ¹

In the context of a single asset real estate Bankruptcy Code case of a mortgagor, the outcome of the contest between the mortgagee and the trustee for control over the rental stream from the mortgaged premises will materially affect the strengths and bargaining positions of the parties. A mortgagee receiving a stream of payments in the postpetition period will have a different posture in the case than will a mortgagee that is constrained to stand by while the application of the rents and profits is controlled by the trustee.ⁿ² Accordingly, the following sections will deal with:

(1) the preparation by a lender of instruments of assignment that tend to enhance the prospects for early control over rents and profits of the mortgaged premises under a defaulted mortgage, to the extent such control is permitted under applicable law; and

(2) the effect of the mortgagor's Bankruptcy Code case upon the lender's remedies under the assignment.

[b] Varieties of Assignment of Rents

Assignments of rents tend to take different forms in different jurisdictions reflective of the governing law, and of local custom and practice.ⁿ³ The differences in local practice are also reflected in differences in terminology employed to describe the various assignment instruments.

The bankruptcy courts, when adjudicating the rights and remedies of a mortgagee under an assignment of rents with

respect to a debtor-mortgagor, are required to apply state law to determine the fundamental rights of the mortgagee before determining how those rights may be affected by the provisions of the Bankruptcy Code.ⁿ⁴ Therefore, in reviewing the numerous bankruptcy court decisions involving the rights of mortgagees under rent assignments following the mortgagor's filing of a Bankruptcy Code petition, it is important to consider each result in the context of the state law applied therein and of the variations in terminology that arise by reason of legal and practice differences among the states. Thus, a bankruptcy court in New York and another bankruptcy court in California, faced with the same facts but construing assignment instruments prepared in accordance with standard practice as understood in their respective jurisdictions, may well render different rulings with respect to the secured creditor's right to receive all or part of the rents and profits from the property.ⁿ⁵ Both decisions may be correct, but they will be distinguishable.

In order to appreciate the distinctions between the cases, it is first necessary to understand certain of the terminology employed in this area. Assignments of rents may be classified as "true absolute" assignments of rents, "conditional absolute" assignments of rents and "collateral" assignments of rents.ⁿ⁶

A "true absolute" assignment of rents is one in which the assignor presently sells and disposes of all of its title and interest in a property's rents and profits. This type of assignment is typically used in purchase and sale transactions, where a present and total transfer of the rents is in fact intended, but is inappropriate for real estate mortgage transactions inasmuch as the assignment cannot survive the satisfaction and discharge of the underlying indebtedness.ⁿ⁷ In the context of a loan workout or restructuring, it may be the case that the borrower absolutely assigns to the lender the right to collect designated rent receivables. However, such an assignment itself constitutes a payment against the debt, placing the risk of collection upon the lender. This would be a transfer or "sale" transaction employed as a methodology for the lender's realization upon its collateral, and not a transaction creating a security interest.^{n7a}

When an assignment purporting to be an "absolute assignment" is used in a real estate mortgage transaction, the right of the mortgagee to directly collect the rents typically is made conditional upon the occurrence of a default by the mortgagor under the mortgage. This form of "conditional absolute" assignment is usually drafted in the form of a present and absolute assignment of the rents by the mortgagor to the mortgagee together with a license back from the mortgagee to the mortgagor, permitting the mortgagor to continue to collect and use the rents until the occurrence of a default under the mortgage.ⁿ⁸ Upon the occurrence of a default, the license will expire either automatically or upon notice to the mortgagor, depending on the preference of the drafter.ⁿ⁹ The rental proceeds will represent cash collateral in the hands of the mortgage lender, which would be subject to a turnover order under section 542(a).^{n9a}

A "collateral" assignment of rents does not purport to be a present assignment of rents, but instead is a grant of a lien and security interest in the rents as additional security for the mortgage loan.ⁿ¹⁰ Even language such as "absolute assignment" in the document will not preclude the court from deeming the grant to be a collateral assignment if the purpose of the language was to signify the creation of a security interest.^{n10a} Under a "conditional absolute" assignment of rents, absent the interposition of a Bankruptcy Code filing by the mortgagor, the only step required to be taken by the mortgagee to take control over the asset's rental stream after termination of the mortgagor's right of collection is to notify each tenant at the property that rentals should thereafter be paid to the mortgagee.ⁿ¹¹ In contrast, under a collateral assignment of rents, some additional action must be taken by the mortgagee after a default under the mortgage to activate the mortgagee's right to begin to collect the rents. In most jurisdictions, this action will be either: (1) the appointment of a receiver for the property; (2) the issuance by a state court of an order of sequestration of the rents; (3) the taking of possession of the mortgaged premises by the mortgagee; or (4) foreclosure.ⁿ¹²

As more fully discussed below, the characterization of an instrument of assignment of rents may significantly affect the remedies available to the mortgagee respecting the rental stream from the mortgaged premises following the filing of a Bankruptcy Code petition by the mortgagor.

[c] Enforcement of Assignments of Rents Against the Mortgagor's Trustee

[i] The Relationship Between State Law and the Bankruptcy Code

As noted above, the underlying enforceability of an assignment of rents by a mortgagee against a mortgagor-debtor in a Bankruptcy Code case is determined by applicable state law. In *Butner v. United States*,ⁿ¹³ the Supreme Court addressed squarely the question whether state or federal law should govern assignments of rent in the context of the obligor's bankruptcy. The Court held that state law, rather than a federal rule of equity, should govern determinations as to the validity and enforceability of the assignments. With respect to the circumstance under which bankruptcy intervened before the mortgagee could take the steps necessary to enforce or "perfect" the assignment, the court stated that "the federal bankruptcy court should take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy the same protection he would have [received] under state law if no bankruptcy had ensued."ⁿ¹⁴

The *Butner* case was decided in the context of a proceeding under Chapter XI of the former Bankruptcy Act. Accordingly, the opinion did not address the effect of section 552(b), and focused instead on procedures to be followed in bankruptcy courts to permit mortgage creditors to enforce or "perfect" their liens notwithstanding the interposition of the bankruptcy case. However, the Court acknowledged that Congress could enact a statute defining a mortgagee's interest in rents and profits of a debtor in bankruptcy should it choose to do so. The Court stated:

The constitutional authority of Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States [fn. Omitted] would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule.^{n14a}

The Bankruptcy Code, as enacted in 1978, contained a section 552(b), which provided as follows:

Except as provided in sections 363, 506(c), 522, 544, 545, 547 and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement *and by applicable nonbankruptcy law*, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. (emphasis added).

The phrase in section 552(b) referring to applicable nonbankruptcy law codified the Supreme Court's position in the *Butner* case that state law, and not a federal rule of equity, should govern the enforceability and perfection of assignments of rents in cases under the Code. Under this version of section 552(b), once a mortgagee's entitlements to rent receivables was established under applicable state law, the bankruptcy court would recognize the lender's interest in such receivables generated in the postpetition period.

Section 552(b) was amended by the Bankruptcy Reform Act of 1994 to provide that:

(2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.ⁿ¹⁵

One of the significant changes effected by the 1994 amendments adding section 552(b)(2) was the omission of the phrase referring to "applicable nonbankruptcy law" as a determinant of the postpetition effect of a security interest in rent receivables. Although not free from doubt,^{n15a} it appears that section 552(b)(2) reflects the Supreme Court's ruling in *Butner* to the effect that Congress may constitutionally enact a statute creating a federal law of enforceability for rent assignments in bankruptcy cases.^{n15b}

Section 552(b)(2), in recognizing the postpetition effect of an assignment of rents, constitutes an exception to the general rule set forth in section 552(a) to the effect that property acquired by the estate after the filing of a debtor's petition is not subject to a lien granted under a security agreement entered into by the debtor prior to the filing.ⁿ¹⁶

Section 552(b)(2) should be read in conjunction with section 363(a), which provides:

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.ⁿ¹⁷

Section 363(a) may be read as providing that all postpetition rents that are subject to an enforceable assignment of rents instrument necessarily constitute cash collateral regardless of whether the assignment has been activated in the prepetition period.^{n17a} Section 363(a) may also be construed as meaning that postpetition rents will qualify as cash collateral if in a particular case such rents are to be treated as collateral under the provisions of the specific assignment of rents and section 552(b)(2).ⁿ¹⁸ If, in a particular instance, postpetition rents are treated as cash collateral, then under section 363(c)(4) such rental proceeds must be segregated and accounted for by the trustee,ⁿ¹⁹ and cannot be expended unless such use is consented to by the secured party or authorized by the court pursuant to section 363(c)(2).ⁿ²⁰ Under provisions that were added to the Code by the 2005 Act, the unauthorized use of cash collateral can constitute cause for conversion or dismissal of a chapter 11 case.^{n20a} If use of cash collateral is authorized by the court, the secured party is entitled under section 363(e) to adequate protection of its interest in such collateral.ⁿ²¹

In view of the foregoing, it is clear that a mortgagee holding an assignment of rents must first establish that postpetition rental payments are subject to its lien under the terms of the assignment instrument and state law in order to: (1) establish its interest in such rents under section 552(b)(2); (2) prevent the trustee from using such rents unless authorized to do so under section 363(c)(2); and (3) seek adequate protection under section 363(e) if the trustee is authorized to use the rents.

If prior to the filing of the mortgagor's petition under the Code the mortgagee under a "conditional absolute" assignment of rents has suffered a mortgage default, properly terminated the mortgagor's collection license and begun to directly collect the rents from the property or, if the mortgagee under a collateral assignment of rents has taken one of the steps required under state law to become entitled to directly collect the rents, there should be no question as to the characterization of the postpetition rents as cash collateral.ⁿ²² If the holder of the "conditional absolute" assignment or of a conditional assignment has not completed the steps required to place the rents under direct collection prior to the filing of the mortgagor's petition, the postpetition rents should likewise constitute cash collateral notwithstanding the mortgagee's failure to place the rents under direct collection under the provisions of section 552(b)(2).ⁿ²³

However, certain issues existing prior to the amendment of section 552(b) remain outstanding. Some courts have held that under applicable state law, an absolute assignment from a borrower to a mortgage lender vests title to the rent receivables in the lender, makes such receivables immune from a turnover under section 542(a), and divests the estate of

a property interest in the receivables.^{n23a} Other courts, while acknowledging the provisions of state law, have held that federal law governs the characterization of assignments of rent in cases under the Code and that such so-called "absolute assignments" are to be considered security interests for Code purposes.^{n23b} In cases involving an assignment for security in which the lender has completed the steps required for possession of the rents prior to the filing of a petition under the Code, there is a question whether the lender has received title to the rents by reason of the right of possession or continues to hold only a security interest.^{n23c}

The resolution of these questions requires a further understanding of the characteristics and legal effect of the three types of assignment instruments described above.

[ii] Absolute Assignments

In the view of some courts, a "conditional absolute" assignment of rents under which the mortgagee has properly revoked the mortgagor's collection license resembles a true absolute assignment in the sense that, under the terms of both instruments, title to the rents from the mortgaged premises has been transferred to the assignee free and clear of any rights of the assignor to collect and receive the rents. Under this construction of "conditional absolute" assignments, the rents will not constitute property of the estate under section 541 if the mortgagor becomes a debtor under the Code after title to the rents has been transferred to the mortgagee.ⁿ²⁴ Therefore, the rents in the hands of the mortgagee will not be subject to the proscriptions of the automatic stay, and the mortgagee will be entitled, notwithstanding the mortgagor's filing under the Code, to continue to collect the rents.ⁿ²⁵ Thus, in a single asset real estate case, the filing of a petition by the mortgagor after title to the rents from the asset has passed to the mortgagee may be a futile act, because the loss of the rental stream has divested the debtor of the very resources it would otherwise employ to formulate a plan of reorganization.

Courts applying the law of Arizona, Arkansas, California, Georgia, Idaho, Michigan, Nevada, New Jersey, Texas, Vermont and Virginia have held that "conditional absolute" assignments of rents are enforceable, provided that the parties' intent to create an absolute assignment is clear and unequivocal.ⁿ²⁶ In addition, Florida and Michigan have enacted statutes which recognize "conditional absolute" assignments of rents.ⁿ²⁷

However, the concept of an indefeasible transfer of title to rents by a borrower in the context of a mortgage financing transaction may be subject to question.^{n27a} In "title theory" mortgage states, although a mortgage nominally constitutes a conveyance of title by the mortgagor to the mortgagee, it is nevertheless clear for most purposes that the parties have entered into a debtor-creditor relationship in which the indebtedness is secured by the real property described in the mortgage.ⁿ²⁸ Upon full payment and satisfaction of the mortgage debt, the grant of "title" to the mortgagee terminates, and the mortgagee is obligated to deliver an instrument of "reconveyance" to the mortgagor.ⁿ²⁹ Similarly, it may be argued that upon the transfer by a mortgagor to a mortgagee of "title" to rents and profits arising from real property, all that is intended is the creation of a lien on the rents and profits in the hands of the mortgagee.ⁿ³⁰ If the mortgagor fully pays and satisfies the secured indebtedness, the grant of "title" to the rents and profits will be deemed terminated, and such "title" will be reconveyed by the mortgagee to the mortgagor in connection with the discharge of record of the mortgage. If a mortgagee holding "title" to rents and profits revokes the mortgagor's license for collection, and the indebtedness of the mortgagor to the mortgagee is paid in full prior to the completion of foreclosure proceedings, the mortgagee may not continue to collect the rents following the satisfaction of the mortgage debt.^{n30a} If, however, the mortgagee commences to collect the rents, thereafter completes the foreclosure of the mortgage and bids-in the indebtedness at the foreclosure sale then, for state law purposes, indefeasible title (subject only to applicable rights of redemption) will at that time actually pass to the mortgagee.ⁿ³¹

Thus, the denomination of a mortgagee's interest in rents, upon the activation of an assignment of rents in a title theory state, as "title" to such rents, may not be accurate for the purposes of a Bankruptcy Code analysis, and such interest may instead be characterized as a security interest in accordance with the actual intention of the parties.ⁿ³² Accordingly, the title theory of the "conditional absolute" assignment of rents in fact may not accurately describe the legal relationship

between the mortgagor and mortgagee prior to foreclosure of the mortgage, and may instead merely describe a methodology permitted under state law by which the mortgagee may achieve expeditiously direct collection of the rents and profits.ⁿ³³ If this argument is accepted, then a mortgagee that is collecting rents under an activated "conditional absolute" assignment may not in fact have title to such rents and, therefore, may be subject to the assertion by the mortgagor's trustee in a Bankruptcy Code case that the rents have remained the property of the estate. As noted above, if such rents are deemed to be property of the estate and merely collateral in the hands of the mortgagee, the mortgagee may not continue to collect and apply the rents following the filing of the mortgagor's Bankruptcy Code petition, but the trustee will be subject to the limitations of section 363 relating to the segregation, accounting and use of cash collateral.ⁿ³⁴

[iii] Collateral Assignments

As described above, an assignment of rents can be drafted explicitly as a collateral assignment of rents, in which case certain steps must be taken upon a default by the mortgagor under the mortgage before the mortgagee will have the right to take possession of the rents.ⁿ³⁵ In addition, in most lien theory jurisdictions, courts refuse to recognize absolute assignments of rents in the context of mortgage financing transactions, no matter how clearly the provision or document may be drafted.ⁿ³⁶ In these states, a mortgagee holding an assignment of rents typically must take possession of the mortgaged property, obtain the appointment of a receiver for the property, obtain an order for sequestration of the rents or foreclose the mortgage before it may begin to collect the rents.ⁿ³⁷ Until one of these steps has been completed and the assignment of rents is deemed to have been "perfected,"ⁿ³⁸ the mortgagor is regarded as the owner of the rents and profits of the mortgaged property.ⁿ³⁹ Consequently, if the mortgagor becomes a Bankruptcy Code debtor and the mortgage is governed by the laws of a jurisdiction that recognizes only a collateral assignment of rents (or if the parties have otherwise intentionally crafted a collateral assignment of rents), and the assignment of rents has not yet been "perfected," the proscriptions of the automatic stay will prevent the mortgagee from taking any of the steps required under state law to trigger its right to collect the rents.ⁿ⁴⁰

Prior to the enactment of the 1994 amendments to section 552(b), a mortgagee unable to achieve direct collection of rents and profits from the mortgaged premises by reason of the mortgagor's filing a petition under the Code and the imposition of the automatic stay had several options.

First, the mortgagee could commence a contested matter in the bankruptcy court seeking modification or lifting of the stay to the extent necessary to permit the mortgagee to take the steps required under state law to trigger its rights to collect the rents.ⁿ⁴¹

Second, the mortgagee could move in the bankruptcy court for an order of sequestration of the rents or an order of the bankruptcy court substantially equivalent thereto. In certain jurisdictions, the courts held that this action by the mortgagee was the functional equivalent of the corresponding action required under state law in the state courts, and recognized such action as sufficient to trigger the mortgagee's rights to the rents and profits. Indeed, in some instances, courts held that the mere commencement of a contested matter to lift the stay will be deemed to constitute the necessary state law action entitling the mortgagee to collect the rents.ⁿ⁴²

Third, in a substantial number of jurisdictions, courts held that the filing of a notice of "perfection" under section 546(b) was sufficient to constitute "perfection" of the mortgagee's rights to the rents for state law and Bankruptcy Code purposes.ⁿ⁴³

Fourth, the mortgagee could, instead of merely moving to lift the stay to the extent necessary to perfect its state law rights to the rents and profits, move to dismiss the debtor's petition,ⁿ⁴⁴ to lift the stay to permit foreclosure of the mortgage,ⁿ⁴⁵ to reduce the 120 day period in which the debtor has the exclusive right to file a plan,ⁿ⁴⁶ or for the appointment of a trustee,ⁿ⁴⁷ and could file such other motions as may typically be made by a secured creditor seeking to affect the trustee's control over the collateral.

Fifth, if the mortgagee believed that it was oversecured, it could seek under section 506(b) the allowance of postpetition interest on its claim.ⁿ⁴⁸

Since the enactment of section 552(b)(2) as part of the Bankruptcy Reform Act of 1994, a mortgage creditor that is unable to complete the steps required under state law to trigger its right to collect rents under an assignment of rents by reason of the intervention of a Bankruptcy Code case appears to nevertheless have a security interest in rents generated in the postpetition period. Thus, it should no longer be necessary for the mortgagee to consider many of the steps enumerated above in order to give rise to or confirm the existence of a security interest in postpetition rents. Nevertheless, as discussed more fully below,ⁿ⁴⁹ the debtor in possession or trustee may seek to invade the cash collateral of the creditor for the purpose of operating the real estate collateral and for other purposes.^{n49a} The existence of a security interest in postpetition rents does not necessarily mean that the secured creditor may control completely their disposition. Absent such control, the debtor in possession or trustee may be able to utilize the assets available to them to fund postpetition operation of the collateral, and to delay resolution of the battle between the debtor and the secured lender as to the retention of title to the collateral, thereby in some instances improving the debtor's chances to reach a satisfactory settlement with the secured creditor.

[iv] "Perfection" of Assignments of Rents

Although it is generally believed that section 552(b)(2), as enacted as part of the Bankruptcy Reform Act of 1994, eliminated the requirement of "perfection" as a condition to the enforceability in cases under the Bankruptcy Code of otherwise valid rent assignments,^{n49b} it remains necessary to consider the issues involved in the concept of the "perfection" of an assignment of rents. Section 552(b)(2) contains the phrase "notwithstanding section 546(b) of this title." Section 546(b) deals with, among other things, the postpetition perfection of certain prepetition security interests. The reference in section 552(b)(2) to section 546(b) is remarkably cryptic, but in order to seek to understand the import of the reference it is necessary to review the "perfection" problem under section 552(b) as it existed prior to the 1994 amendment to section 552(b).

Under the Uniform Commercial Code, the concept of "perfection" means the obtaining by the debtor of rights in collateral, the execution and delivery of a binding security agreement and the execution and proper filing of one or more Uniform Commercial Code financing statements or the taking of possession of the collateral or other prescribed means of perfection.ⁿ⁵⁰ However, under the separate body of real estate law, the term "perfection" is frequently used to describe the moment at which the holder of a collateral assignment of rents has taken the steps required under state law to be entitled to direct payment of the rents from the tenants at the mortgaged property.ⁿ⁵¹ The unfortunate use of the term "perfection" to describe this moment can give rise to the inference that during the period prior to the moment of "perfection" the holder of a collateral assignment of rents is "unperfected" with all of the negative consequences that flow from such a label in a Bankruptcy Code case. In fact, the lien of a mortgagee in rents and profits from mortgaged premises attaches, and is valid and enforceable, from the moment that an instrument of assignment of rents is duly executed and delivered by the mortgagor.ⁿ⁵² This lien obtains priority as against third parties at the moment that the assignment instrument is recorded by the appropriate local governmental official.

The requirements of state law setting forth the steps to be taken before the rents can be placed on direct collection in the hands of the mortgagee do not affect the validity of the security interest granted by an assignment, and relate only to the measures required to divest a mortgagor of possession of the rental stream from the mortgaged premises.ⁿ⁵³ Instead, the imposition of obstacles to divestiture of a mortgagor's dominion over the rents reflect historical modes of protection for debtors against arbitrary and unilateral creditor actions which may be used to obtain an unfair advantage on the part of a lender.ⁿ⁵⁴ These requirements resemble closely the protections afforded by the Supreme Court under the due process clause of the Constitution against certain types of foreclosures against consumer collateral without proper notice and an opportunity to be heard.ⁿ⁵⁵ These requirements do not deal with the initial "perfection" of the mortgagee's lien.

Furthermore, if the "perfection" theory is tested without consideration of the effect of section 552(b)(2), it cannot be fairly suggested that the triggering of a mortgagee's right to directly collect rents and profits evidences a new transfer that is subject to attack as a preference under section 547 if such occurrence took place within the 90-day or one-year period prior to the filing of the debtor's Bankruptcy Code petition, as applicable.ⁿ⁵⁶ Similarly, the notion that under section 544(a) a trustee may avoid any assignment of rents that was "perfected" by enforcement of a right of possession within the applicable period of limitations would render most such assignments unenforceable under the Code.^{n56a} Therefore, it appears that the mortgagee's lien in rents and profits under an instrument of assignment attaches and is perfected, for Bankruptcy Code purposes, at the moment of execution, delivery and recordation of the instrument. The moment at which the mortgagee becomes entitled to collect the rents and profits therefore does not give rise to a "relation back" of the lien to the time of such execution, delivery and recordation, inasmuch as the lien is already effective.ⁿ⁵⁷ Although it is true that an intervening attaching creditor may interdict a mortgagor's rents and profits that are subject to a previously recorded assignment of rents prior to the time at which the mortgagee obtains the right to directly collect such rents, activation of the assignment gives the mortgagee priority over the attaching creditor from and after the date of such activation.ⁿ⁵⁸ Therefore, the mortgagee's lien at all times remains valid and enforceable, subject only to third party claims until the mortgagee proceeds to enforce its rights.

In view of the foregoing, it may be argued that upon the filing of a Bankruptcy Code petition by a mortgagor that has granted an assignment of rents to its mortgagee, the accrued and unpaid rents and, by operation of section 552(b)(2), the rents arising postpetition, constitute cash collateral from and after the date of the petition without further action on the part of the mortgagee.ⁿ⁵⁹ⁿ⁶⁰

[v] Section 546(b)

Through section 362(b)(3), the provisions of section 546(b) are available in certain cases as an exception to the automatic stay.ⁿ⁶¹ Section 546(b), as amended by the Bankruptcy Reform Act of 1994, provides:

(b)(1) The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that--

(A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection; or

(B) provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquired rights in such property before the date on which action is taken to effect such maintenance or continuation.

(2) If--

(A) a law described in paragraph (1) requires seizure of such property or commencement of an action to accomplish such perfection or maintenance or continuation of perfection of an interest in property; and

(B) such property has not been seized or such an action has not been commenced before the date of the filing of the petition;

such interest in property shall be perfected, or perfection of such interest shall be maintained or continued, by giving notice within the time fixed by such law for such seizure or such commencement.ⁿ⁶²

The legislative history for section 546(b) includes the following passages:

The rights granted to a creditor under this subsection prevail over the trustee only if the transferee

has perfected the transfer in accordance with applicable law, and that perfection relates back to a date that is before the commencement of the case.

The purpose of the subsection is to protect, in spite of the surprise intervention of a bankruptcy petition, those whom State law protects by allowing them to perfect their liens or interests as of an effective date that is earlier than the date of the perfection.

The phrase "generally applicable law" relates to those provisions of applicable law that apply both in bankruptcy cases and outside of bankruptcy cases. For example, many State laws, under the Uniform Commercial Code, permit perfection of a purchase-money security interest to relate back to defeat an earlier [perfected non-purchase-money security interest] (text of the House Report) [levy by another creditor] (text of the Senate report) if the former was perfected within ten days. *U.C.C. § 9-301(2)*. Such perfection would then be able to defeat a hypothetical judicial lien creditor on the date of the filing of the petition.ⁿ⁶³

Section 544--the so-called "strong-arm" provision--provides, among other things, for the avoidance by a trustee of unperfected liens.ⁿ⁶⁴ Although far from clear, the thrust of section 546(b) and its legislative history appears directed toward an exception to the avoidance power with respect to a consensual lien granted to a secured party in the prepetition period when:

- (1) the secured party has not as of the date of the filing of the debtor's Bankruptcy Code petition duly recorded or filed a financing statement or other document of record creating priority over subsequent third party claimants;
- (2) state law expressly recognizes the right to effect such filing or recordation on a date subsequent to the date on which such security interest was initially granted; and
- (3) under applicable state law, such filing or recordation results in a "relation-back" of the lien or security interest to the date of its initial grant.

However, in the case of an assignment of rents executed and recorded substantially contemporaneously with the consummation of a mortgage loan transaction, the relevant question is not whether a trustee may employ its powers to avoid the lien in rents and profits created by the assignment, but when (not whether) the secured party may under state law lawfully begin to directly collect rents from tenants of mortgaged premises. During the period following the filing of a mortgagor's Bankruptcy Code petition, the rents and profits from the mortgaged premises are payable to the trustee, subject to the rights of the secured party under section 363(c).^{n64a} Nevertheless, the trustee's right to receive the rents during this period does not constitute an "avoidance" of the lien or of rights of collection thereunder in the hands of the holder of the assignment. Moreover, absent the intervention of bankruptcy, although the mortgagee's rights to direct collection of rents may entitle the mortgagee to "reach back" and collect rents held by the debtor, and does entitle the mortgagee to collect accrued and unpaid rents, this is a relation-back of the mortgagee's remedy and not a relation-back of the mortgagee's lien.ⁿ⁶⁵ For these reasons, it appears that section 546(b) deals only with an exception to the lien avoidance powers of a trustee under the Bankruptcy Code, and does not provide a methodology for establishing a mortgagee's entitlement to directly collect rents under an assignment of rents.

Nevertheless, prior to the enactment of the 1994 amendments to section 552(b),^{n65a} the courts were divided over the meaning of the term "perfection" as employed in section 546(b). Some courts held that the holder of an assignment of rents could simply file a notice with the court in order to achieve the state law equivalent of the right of direct collection.ⁿ⁶⁶ A second line of cases held that section 546(b) was inapplicable and that other methods of "postpetition perfection" must be employed.ⁿ⁶⁷ Still a third line of cases appeared to accept the proposition that as of the date of filing of a mortgagor's Bankruptcy Code petition, the holder of an assignment of rents is entitled, without further action, to the rents in the hands of the debtor as of the date of the filing, to the rents accrued and unpaid as of the date of the

filing, and, under section 552(b) as in effect prior to the enactment of the 1994 amendments, to the rents arising and payable in the postpetition period.ⁿ⁶⁸

Nonetheless, the Bankruptcy Reform Act of 1994 appears in some sense to have perpetuated the view that section 546(b) provides a methodology for establishing a mortgagee's entitlement to directly collect rents under an assignment of rents and is not simply an exception to the lien avoidance powers of the trustee. The 1994 legislation amended section 552(b) to add in section 552(b)(2) the phrase "notwithstanding section 546(b) of this title" before the provisions that provide for the extension of a prepetition security interest to rents acquired by the debtor after the commencement of the case. The legislative history to the amendment, indicates that Congress intended to clarify the rights of a lender with respect to postpetition rents:

Under current *section 552 of the Bankruptcy Code*, real estate lenders are deemed to have a security interest in postpetition rents only to the extent their security interest has been "perfected" under applicable State law procedures. Inclusion under section 552, in turn, allows such proceeds to be treated as "cash collateral" under *section 363(a) of the Bankruptcy Code*, which prohibits a trustee or debtor-in-possession from using such proceeds without the consent of the lender or the authorization by the court. In a number of States, however, it is not feasible for real estate lenders to perfect their security interest prior to a bankruptcy filing; and, as a result, courts have denied lenders having interests in postpetition rents the protections offered under *section 552 and 363 of the Bankruptcy Code*. *[The amendment] provides that lenders may have valid security interests in postpetition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable State law*. This is accomplished by adding a new provision to *section 552 of the Bankruptcy Code*, applicable to lenders having a valid security interest which extends to the underlying property and the postpetition rents.^{n68a}

For the reasons set forth above, it appears that section 546(b) as in effect prior to enactment of the 1994 amendments was not directly relevant to the issue of whether the mortgagee had taken the steps required under state law to have a security interest in postpetition rents that would be protected under sections 552 and 363. Thus, the reference in section 546(b) contained in section 552(b)(2) as enacted in 1994 appears to be based on a misunderstanding of the concept of perfection as applied to assignments of rent, and does not assist in resolving the issues Congress clearly had in mind. It is also unclear whether the reference in the legislative history to "perfection" was intended to encompass acts such as seizure of the property (i.e., the type of act that may not be "feasible" prior to the petition date) or the relatively simple act of recording the appropriate instrument or uniform commercial code filing. It would appear that Congress had in mind the former type of acts and that the amendment to section 552(b) was intended to provide mortgagees with the protections of section 363 notwithstanding the failure to "activate" the assignment of rents.

Unfortunately, the language employed in section 552(b)(2) does not clearly convey the congressional intent evidenced by the passage from the legislative history set forth above.^{n68b} For convenience of reference, section 552(b)(2) is set forth herein again:

(2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

It is difficult to glean from this language a direction to recognize a security interest in postpetition rents notwithstanding any prepetition failure to "perfect," "activate," or "enforce" the rights of a secured lender to the rents. The reference in section 552(b)(2) to section 363 is problematic inasmuch as nothing in section 363 limits the existence of a security interest in postpetition rents. The reference to section 506(c), which provides for a charge against collateral,^{n68c} is understandable and appropriate. The reference to section 522 appears to refer to postpetition rents as a possible category of exempt property.

The references to sections 544 and 547 will provide difficulty only under the view that the act under state law which entitles the holder of an assignment of rents to take possession of the rents constitutes perfection of a theretofore unperfected security interest.^{n68d} Under this view, section 544--the so-called strong-arm provision--may operate to permit avoidance of the lien of the rent assignment if the prepetition perfection occurred prior to the expiration of a the applicable period of limitation.^{n68e} Similarly, section 547, dealing with preferential transfers, may operate to permit avoidance of the lien of the rent assignment if the prepetition perfection thereof occurred within the 90-day or one year (as applicable) period prior to the date of filing of the debtor's petition under the Code, and the transfer was otherwise preferential under the requirements set forth in section 547(b). This reading of section 552(b)(2) would cause the exception to swallow the rule and would permit avoidance of the lien of most every rent assignment, and therefore would take away precisely the rights that section 552(b)(2) is thought to grant.^{n68f}

The better reading of the reference in section 552(b)(2) to sections 544 and 547 would relate to the power to avoid an assignment of rents that was not properly recorded, did not constitute a valid and enforceable grant of a security interest under state law, was not properly executed and delivered, or which suffered some other infirmity unrelated to the subsequent enforcement of the right to realize on the encumbered rents thereunder.

A similar reading would apply to the reference to section 548, dealing with fraudulent transfers. The transfer to be analyzed under section 548 would be the initial grant of the security interest in an assignment of rents, and not the subsequent attainment by the secured lender of the right to realize on its lien through the collection of the rents.^{n68g}

The reference in section 552(b)(2) to section 545 relates to a trustee's power to avoid statutory liens for rent and for distress for rent.

However, the principal drafting problem in section 552(b)(2) is that it attempts to provide for a security interest in postpetition rents in the absence of prepetition "perfection"^{n68h} under state law merely by omitting the pre-amendment reference in section 552(b) to "applicable nonbankruptcy law,"ⁿ⁶⁸ⁱ rather than by expressly stating the rule and meaning intended to be conveyed. Although at least one court has gleaned such an intent from the removal of the statutory reference to applicable bankruptcy law, the section cannot be truly understood without reference to its predecessor provision and to its legislative history.^{n68j} This may be especially problematical in this instance, inasmuch as *Butner v. United States* ^{n68k} provides squarely that state law is to govern the enforceability and perfection of assignments of rent, and could be deemed to have retained its viability with respect to a statute that does not expressly provide for the application of federal law to the perfection issue.

[vi] Retroactive and Prospective Effect of an Activated Assignment of Rents

Assuming that a mortgagee has taken the steps required to become entitled under state law to directly collect the rents from tenants at the mortgaged premises, certain issues nevertheless remain as to both the retroactive and prospective effect of such an activated assignment. The rents that arguably are subject to the coverage of an activated assignment of rents include:

- (1) rents paid to and remaining in the possession of the mortgagor;
- (2) rents that are accrued and unpaid as of the date of activation of the assignment of rents;

(3) rents accruing and paid from and after the date of activation; and

(4) rents arising under leases of space at the mortgaged premises entered into following the date of such activation.

The issues are further complicated by the interposition of a Bankruptcy Code petition of the mortgagor, and the effect of such filing, and of the automatic stay associated therewith, upon a mortgagee's rights in respect of each of the types of assets and obligations referred to in the preceding sentence.

If a mortgagee holds an assignment of rents that has been activated prior to the filing of a Bankruptcy Code petition by the mortgagor, with respect to events occurring prior to the filing of the petition, state law alone will govern the mortgagee's entitlement to the different types of rents and accruals referred to above.ⁿ⁶⁹ The law appears to vary among the states with respect to a mortgagee's entitlement to rents collected and held by the mortgagor as of the moment of activation of an assignment of rents.ⁿ⁷⁰ However, it appears to be a general rule that a mortgagee holding an activated assignment is entitled to rents that have accrued but are unpaid as of the time of activation.ⁿ⁷¹ It is also a general rule that the mortgagee is entitled to collect directly rents accruing and paid from and after the date of activation.ⁿ⁷² Finally, a mortgagee's entitlement to rents paid or payable under leases first entered into after the date of activation appears to be a function of the provisions of the particular instrument of assignment and of local law.

The filing of a Bankruptcy Code petition by a mortgagor should not affect the rights of the holder of an assignment of rents after the date of such filing in respect of: (1) rents collected and held by the debtor on the date of such activation; (2) accrued and unpaid rents outstanding as of the date of activation; and (3) rents paid or payable from and after the date of activation.ⁿ⁷³ Section 552(b)(2)ⁿ⁷⁴ applies to "payments acquired by the estate after the commencement of the case." The scope of coverage of the assignment of rents will be recognized under section 552(b)(2) "to the extent provided in such security agreement"

It is less clear, however, what rights the mortgagee has with respect to the rents generated by leases that are entered into after the commencement of a case. The text of section 552(b)(2) refers to security agreements that extend "to property of the debtor acquired before the commencement of the case and to "amounts paid as rents of such property...". If the "property of the debtor" means a lease itself, then a lease entered into postpetition would seem not to constitute property acquired before the commencement of the case. If, however, the term "property" means the mortgaged premises, then the rents arising under a postpetition lease would constitute "rents or profits of such property." This latter interpretation would appear to be consistent not only with the text of section 552(b)(2), but also with customary commercial practice, as evidenced by the text of most well-drafted assignments of rents, which assign to the mortgagee the rents from all leases "now existing or hereafter entered into."

[vii] Interdiction of Rents by the Trustee

Section 506(c) provides that the trustee may recover from property securing an allowed secured claim the "reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."ⁿ⁷⁵ In the context of a single asset real estate Bankruptcy Code case, this may mean that the trustee may apply the rental stream to payment of operating expenses (taxes, insurance premiums, etc.) before any funds are remitted to the holder of an activated assignment of rents.ⁿ⁷⁶ However, inasmuch as such rents should be deemed cash collateral within the meaning of section 363(a), the mortgagee will be entitled under section 363(c)(2) to notice and a hearing prior to the application by the trustee of the rental stream, and may be entitled to adequate protection of its interest in such cash collateral under section 363(e).ⁿ⁷⁷

Although under section 363(e) a secured creditor is entitled to adequate protection of its interest in cash collateral that is used by the trustee, it appears that the trustee's application of cash collateral to the cost of preservation and protection of the underlying mortgage collateral may in itself provide adequate protection of the mortgagee's lien.ⁿ⁷⁸ It may be

argued, on the other hand, that under section 363(e) the mortgagee is entitled to adequate protection of the cash expended by the trustee, rather than protection of the underlying real estate collateral provided by the expenditure of the cash, and that adequate protection of cash collateral may be provided only by: (1) a clear and substantial "equity cushion" in the mortgaged premises in the hands of the trustee;ⁿ⁷⁹ or (2) the posting of additional collateral that is sufficiently liquid to constitute the equivalent of cash under generally accepted commercial standards.ⁿ⁸⁰

Perhaps a conflict exists between sections 506(c) and 363(e) in the context of a single asset real estate case involving an activated assignment of rents. Section 506(c) is intended to charge a secured party with collateral protection expenses that would have been incurred for the secured party's own account had the collateral been turned over by the trustee. However, section 506(c) does not contemplate the circumstance in which the funds deducted from a mortgagee's collateral base for collateral protection purposes is itself collateral within the meaning of section 363(a). Assuming, as noted above, that rental proceeds from mortgaged property will be applied to the cost of protection and preservation of the asset whether in the hands of the trustee or the mortgagee, perhaps the real issue is whether the mortgagee or the trustee should control the decisions as to the disbursement of rental proceeds to particular protection and preservation expenses. In most single asset real estate cases involving an undersecured mortgage, application of section 363(e) to the expenditure of cash collateral would mean that the trustee could not provide the necessary adequate protection, and, therefore, in all likelihood would be constrained to turn the asset over to the mortgagee. Accordingly, section 363(e) may not be applicable in the context of a single asset real estate case involving an activated assignment of rents to the extent such rents are devoted to protection and preservation of the mortgaged premises.ⁿ⁸¹

Moreover, under section 552(b)(2), the court, after notice and a hearing, "based on the equities of the case" may order that the postpetition effect of an assignment of rents be limited or modified. This so-called "equity exception" to section 552(b)(2), which was also contained in section 552(b) prior to enactment of the 1994 amendments,ⁿ⁸² has been explained as follows:

The equity exception is meant for the case where the trustee or debtor in possession uses other assets of the bankrupt estate (assets that would otherwise go to the general creditors) to increase the value of the collateral.[citation omitted] Suppose a creditor had a security interest in raw materials worth \$1 million, and the debtor invested \$100,000 to turn those raw materials into a finished product which he then sold for \$1.5 million. The proceeds of this sale (after deducting wages and other administrative expenses) would be added to the secured creditor's collateral unless the court decided that it would be inequitable to do so--as well it might be, since the general creditors were in effect responsible for much or all of the increase in the value of the proceeds over the original collateral.^{n82a}

Thus, the principal thrust of the "equities of the case" exception to section 552(b)(2) is to prevent the unfair value enhancement of a secured creditor's collateral through the estate creating proceeds by employing unencumbered funds that might otherwise be available to unsecured creditors.^{n82b} In the circumstance of a single asset real estate case involving an undersecured nonrecourse mortgage and an enforceable assignment of rents, there is ordinarily no source of unencumbered funds within the operating system of the debtor inasmuch as all funds are comprised of rental proceeds that are subject to the lien of the assignment of rents. Therefore, in the absence of a new contribution by the owners of the entity or from other outside sources, there can be no instance in which the "equities of the case" exception as described above would apply in the typical single asset case involving an undersecured mortgage lender.^{n82c}

However, the "equities of the case" exception is not always described in the manner set forth above. In *In re Vienna Park Prop.*,^{n82d} the Court of Appeals for the Second Circuit stated that "the court might well exercise its equitable power to strip a creditor of rights to post-petition rents prior to the point at which, under applicable state law, the creditor would likely have been able to enforce those rights."^{n82e} It appears that this characterization of the equity exception was made in the context of the view that a lender holding an enforceable assignment of rents is, under section 552(b), entitled to a lien on postpetition rents commencing as of the petition date. The court was concerned that lenders that had been tardy in enforcing their rights against mortgage debtors could realize an unintended benefit as a result of

the filing of a petition under the Code by such debtors, and was articulating a rule that would defer the lenders' rights in respect of postpetition rents to the time when the rights would first have accrued under state law. This part of section 552(b) could be construed as meaning that when a reasonable prospect for reorganization exists, a court may not permit a mortgagee in a single asset real estate case to enforce its rights to collect all of the rents and profits of the mortgaged property, and to thereby frustrate the debtor's efforts to promulgate a plan.^{n82f} Finally, it should be noted that, under the laws of some states, an assignment of rents is deemed to apply to the net rents, and not the gross rents of the mortgaged premises. Under this formulation, the mortgagee's lien is deemed never to have attached to the portion of a rental stream used for expenses of preservation and protection of mortgaged premises.ⁿ⁸³ Therefore, this portion of the rent stream would not constitute cash collateral under section 363(a), and could be expended without any requirement to provide to the mortgagee adequate protection under section 363(e).

[viii] Application of Rental Proceeds to Interest and Principal

Under section 506(b), the holder of an allowed secured claim secured by property having a value, after deduction of the reasonable and necessary costs and expenses of protecting and preserving the collateral, that is greater than the amount of such claim, is entitled as part of its allowed claim to the payment of postpetition interest, and any reasonable fees, costs or charges provided for under the governing security agreement.ⁿ⁸⁴ Section 506(b) deals only with allowance of a claim for postpetition interest and other charges for the benefit of an oversecured creditor, and does not address the question whether such a creditor is entitled to payment of such interest and charges on a current basis following the filing of an obligor's Bankruptcy Code petition (as opposed to payment of such interest and charges as part of the distributions effected under a plan).ⁿ⁸⁵ However, if the holder of an activated assignment of rents under an oversecured mortgage is permitted to collect all or a part of such rents on a current basis following the filing of a Bankruptcy Code petition by the mortgagor, under the provisions of section 506(b) the mortgagee should be permitted to apply such collections to the payment of interest and costs of collection (including reasonable attorneys' fees) under the terms of the mortgage and the assignment instruments.ⁿ⁸⁶ Any payments received by the mortgagee in excess of amounts necessary to pay interest and such charges should be applied to reduction of principal.

Undersecured creditors are not entitled to an allowed claim for postpetition interest.^{n86a} In addition, undersecured creditors are not entitled to adequate protection payments as compensation for the loss of investment earnings on the proceeds of a hypothetical foreclosure sale of the collateral which could have been realized but for the imposition of the automatic stay in the debtor's Bankruptcy Code case.ⁿ⁸⁷ This rule deals only with the disallowance of a category of adequate protection payments relating to compensation of undersecured creditors for the loss of reinvestment income on the proceeds of collateral. This rule does not mean that an undersecured creditor holding an activated assignment of rents is not entitled to collect rents from the mortgaged premises following the filing of a Bankruptcy Code petition by the mortgagor.^{n87a} The rents to be collected do not constitute adequate protection payments under section 361; instead, such collections constitute the realization on the lien of a mortgagee holding an activated assignment of rents, as permitted under section 552(b)(2). Payments made under section 361 are intended to compensate secured creditors for loss of collateral value arising from, among other things, the imposition of the automatic stay. In contrast, payments received by a secured creditor under section 522(b) are not attributable to protection against loss of collateral value, and instead represent a realization on a secured claim.

In view of the rule that undersecured creditors are not entitled to an allowed claim for postpetition interest, payments received by an undersecured mortgagee holding an activated assignment of rents should be applied to reduction of its claim for principal.ⁿ⁸⁸ However, the analysis must consider whether the amount of the total principal claim of an undersecured creditor is determined with or without reference to the incremental value to the secured creditor of rents collected but not actually paid to the secured creditor. If the amount of the secured claim is determined with reference to the incremental value of postpetition rents collected and not disbursed, then, in the view of some courts, the unexpended rents are to be added to the collateral value available to the secured creditor, thereby increasing the amount of its secured claim and correspondingly decreasing the amount of its deficiency claim.ⁿ⁸⁹ Under this approach, sometimes characterized as the "wash" method, (1) rents received (but not yet disbursed) under section 552(b)(2) are added to the

value of the secured claim, fixed as of the date of confirmation, (2) the deficiency claim is reduced by an amount equal to the amount so added to the secured claim, and (3) the secured claim is then reduced by the amount of the section 552(b)(2) rents theretofore or then paid to the secured creditor--the wash. The net result of the "wash cases" is that for confirmation purposes the total allowed claim of an undersecured creditor receiving payments under section 552(b)(2) is equal to (a) a secured claim in an amount equal to the value of the creditor's interest in the collateral determined as of the confirmation date, and (b) an unsecured claim in an amount equal to the deficiency determined as of the confirmation date, less the amount of the postpetition payments received by the creditor under section 552(b)(2).ⁿ⁹⁰ Thus, the total principal claim of the undersecured creditor (secured and unsecured) will be reduced by the same amount as reduced the deficiency portion of the total claim. Under these holdings, postpetition section 552(b)(2) payments to undersecured creditors are applied in the same manner as would be prepetition prepayments of principal that are not subject to avoidance under the Code.

In view of the application of collateral proceeds to the reduction of principal, the foregoing approach does not result in the payment of postpetition interest to an undersecured creditor. However, it is theoretically possible that the augmentation of the secured claim of an undersecured creditor through the addition thereto of postpetition rents will eliminate the deficiency and result in an oversecured claim. If payment to the creditor of postpetition rents does not restore the secured claim to undersecured status, the secured creditor will be entitled to postpetition interest for the period during which and to the extent that it is oversecured.ⁿ⁹¹

Another attribute of the wash cases is that the treatment of section 552(b)(2) payments as additions to the collateral package subject to the security interest renders such funds eligible for adequate protection under the Code. Thus the disbursement of such funds for the benefit of the debtor (rather than for the benefit of the secured creditor under section 506(c)) requires the provision of adequate protection for the cash so expended.ⁿ⁹²

A second approach is found in the "subtraction cases."ⁿ⁹³ In these cases, the value of the collateral is fixed as of the date of filing of the petition rather than as of the date of confirmation. The postpetition rents to which an undersecured creditor is entitled under section 552(b)(2) are subtracted from the amount of principal of the secured portion of the claim, leaving unaffected the unsecured portion of the claim.

The courts adopting the subtraction approach appear to view monies paid to an undersecured creditor under section 552(b)(2) as some type of adequate protection payment that under governing law can be applied nowhere other than to principal. Inasmuch as these cases all arise in the absence of postpetition erosion of the value of the collateral, these courts have concluded that failure to apply the section 552(b)(2) funds to reduction of the secured claim of an undersecured creditor would result in the payment of postpetition interest or of adequate protection compensation contrary to the holding of the Supreme Court in the *Timbers* case.ⁿ⁹⁴ These courts have also accepted the argument that the valuation of income producing real property at the outset of a case is ordinarily calculated as a multiple of the projected cash flow of the property, and that the augmentation of this value through the addition of postpetition rents results in an impermissible double counting of the same rental stream. The perceived double counting is, of course, viewed as a windfall to the secured creditor and an unwarranted detriment to the debtor.ⁿ⁹⁵ These courts view the subtraction from the original secured claim of an undersecured creditor of rents paid to that creditor under section 552(b)(2) as simply the ordinary process of liquidation of prepetition collateral.ⁿ⁹⁶

A third line of cases rejects both the wash holdings and the subtraction cases, and adopts a so-called dual valuation approach.ⁿ⁹⁷ The holding of these cases has been summarized as follows:

(1) For purposes of adequate protection, the claim of the secured creditor is fixed as of the date of filing. Section 552(b) proceeds increase the collateral securing that claim, but do not increase the claim for purposes of adequate protection. Accordingly, if the underlying collateral is not declining in value the additional cash collateral may be used by the Debtor to pay administrative expenses, as well as to maintain or improve the underlying collateral or to make payments on the creditors [sic] claim. However,

any such expenditures require court authorization after notice and hearing. 11 U.S.C. § 363(c)(2). Thus, the secured creditor has the opportunity of objecting to any expenditures that it believes improperly reduce its collateral.

(2) At confirmation, the secured claim is revalued. The total claim is reduced by any payments made by the Debtor, and the collateral securing the claim is reappraised. Any proceeds under Section 552(b) that have not been expended by the Debtor, and are not necessary to pay expenses of preservation under Section 506(c), increase the amount of the secured claim. Any appreciation in the value of the underlying collateral also increases the secured claim.

(3) If the collateral package at the time of confirmation exceeds the amount of the creditor's total prepetition claim, the creditor is entitled to interest and costs under Section 506(b) to the extent of the surplus.ⁿ⁹⁸

The principal issue involving the application of postpetition rentals constituting collateral under section 552(b)(2) is the effect of section 552(b)(2) payments on the amount of the nonrecourse undersecured claim in a single asset real estate case. The resolution of this issue requires the resolution of a number of subsidiary or related issues, including (a) whether the amount of the secured claim in question is to be determined as of the petition date and must remain fixed at that amount through the claim determination stage for purposes of plan confirmation, (b) whether postpetition rents to which the undersecured creditor is entitled under section 552(b)(2) are themselves properly the subject of an adequate protection request until disbursed to the creditor or otherwise, (c) if such postpetition rents are to be adequately protected prior to disbursement, what measures can constitute adequate protection of cash other than appropriate preservation of the cash without invasion, (d) does the payment to the creditor of such postpetition rents constitute some type of adequate protection payment that is subject to the rules of the *Timbers* case,ⁿ⁹⁹ and (e) what is the relationship among, and the difference between, payments made on account of adequate protection of a secured creditor's interest in collateral, payments made under section 506(c), and rents disbursed to a secured creditor under section 552(b)(2).

Under the first sentence of section 506(a), the allowed claim of a nonrecourse undersecured mortgage creditor in a single asset real estate case is split into a secured claim in an amount equal to the value of the creditor's lien (which in a simple case is equal to the value of the real property collateral), and an unsecured claim in an amount equal to the deficiency. Under the second sentence of section 506(a), the value of the secured portion of such a claim is to be determined in light of the purpose of the valuation and of the proposed disposition or use of the collateral, and in conjunction with any hearing on such disposition or use, or any hearing on a plan in the case. Thus it is clear that the second sentence of section 506(a) contemplates the possibility of separate valuation hearings in connection with such diverse matters as a creditor's demand for adequate protection, avoidance issues including preferential transfer and fraudulent transfer litigation, and valuation for plan purposes including cramdown plans.ⁿ¹⁰⁰

The establishment of collateral value in a single asset real estate case as of the petition date for the purpose of determining whether an undersecured creditor is thereafter suffering erosion in the value of its secured claim is clearly appropriate and contemplated by the Code. If it is determined that the value of the collateral is eroding in the postpetition period, then the secured creditor will be entitled to adequate protection payments or some other modality of protection.ⁿ¹⁰¹ If the protection is in the form of payments, the funds with which to make the payments cannot be derived from the collateral itself, in order to avoid a still greater erosion in collateral value to the detriment of the very creditor whose interest therein is being protected. Thus in a single asset real estate case, such adequate protection payments may not be derived from section 552(b)(2) rents and proceeds to which the secured creditor is entitled, or otherwise from the collateral subject to the security interest of the creditor. Instead, such payments must be drawn from assets available to the debtor not constituting a part of the collateral package.ⁿ¹⁰² If no such source is available, the adequate protection payments will not be made, the mortgage creditor will be entitled to the lifting of the automatic stay in order to foreclose its lien,ⁿ¹⁰³ and the case will have been effectively terminated.

The adequate protection payments discussed above appear to differ from payments made under section 506(c), which provides in substance that a trustee or debtor in possession may recover from the collateral the reasonable and necessary costs and expenses of preserving or disposing of the collateral to the extent that such expenditures benefit the holder of an allowed secured claim. This means, in the context of a single asset real estate case, that the rental stream from the real estate collateral may be applied to costs such as real estate taxes, insurance premiums, maintenance and repair costs, and reasonable management fees.ⁿ¹⁰⁴ These costs, in contrast to adequate protection payments, are to be paid from the collateral. The disbursement of funds for these collateral preservation expenses appear to be intended as a break-even transaction for the secured creditor, inasmuch as the amounts paid should be roughly equal to the value preserved as a result of such expenditures.ⁿ¹⁰⁵

Section 506(c) and the payments that may be disbursed thereunder do not relate to a secured creditor making a demand for adequate protection or for relief from the automatic stay. The effectuation of disbursements from the rental stream of a real estate asset under section 506(c) does not give rise to an issue of reduction of the secured claim of the mortgage holder, and instead may be made only to the extent that the interest of such holder is benefited by such payments from the rental stream. Although it may be argued that payments made under section 506(c) protect the interests of the secured creditor in the collateral, and are therefore a form of adequate protection against loss of value as the result of physical deterioration, inadequate property management or similar causes, it appears that true adequate protection payments relate either to an erosion of market value of the collateral occurring by reason of factors other than those dealt with in section 506(c), or to the making of payments for preservation expenses contemplated by section 506(c) when the collateral is itself not generating sufficient gross income to pay such expenses.ⁿ¹⁰⁶

Payments made under section 506(c) in single asset real estate cases are properly chargeable against the interest of an undersecured mortgage creditor, inasmuch as these payments would have been made directly by the mortgage holder had it been able to obtain the appointment of a receiver, or if it had been able to foreclose on the property. Thus, the interposition in the case of the automatic stay is not the cause of these expenditures. In contrast, adequate protection payments relating to a decline in the market value of a real estate asset in a single asset case, during the period when the automatic stay has prevented the mortgage creditor from realizing on its collateral, are engendered by the interposition of the stay, and cannot be funded by the collateral so as to further erode the very value that the adequate protection payments are intended to preserve.

In contrast to payments to or for the benefit of a mortgage creditor on account of adequate protection requirements, or under section 506(c), payments to a mortgage creditor of net rents under section 552(b) represent a realization by that creditor on the value of its collateral.ⁿ¹⁰⁷ In circumstances in which these payments are derived from rentals under leases that will not be renewed, extended or replaced, or will be replaced with leases of lower value, these payments may be viewed as the proceeds of a partial liquidation of collateral.ⁿ¹⁰⁸ However, to the extent that payments to a secured creditor under section 552(b)(2) are derived from leases with long terms remaining, or from leases that will be replaced at no net loss, the analogy to a partial liquidation of collateral is not appropriate. Payments under section 552(b)(2) are to be made regardless of whether the secured creditor has made a demand for adequate protection, and do not relate to the question of whether the value of the collateral is eroding. In contrast to adequate protection payments, payments under section 552(b)(2) are necessarily derived from the collateral. Payments under section 552(b)(2) are net of expenditures made under section 506(c), and therefore there is no overlap between the two sections.

The subtraction cases, which provide for the reduction of an undersecured creditor's secured claim below the value of the collateral, as determined as of the petition date, appear to be incorrect because they deny to the secured creditor in a single asset case the possibility that it may recover on the secured portion of its claim in an amount equal to the actual value of its collateral (as ultimately determined by the market), unless it elects fully secured status through section 1111(b).ⁿ¹⁰⁹ If an undersecured creditor in a single asset real estate case proceeds to confirmation with a bifurcated claim, application of section 552(b)(2) payments to reduction of the secured portion of the claim will forever limit the creditor's recovery on the secured portion of its claim, with the unsecured portion also unlikely to receive a full recovery. Indeed, under the subtraction cases, it is theoretically possible that subtraction of postpetition section

552(b)(2) rents from the secured portion of an undersecured claim will reduce that claim to zero, leaving the creditor with only an unsecured claim. Obviously, this prospect compels election of fully secured status under section 1111(b), so that there can be no unsecured claim.ⁿ¹¹⁰ However, the compelled elimination of the deficiency portion of an undersecured creditor's claim will deny such creditor the right to vote against a cramdown plan as a member of the unsecured class.ⁿ¹¹¹ The subtraction cases deny to a secured creditor the benefit of any increases in the value of its collateral during the postpetition period.^{n111a} Moreover, in cases in which the secured claim is being reduced by postpetition payments under section 552(b)(2), the debtor in possession may be benefitted by prolonging the chapter 11 case.

The subtraction cases seem to express a valid concern relating to the double counting of secured claims on income producing real estate assets. If an income producing property is valued at the outset of a case under the Code for purposes of adequate protection litigation, it is highly likely that the valuation will be based on a multiple of net earnings of the property. To then add to this valuation once again some part of the ensuing net earnings of the property appears to result in double counting of the same income stream. The response of the courts in the wash cases and in the dual valuation cases is to prospectively revalue the property as of the confirmation date, to subtract from the total claim the amount of any section 552(b)(2) payments made prior to the new valuation date, and to augment the newly valued secured claim with the amount of any section 552(b)(2) rents that have been collected but have not been disbursed to the secured creditor.ⁿ¹¹² Some courts adopting the wash approach also characterize the rents as a separate item of collateral apart from the underlying real estate, so that the amount of the rents paid to the undersecured creditor are deemed to be somehow excluded from the valuation of the "underlying" real estate collateral.ⁿ¹¹³

The salient feature of the dual valuation cases is the manner in which they distinguish valuation for purposes of claims allowance and for purposes of adequate protection. As employed in these cases, the term "dual valuation" does not refer to valuation of the collateral for claims allowance purposes first at the outset of the case and again as of the date of confirmation, but rather to one valuation for the purpose of determining the need for adequate protection, and a second valuation as of the confirmation date for the purpose of claims allowance.ⁿ¹¹⁴

Certain of the dual valuation cases arise in the context of a motion by the debtor in a single asset real estate case to use a portion of the postpetition rents to pay attorneys' fees.ⁿ¹¹⁵ Of course, this motion is ordinarily opposed by the secured party in order to enhance the pressure on the debtor to terminate the chapter 11 proceedings and to surrender the property to the creditor. Thus the issue in these cases is whether section 552(b)(2) rents to which the lender is entitled may be diverted in part to the payment of counsel fees of the debtor without provision of adequate protection of the lender's interest in such funds. The dual valuation cases hold that:

(1) For purposes of adequate protection only, the secured creditor's claim is fixed as of the date of filing of the chapter 11 petition, the section 552(b)(2) proceeds do not increase the secured claim of the creditor, and in the absence of a decline in the value of the underlying real estate collateral, the section 552(b)(2) proceeds are not themselves properly the subject of a demand for adequate protection. Therefore, such collateral may be used for the payment of administrative expenses, including postpetition attorneys' fees of the debtor;ⁿ¹¹⁶ and

(2) For purposes of claims allowance only, the real estate collateral is valued as of the confirmation date, and is augmented by the amount of any section 552(b)(2) rents received by the debtor in possession or trustee. The unsecured portion of the secured creditor's claim is then reduced by the amount of such section 552(b)(2) rents actually paid to the undersecured creditor, and the secured claim reverts back to its value determined as of the confirmation date.ⁿ¹¹⁷

The holdings in the dual valuation cases permitting use of postpetition cash collateral to pay administrative expenses in the absence of adequate protection conflict with the provisions of *section 363 of the Code*. Under section 363(a), postpetition rents falling under the provisions of section 552(b)(2) constitute cash collateral. Under section 363(c)(2),

the debtor in possession or its trustee may not use cash collateral without the consent of the secured creditor unless the court, after notice and a hearing, authorizes such use in accordance with section 363. Section 363(d) provides that the debtor in possession or its trustee may use property under subsection (c) only to the extent not inconsistent with any relief granted under section 362(d), which includes the provision for adequate protection. In addition, section 363(e) provides generally that at any time upon request of a party that has an interest in property being used by the debtor in possession or its trustee, the court, with or without a hearing, shall prohibit or condition such use as is necessary to provide adequate protection of such interest. Therefore, a secured party with a lien on postpetition rents constituting cash collateral under section 363(a) is entitled to adequate protection of its interest in such cash as a condition to the use thereof.

The wash cases, and the dual valuation cases to the extent that they deal with claims allowance for undersecured creditors, appear to be correct. The creation under section 506(a) of a bifurcated claim for a nonrecourse secured creditor gives rise to an artificial construct for the purposes of the claims classification and plan voting system of the Code. The reality is that payments to a secured creditor from its collateral reduces the indebtedness owing to that creditor. If the value of that creditor's collateral has not been diminished by reason of such payments having been made, then the secured portion of that creditor's claim should not be diminished for the purposes of claims allowance under the Code.

[2] The Lessee as Debtor Under the Code

A mortgagee holding an assignment of rents encounters a separate group of problems when the lessee under a lease covered by the assignment becomes a debtor under the Code. If the lessee rejects the lease and both mortgagee and mortgagor file a proof of claim for the damages arising out of the rejection, the mortgagee and mortgagor will be competing for the same asset. The mortgagee will assert that the rejection damages payable by the lessee are a form of rents assigned to it under the assignment of rents. The mortgagor will argue that as owner of the mortgaged property and lessor under the lease it is entitled to the proceeds of the damage claim. Indeed, Bankruptcy *Rule 3001(e)(3)* and *(e)(4)*, dealing with transfers of claims for security, contemplates competing filings by the transferor and transferee, and provides for a mechanism for resolution of the conflict in the bankruptcy court.

If the mortgage has gone into default, and the mortgagee has taken possession of the property, obtained the appointment of a receiver or a state court order for sequestration of rents, and the lease subject to the assignment of rents is thereafter rejected by the lessee or its trustee, the mortgagee should be entitled to payment of the damage claim together with any claim for use and occupation charges and prepetition rents.ⁿ¹¹⁸ If, however, the affected property is in a lien theory jurisdictionⁿ¹¹⁹ and the mortgagee has not perfected its rights under the assignment of rents, the mortgagor may successfully claim the damage proceeds inasmuch as the mortgagee has not established its entitlement thereto. Indeed, even if the mortgagor fails to file a proof of claim for damages arising out of the rejection of the lease, the trustee may seek to object to the allowance of the mortgagee's claim on the grounds that the mortgagee is without standing to assert the right to payment. The mortgagee may argue in response that the filing of the mortgagee's proof of claim is substantially equivalent to a petition for sequestration of rents and that the bankruptcy court will have jurisdiction to resolve any disputes between the mortgagee and mortgagor as to the entitlement to the funds and the rights of the mortgagee under the assignment of rents.ⁿ¹²⁰ Accordingly, under the mortgagee's argument, the protections available to the mortgagor in a state court sequestration action will be likewise available in the bankruptcy court (notwithstanding that the mortgagor is not a debtor under the Code) and no further steps on the part of the mortgagee should be required to perfect its claim. The mortgagee's rights in this context remain subject to further judicial elaboration.ⁿ¹²¹ A form of proof of claim by a mortgagee holding an assignment of rents and seeking lease rejection damages and other sums is provided at the end of this chapter.ⁿ¹²²

An even more difficult problem for a mortgagee holding an assignment of rents arises when a lease subject to the assignment is rejected by the debtor-lessee or its trustee before a default has occurred under the mortgage. If the mortgage transaction was structured to depend upon the rental flow from the lease to support the mortgage debt, the

mortgagor may seek to carry the property for a period of time while searching for a new tenant, but there is a substantial likelihood that the mortgage will go into default unless a new tenant is found promptly. Nevertheless, the mortgagee holding the assignment of rents cannot file an allowable proof of claim for the rejection damages in the absence of a mortgage default, even under the typical form of absolute assignment.ⁿ¹²³ In this fact pattern, if the damage claim were allowed and paid prior to the occurrence of the mortgage default, the proceeds would belong to the mortgagor without any obligation to apply them to the payment of the mortgage debt. If the mortgage were thereafter to go into default, the mortgagee would under a recourse mortgage have only the rights of an ordinary unsecured creditor to any proceeds of such claim remaining in the hands of the mortgagor and under a nonrecourse mortgage have no rights to such proceeds.

[3] Drafting Considerations

Certain drafting suggestions may be offered in view of the issues discussed above.ⁿ¹²⁴ In jurisdictions which hold an absolute assignment of rents to be automatically activated upon default, it is necessary to understand the considerations that may result in an instrument being held to be an absolute rather than a collateral assignment. One commentator has set forth these considerations (under California law) as follows:

First, there appears to be a presumption that assignment of rents clauses create a security interest. If the parties intend the assignment to be absolute, such an intent must be "clearly expressed." Presumably, this can be done through the use of clear and absolute language in the assignment clause. A statement such as "trustor hereby absolutely and irrevocably assigns" should be sufficient. Second, if the term "as additional security" or its equivalent precedes the rents clause or in any way modifies it, the assignment most likely will be deemed to be for security purposes. Third, if the assignment of rents clause is contained in the portion of the deed [of trust] detailing the security agreement, it may be construed as creating only a security interest. Therefore, the assignment must be given a distinct heading and should be completely separate from the listing of obligations secured by the deed of trust. Fourth, if a portion of the deed first assigns the rents to the trustee as security, later language conferring collection rights upon the beneficiary will be subordinated. Thus, probably no mention of rents whatsoever should be made in the granting portion of the deed of trust.

The crucial factor, however, appears to be the requirement of taking possession. If the deed requires the beneficiary to take possession or its equivalent before it becomes entitled to rents, the assignment clause likely will be held to be for security purposes. This is not surprising because if the deed requires possession, distinguishing between the two types of assignment becomes moot. The action that a creditor must take to receive rents under the instrument is the same action required to perfect a security interest in rents. Thus, to be an absolute assignment, an assignment of rents clause should indicate that the creditor is entitled to the rents without first having to take possession.ⁿ¹²⁵

Another drafting consideration is simply to compare for purposes of consistency the assignment of rents and leases contained within most forms of mortgages with the separate assignment of rents employed as a companion document in the same transaction. One bankruptcy court has considered the import of a collateral assignment of rents set forth in a mortgage and an absolute "conditional" assignment of rents set forth in a separate instrument securing the same indebtedness. The court determined that under the circumstances, the parties had intended to create an absolute "collateral" assignment of rents. In this case, the tenant under the lease in question had expressly attorned, and had been directly paying rent, to the mortgagee.ⁿ¹²⁶

Another drafting suggestion relates to the circumstances in which a mortgagor is diverting rents from mortgaged premises following the occurrence of a default under the mortgage. In many instances, the delays inherent in the judicial process may render the mortgagee unable to quickly take control over the rents. Accordingly, many mortgagees have, in the context of nonrecourse mortgage transactions, added to the list of exceptions to the general exculpation clause the diversion of rents paid under leases of space at the mortgaged premises following the occurrence of a default. In the

case of a single asset real estate mortgage borrower, the exception from exculpation should extend to partners (in the case of a partnership borrower), or to shareholders and guarantors (in the case of a corporate borrower).

Another drafting consideration relates to the rights of the holder of the assignment to claim for and collect damages arising out of the rejection of a lease subject to the assignment.¹²⁷ Assignments of rent should include a specific assignment of the right to claim and collect such damages to eliminate any doubt as to the intent of the parties. Such a clause might read:

Assignor further assigns, transfers and sets over to Assignee all of Assignor's right, title and interest in and to all claims and rights to the payment of money at any time arising in connection with any rejection or breach of any of the Leases [defined] by any lessee thereunder or trustee of any such lessee under *Section 365 of the Bankruptcy Code, 11 U.S.C. § 365*, including, without limitation, all rights to recover damages arising out of such breach or rejection, all rights to charges payable by such lessee or trustee in respect of the leased premises following the entry of an order for relief under the Bankruptcy Code in respect of such lessee and all rentals and other charges outstanding under the lease as of the date of entry of such order for relief.

Another problem discussed above¹²⁸ relates to the rights of the holder of an assignment of rents to file and recover on a proof of claim against the lessee under an assigned lease prior to the time when a default has occurred under the mortgage. The mortgagee will be anticipating that a mortgage default will occur shortly after the rejection of the lease, but under the law¹²⁹ is not entitled to the proceeds of the claim in the absence of a default. Perhaps the proceeds of the claim as collected by the mortgagor could be segregated and held as further collateral for the mortgage obligations until a new and satisfactory lease is entered into for the vacated premises. This cash collateral account may be viewed as substitute security for the rejected lease. The following is a suggested provision which seeks to create a security interest in the proceeds of a claim filed by a mortgagor and which requires the release of the funds to the mortgagor upon the entry by the mortgagor into a new lease of the premises or on a specified date. If the mortgage has not gone into default for a considerable period of time notwithstanding the loss of an important supporting lease, it should be safe to assume that the mortgagor has committed to pay the mortgage debt from other resources.

If Assignor shall receive on account of any claim, demand, action, suit or proceeding, including, without limitation, any claim, contested matter or adversary proceeding under the Bankruptcy Code, *11 U.S.C. § 101 et seq.*, any sums relating to the breach or rejection of any of the Leases [defined] by any lessee thereunder or trustee of any such lessee under *Section 365 of the Bankruptcy Code, 11 U.S.C. § 365*, including, without limitation, all damages arising out of such breach or rejection, all rights to charges payable by such lessee or trustee in respect of the premises demised under such Lease following the entry of an order for relief under the Bankruptcy Code in respect of such lessee and all rentals and other charges outstanding under the Lease as of the date of entry of such order for relief, the Assignor shall promptly deposit such sums in a segregated account (the "Account") with the Depository [defined] and shall cause the Account to be designated on the records of the Depository as collateral for the payment and performance of the Mortgage Obligations [defined]. Assignor hereby assigns, transfers and sets over to Assignee, and grants to Assignee a security interest in, all sums in the Account as further security for the payment and performance of the Mortgage Obligations. Assignor shall not withdraw any sums from or further encumber the Account without the Assignee's prior written consent so long as the Mortgage Obligations shall remain outstanding; provided, however, that if there shall not have occurred and be continued any Event of Default [defined] or event, which with the giving of notice or lapse of time, or both, would constitute an Event of Default, the Account shall be released to the Assignor free of the lien and security interest granted hereby on the earlier of (a) [date], or (b) the date on which Assignor shall have entered into a new lease of the premises theretofore subject to such Lease with a lessee and on terms and conditions satisfactory to Assignee.

The disposition of interest earned on the cash collateral account should be a subject for negotiation. The mortgagee's right of approval over a new lease and lessee may also be dealt with in various ways, including the use of objective standards for creditworthiness and lease terms.

Another problem confronted by a mortgagee holding an assignment of rents arises in the common law jurisdictions when the mortgagee files a proof of claim for rejection damages against the estate of a lessee under an assigned lease without having first taken one of the steps required to perfect the assignment.ⁿ¹³⁰ It has been suggestedⁿ¹³¹ that the filing of the mortgagee's proof of claim may be deemed to sufficiently approximate a state court petition for sequestration of rents and that no further action on the mortgagee's part may be required. The inclusion in the assignment of rents of a provision acknowledging the sufficiency of a filed proof of claim as a substitute for a sequestration petition, while not binding on the courts, may be helpful in forestalling an argument by the mortgagor that the mortgagee's proof of claim filed in the lessee's Bankruptcy Code case does not perfect its right to the proceeds of the claim. The provision might be drafted as follows:

Any proof of claim or similar document filed by the Assignee in connection with the breach or rejection of any of the Leases [defined] by any lessee thereunder or trustee of any such lessee under *Section 365 of the Bankruptcy Code, 11 U.S.C. § 365*, shall for the purpose of perfecting the Assignee's rights conferred in Section hereof [assignment of rights to rejection damages] be deemed to constitute a petition by Assignee against Assignor for sequestration of rents under the laws of the State of

The above provision should be appropriately modified if in a particular jurisdiction the action by an assignee of rents required to perfect its rights involves something other than a petition for sequestration.

As briefly noted, subdivisions (e)(3) and (e)(4) of *Bankruptcy Rule 3001* appear to directly address the likely competition between mortgagor and mortgagee for the proceeds of a lease rejection. Those subdivisions provide:

(3) *Transfer of Claim for Security Before Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.

(4) *Transfer of Claim for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 21 days of the mailing of the notice or within any additional time allowed by the court. If a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such order respecting these matters as may be appropriate.^{n131a}

The intent of these rules are further elaborated in the rule's Advisory Committee Note, which provides in part:

Subdivision (e). The rule recognizes the differences between an unconditional transfer of a claim and a transfer for the purpose of security and prescribes a procedure for dealing with the rights of the transferor and transferee when the transfer is for security.

...

Paragraphs (3) and (4) clarify the status of a claim transferred for the purpose of security. An assignee for security has been recognized as a rightful claimant in bankruptcy. *Feder v. John Engelhorn & Sons*, 202 F.2d 411 (2d Cir. 1953). An assignor's right to file a claim notwithstanding the assignment was sustained in *In re R & L Engineering Co.*, 182 F. Supp. 317 (S.D. Cal. 1960). Facilitation of the filing of proofs by both claimants as holders of interests in a single claim is consonant with equitable treatment of the parties and sound administration. See *In re Latham Lithographic Corp.*, 107 F.2d 749 (2d Cir. 1939). n131b

In light of the provisions, and the strong possibility that any dispute over the ultimate disposition of the claim will be adjudicated by the bankruptcy court, it would appear to be useful to address that possibility directly in the assignment of rents, perhaps directly after the provision that contains a specific assignment of the right to claim and collect such damages, set forth *supra*. Although it is questionable whether the bankruptcy rule was intended to or would have the effect of preempting state law analysis for deciding the ultimate ownership of the claims proceeds, in light of the specific provisions of the rule that make reference to "an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate," the following suggested provision may be deemed persuasive or dispositive by a bankruptcy court in resolving the competing claims:

Assignor hereby authorizes Assignee at any time to file a proof of claim pursuant to *Federal Rule of Bankruptcy Procedure* 3001(e)(3) or (e)(4) (or any similar or successor statute or rule) or otherwise assert any claim against a lessee under any of the Leases [defined] in the event that any such lessee is a debtor ("Debtor") in a case under the Bankruptcy Code. Lessor may include a copy of this Assignment as an exhibit to any such proof of claim or any other document or pleading filed in connection with the assertion of such claim by Assignee. This assignment and this provision shall constitute *prima facie* evidence of the transfer of any such claim by Assignor to Assignee and the Assignor hereby waives any right to object to such transfer. In the event that Assignor also files a proof of claim against any such Debtor, Assignor acknowledges and agrees that Assignee's right, title and interest in and to any claim against Debtor is superior and prior to the right, title and interest of Assignor, and Assignor agrees to take such acts and execute and deliver such instruments and documents, including acknowledgments to a court, as may be reasonably requested by Assignee, to cause the proceeds of any claim against Debtor to be paid or otherwise transferred directly to Assignee. For the avoidance of doubt, Assignee hereby acknowledges that, unless Assignor otherwise agrees in writing following the commencement of any such case under the Bankruptcy Code, Assignee shall control the voting of any such claim, the right to payment of dividends thereon, and the participation in the administration of the estate of any Debtor.

The foregoing provision in the assignment can also be modified to deal with the uncommon situation where the mortgage is not in default notwithstanding the rejection of the assigned lease; for example, the proceeds of the claim against the debtor lessee can be placed in a cash collateral account or in appropriate circumstances made available to the assignee/mortgagor.

[4] Certain Preference Issues

Section 547(b) of the Code provides that a trustee may avoid any transfer of property of the debtor:

- (1) to or for the benefit of a creditor;

- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made--
 - (A) on or within 90 days before the date of filing of the petition; ...
- (5) that enables such creditor to receive more than such creditor would receive if--
 - (A) the case were a case under chapter 7 of this title;
 - (B) such transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.ⁿ¹³²

Section 547(e)(3) provides that a transfer is not made for purposes of section 547 until the debtor has acquired rights in the property transferred.ⁿ¹³³ Under section 547(f), the debtor is presumed to have been insolvent during the 90-day prepetition period.ⁿ¹³⁴

Section 547 as it relates to payments received by a mortgagee pursuant to an assignment of rents on or within the 90 days prior to the filing of a Bankruptcy Code petition by or against the mortgagor has lead one bankruptcy court to hold in the context of an assignment of rents arising from an equipment lease that the mortgagee must disgorge as preferential the rents received from the underlying lessee within the 90-day period.ⁿ¹³⁵ The theory of this holding is that the rents provided for under the lease are not due, and the lessor-mortgagor acquires no rights in such rents, until the payment date provided for in the lease.ⁿ¹³⁶ Accordingly, under section 547(e)(3), the transfer of such rental payments to the mortgagee is made on the date when the rental payment is made and not on the date of execution and recordation of the rent assignment. All such payments received on or within 90 days of the filing are therefore subject to challenge as preferences.

Three dates are relevant to the preference issue as it affects rent assignments:

The first date is the point of time at which the assignment is executed, delivered, and properly recorded under state law. If this date is itself within the 90-day period and the assignment is being given to secure an antecedent debt, then the granting of the assignment may itself be preferential. If the assignment is given prior to the commencement of the 90-day period, assuming the assignee is not an insider, it should be invulnerable to a preference challenge.ⁿ¹³⁷

The second date is the date on which the assignment is "perfected" under state law for purposes of vesting in the assignee the right to actually collect rents thereunder. Under a so-called "absolute" assignment, this date would be the date of default under the mortgage. Under a "collateral" assignment, this date would be the date on which the assignee took the steps required by state law to perfect its right to the rents.ⁿ¹³⁸

Third is the date on which the lease rent so assigned is due and is paid. This is the date of transfer under *section 547(e)(3) of the Code*.

Section 547(e)(3), according to the legislative history, was intended to overrule *DuBay v. Williams* ⁿ¹³⁹ and *Grain Merchants of Indiana Inc. v. Union Bank and Sav. Co.*, ⁿ¹⁴⁰ which held that a floating lien on receivables attached

when the security agreement was entered into and perfected and not when each receivable was created.ⁿ¹⁴¹ In place of such holdings, the Code sets forth in section 547(c)(5) an improvement of position test which subjects an inventory and receivables lender to preference attack only to the extent that its collateral position has improved within the 90-day period to the detriment of the estate. In overruling *DuBay* and *Grain Merchants*, however, the Code did not deal with the problem of a real estate lender holding an assignment of rents. Therefore, although it appears that the legislative intent with respect to section 547(e)(3) related only to receivables and inventory liens and to the *DuBay* and *Grain Merchants* issues, the broad language of the section, at least in the view of one bankruptcy court, has created an infirmity in rent assignments which did not exist before enactment of the Code.

It should be noted in addition that if a mortgagee that is fully secured by the value of the mortgaged property receives timely mortgage installment payments within the 90-day period there is no infirmity under section 547.ⁿ¹⁴² If, however, the payments are coming directly from lessees of the property under an activated assignment of rents, the payments may be subject to preference attack even if the mortgagee is fully secured by the property.ⁿ¹⁴³ Indeed, the valuation of the property may in large part be based upon capitalization of the very rent flow which is subject to preference attack. If the fully secured mortgagee, in an effort to avoid the preference problem, directs that the lessees pay rent to the mortgagor and the mortgagor utilizes these rents to pay the amounts due under the mortgage, the payments may be safe from preference challenge but are subject to possible diversion by the mortgagor whose default has activated the assignment of rents in the first instance.

Thus, application of section 547(e)(3) to assignments of rent appears to give rise to results that are contrary to the spirit, if not the letter, of section 552(b),ⁿ¹⁴⁴ which recognizes the postpetition effect of an assignment of rents. It is a curious result that prepetition payments under an activated rent assignment may be challenged under section 547(b) while postpetition payments are preserved under section 552(b). It appears to be more consistent with state law and the intentions of the parties that the date of "perfection" of the mortgagee's rights to the rents as provided in the instrument and under state law--to wit, the first of the three significant dates described aboveⁿ¹⁴⁵--be deemed the date of transfer for purposes of section 547. However, no assurance can be given that the courts will be willing to read assignments of rents out of section 547(e)(3) on the basis of the foregoing considerations.

FOOTNOTES:

(n1)Footnote 1. See Powell, 3 *The Law of Real Property* (1991) at P 454.1[3] [a]; Nelson and Whitman, *Real Estate Finance Law* (2d ed. 1985) at § 4.35; Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07. But see Nelson, *Validity of Assignments of Leases by Mortgagor to Mortgagee Questioned*, N.Y.L.J. (Nov. 19, 1986) at 41 (questioning the enforceability of a separate assignment of rents under New York law).

(n2)Footnote 2. See generally, Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075 (1995).

(n3)Footnote 3. See Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07; Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 *Hastings L.J.* 1433, 1434 (1980); Nelson, *Validity of Assignments of Leases by Mortgagor to Mortgagee Questioned*, N.Y.L.J. (Nov. 19, 1986).

(n4)Footnote 4. *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979). In *Butner*, the Supreme Court resolved a split between the Second, Fourth, Sixth, Eighth and Ninth Circuits, which had held that the interpretation and enforcement of an assignment of rents was to be based on applicable state law, and the Third and Seventh Circuits, which had adopted a federal rule of equity in order to promote the policies of the Bankruptcy Code. The Court held that since Congress had declined to exercise its power to fashion a uniform federal rule for assignments of rents, the federal courts should not do so in its place, but instead should apply relevant state laws. See P 2.03[1][c][i] *infra*. If the lender is an instrumentality of the federal government, however, federal law will govern the means by which the lender may enforce an assignment of rents after the borrower becomes a debtor under the Bankruptcy Code. See *United States v. Landmark Park & Assocs.*, 795 F.2d 683 (8th Cir. 1986) (recording of

mortgage and HUD regulatory agreement constitutes perfection). *Federal Home Loan Mortg. Corp. v. Nazar*, 100 B.R. 555 (D. Kan. 1989) ; see also *In re Executive House Assocs.*, 99 B.R. 266, 275 (Bankr. E.D. Pa. 1989) . However, with the enactment of the amendments to section 552(b) in the Bankruptcy Reform Act of 1994, Congress sought to provide a uniform federal rule affecting the perfection of assignments of rents. See P 2.03[b][iv] *infra*.

(n5)Footnote 5. Compare *In re Ventura Louise Prop.*, 490 F.2d 1141 (9th Cir. 1974) (holding that under California law, no further steps are required to activate an absolute assignment of rents upon a default by the mortgagor), with *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 C.B.C. 474 (Bankr. S.D.N.Y. 1978) (holding that under New York law, additional steps must be taken after a default by the mortgagor to activate an assignment of rents).

(n6)Footnote 6. See Gose, *The Efficacy of an Assignment of Rents and Profits in Bankruptcy*, 12 Real Prop. & Trust J. 507, 508 (1977); Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 Hastings L.J. 1433, 1434 (1980); Comment, *The Mortgagee's Right to Rents and Profits Following a Petition in Bankruptcy*, 60 Iowa L. Rev. 1388, 1390-91 (1975); Casher, Day and DeSieno, *Assignments of Rents in Bankruptcy*, ABA Sec. of Real Prop., Prob. & Tr. Law, Real Property Programs, 1991 Spring CLE Meeting, Vol. III, Sec. B, Tab 3, pp. 3-5 (March 1991) ["Casher I"]; Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1100-13; Heidt, *The Effect of the 1994 Amendments on Commercial Secured Creditors*, 69 Am. Bankr. L.J. 395, 398-404 (1995).

(n7)Footnote 7. Casher, Skelton & Johnson, *Assignments of Rents: Drafting Considerations in Light of Bankruptcy Risks*, presented at A.B.A. Sec. of Real Prop., Prob. and Trust Law, Real Property Programs, Orlando, FL, p.1 n.1, (March 1991) ["Casher II"].

(n8)Footnote 7a. See Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1101-04, commenting that the notion of a transfer of ownership of rent receivables from borrower to lender at the outset of a loan transaction represents a forfeiture of equity that the foreclosure were designed to prevent.

(n9)Footnote 8. *Casher I*, note 6 *supra*, at 4. See *O'Neal Steel, Inc. v. E B Inc. (In re Millette)*, 186 F.3d 638 (5th Cir. 1999) ; *Lyons v. Federal Savs. Bk. (In re Lyons)*, 193 B.R. 637, 646-48 (Bankr. D. Mass. 1996) .

(n10)Footnote 9. See P 2.01[1] *supra* for a discussion of the issues involved in employing automatic default clauses as a means to avoid the proscriptions of the automatic stay relating to notices of default sent after the filing of a Bankruptcy Code petition by the mortgagor.

(n11)Footnote 9a. *In re Guardian Realty Group, L.L.C.*, 205 B.R. 1 (Bankr. D.C. 1997) ; *In re McCann*, 27 C.B.C.2d 44, 140 B.R. 926 (Bankr. D. Mass. 1992) ; *In re Bethesda Air Rights Ltd. Partnership*, 117 B.R. 202 (Bankr. D. Md. 1990) ; *In re Willowood E. Apartments of Indianapolis II, Ltd.*, 114 B.R. 138 (Bankr. S.D. Ohio 1990) . There is a line of Third Circuit cases holding that the activation of a conditional absolute assignment of rents results in a transfer of title to the lender of the rent receivables, thereby divesting the debtor of ownership and rendering the receivables immune from turnover under section 542(a). *Jason Realty, L.P. v. First Fid. Bank, N.A.*, 59 F.3d 423 (3d Cir. 1995) ; *Commerce Bank v. Mountain View Vill., Inc.*, 5 F.3d 34, 29 C.B.C.2d 1241 (3d Cir. 1993) ; *In re Carretta*, 220 B.R. 203 (D.N.J. 1998) ; see also *In re Kingsport Ventures, L.P.*, 251 B.R. 841 (E.D. Tenn. 2001) (following Jason and holding that absolute assignment of rents divested debtor of all right in hotel revenues; because debtor thus lacked ability to access funds to reorganize, relief from the stay granted to creditor to foreclose on motel property). See Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1100-14.

(n12)Footnote 10. Casher, Day and DeSieno, *Assignments of Rents in Bankruptcy*, ABA Sec. of Real Prop., Prob. & Tr. Law, Real Property Programs, 1991 Spring CLE Meeting, Vol. III, Sec. B, Tab 3, (March 1991) at 5; Weg, *The Secured Creditor's Rights to Rents From Real Property*, 17 Real Est. L.J. 29, 32-33 (1988).

(n13)Footnote 10a. *In re Cavros*, 262 B.R. 206 (Bankr. D. Conn. 2001) .

(n14)Footnote 11. See Weg, *The Secured Creditor's Rights to Rents From Real Property*, 17 Real Est. L.J. 29 (1988); Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 *Hastings L.J.* 1433 (1980). However, in most cases, a tenant will not pay rent to a mortgagee when presented with a competing demand for the rent from the mortgagor without indemnification from the mortgagee or a court order specifying its obligations. See Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.04(a). In practice, therefore, the rental stream may not start to flow to the mortgagee simply upon delivery of notice to the tenants.

(n15)Footnote 12. *In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986) ; *In re Village Prop., Ltd.*, 723 F.2d 441, 10 C.B.C.2d 224 (5th Cir. 1984) , cert. denied, 466 U.S. 974, 104 S. Ct. 2350, 80 L. Ed. 2d 823 (1984) ; *In re Executive Square, Ltd.*, 77 B.R. 303 (Bankr. S.D. Fla. 1987) ; *In re Pine Lake Vill. Apt. Co.*, 6 C.B.C.2d 83, 17 B.R. 829 (Bankr. S.D.N.Y. 1982) ; *In re Shoppers Paradise, Inc.*, 3 C.B.C.2d 484, 495-96, 8 B.R. 271, 280 (Bankr. S.D.N.Y. 1980) ; *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 C.B.C. 474 (Bankr. S.D.N.Y. 1978) ; cf. *In re Riverside Nursing Home*, 11 C.B.C.2d 502, 43 B.R. 682 (Bankr. S.D.N.Y. 1984) (holding that an assignee of rents does not have standing as a "party" to compel the trustee of the debtor-lessee under the underlying lease to reject or assume the lease under section 365(d)(2) as in effect prior to the amendments enacted in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised)). Heidt, *The Effect of the 1994 Amendments on Commercial Secured Creditors*, 69 *Am. Bankr. L. J.* 395, 398-400.

(n16)Footnote 13. 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) .

(n17)Footnote 14. 440 U.S. 48, 56, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136, 142, 19 C.B.C. 481, 487 .

(n18)Footnote 14a. 440 U.S. 48, 54, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136, 141 . The *Butner* decision, as a constitutionally based rule of federalism, survived the enactment of section 552(b). See *Prudential Ins. Co. of America v. Boston Harbor Marina Ca.*, 159 B.R. 616, 619 (D. Mass. 1993) .

(n19)Footnote 15. 11 U.S.C. § 552(b)(2).

(n20)Footnote 15a. See P 2.03[1][c][v] *infra*.

(n21)Footnote 15b. *County of Orange v. Merrill Lynch & Co., Inc. (In re County of Orange)*, 191 B.R. 1005, 1019, 35 C.B.C.2d 593, 609-10 (Bankr. C.D. Cal., 1996) (*dictum*).

(n22)Footnote 16. 11 U.S.C. § 552(a).

(n23)Footnote 17. 11 U.S.C. § 363(a). The reference to fees and other amounts connected to the occupancy of hotels, motels and other lodging properties was added by the Bankruptcy Reform Act of 1994.

(n24)Footnote 17a. *Vienna Park Props. v. United Postal Sav. Ass'n (In re Vienna Park Props.)*, 976 F.2d 106 (2d Cir. 1992) ; *Sears Sav. Bank v. Tucson Indus. Partners (In re Tucson Indus. Partners)*, 25 C.B.C.2d 523, 129 B.R. 614 (B.A.P. 9th Cir. 1991) ; *In re Southern Illinois Railcar Co.*, 49 C.B.C.2d 1118, 301 B.R. 305 (Bankr. S.D. Ill. 2002) . A question has been raised as to whether under the "title theory" rent cases cited in note 9a *supra*, sections 552(b)(2) and 363(a) are applicable as much as the lender's interest is one of ownership rather than as a secured party. Heidt, *The Effect of the 1994 Amendments on Commercial Secured Creditors*, 69 *Am. Bankr. L. J.* 395, 402.

(n25)Footnote 18. The amendments enacted in the 1984 Amendments included an expansion of the definition of cash collateral to include "the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title." Such expansion was retained and further broadened by the amendments enacted in the Bankruptcy Reform Act of 1994 to include hotel and related charges. See *In re Hillside Assocs. L.P.*, 121 B.R. 23 (B.A.P. 9th Cir. 1990) , *appeal*

dismissed, 990 F.2d 1258 (9th Cir. 1993) (nursing home revenue is not rent for section 552(b) purposes); *In re Northport Marina Assoc.*, 136 B.R. 911 (Bankr. E.D.N.Y. 1992) (fees from boat slip leases constitute rent, but dockage and winter storage fees are not rent under section 552(b)).

(n26)Footnote 19. 11 U.S.C. § 363(c)(4).

(n27)Footnote 20. 11 U.S.C. § 363(c)(2).

(n28)Footnote 20a. 11 U.S.C. § 1112(b)(4)(D).

(n29)Footnote 21. 11 U.S.C. § 363(e); *Prudential Ins. Co. of Am. v. Boston Harbor Marina Co.*, 159 B.R. 616, 623 (D. Mass. 1993) . However, some courts have taken the position that adequate protection is to be granted only to assure against a decline in the value of a creditor's security interest, and not to enhance the value of such interest. As applied to a security interest in postpetition rents, this view has been held to mean that the debtor may utilize the rent stream for the operation of the property, inasmuch as subsequent payments of rent will take the place of the rent so expended, thereby leaving the secured creditor in a wash position without any diminution in value of its security interest in the rent receivables. *In re Princeton Square Assocs.*, 37 C.B.C.2d 55, 61-2, 201 B.R. 90, 96 (Bankr. S.D.N.Y. 1996) ; *In re Mullen*, 31 C.B.C.2d 1765, 1771, 172 B.R. 473, 476 (Bankr. D.Mass. 1994) . The court in *In re Wrecclesham Grange, Inc.*, 221 B.R. 978 (Bankr. M.D.Fla. 1997) , also held that no adequate protection of a creditor's security interest in postpetition receivables is required, but acknowledged that this would not be the case if the value of the rent stream is declining. 221 B.R. 978, 981 .

(n30)Footnote 22. See *In re One Fourth St. N., Ltd.*, 103 B.R. 320, 321-22 (Bankr. M.D. Fla. 1989) ; *In re Aloma Square, Inc.*, 85 B.R. 623 (Bankr. M.D. Fla. 1988) . Compare *In re Greenhaven Village Apts. of Burnsville Phase II Ltd. P'ship*, 100 B.R. 465 (Bankr. D. Minn. 1989) , with *Waldron v. Northwest Acceptance Corp. (In re Johnson)*, 15 C.B.C.2d 367, 373, 62 B.R. 24, 30 (B.A.P. 9th Cir. 1986) . But see *In re Fry Rd. Assocs., Ltd.*, 64 B.R. 808, 809 (Bankr. W.D. Tex. 1986) .

(n31)Footnote 23. See P 2.03[1][c][v] *infra* for a discussion of some of the drafting deficiencies in section 552(b)(2).

(n32)Footnote 23a. See cases cited note 25 *infra*.

(n33)Footnote 23b. *In re Guardian Realty Group, L.L.C.*, 205 B.R. 1, 4 (Bankr. D.C. 1997) .

(n34)Footnote 23c. *Carlson, Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1099-1114 (1995).

(n35)Footnote 24. *In re Jason Realty, L.P.*, 59 F.3d 423 (3d Cir. 1995) ; *Commerce Bank v. Mountain View Village, Inc.*, 5 F.3d 34, 29 C.B.C.2d 1241 (3d Cir. 1993) ; *In re Ventura--Louise Properties*, 490 F.2d 1141 (9th Cir. 1974) ; *In re Fry Rd. Assocs., Ltd.*, 64 B.R. 808, 809 (Bankr. W.D. Tex. 1986) ; *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981) ; *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450, 453 (Cal. 1941) ; *Averch, Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 Comm. L.J. 516, 523-24 (Winter 1988).

(n36)Footnote 25. *Rogers, Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 Hastings L.J. 1433 (1980) at 1435. An absolute assignment was upheld through application of New Jersey law in *In re Winslow Center Assocs.*, 50 B.R. 679 (Bankr. E.D. Pa. 1985) , application of Michigan law in *In re P.M.G. Prop.*, 55 B.R. 864 (Bankr. E.D. Mich. 1985) , application of Texas law in *In re Fry Rd. Assocs., Ltd.*, 64 B.R. 808, 809 (Bankr. W.D. Tex. 1986) , application of Idaho law in *In re Gould*, 78 B.R. 590 (D. Idaho 1987) , and application of Vermont law in *In re Galvin*, 120 B.R. 767, 772 (Bankr. D. Vt. 1990) ; see also *Commerce Bank v. Mountain View Vill., Inc.*, 5 F.3d 34, 29 C.B.C.2d 1241 (3d Cir. 1993) (citing text and construing Pennsylvania law in

holding that rents were not property of the debtor's bankruptcy estate because creditors commenced collecting tenants' rents prior to petition date). It should be noted, however, that some commentators have questioned the viability of the cases upholding the absolute assignment theory under California law. See Geiger and Frobes, *Lenders and Leases*, 7 Calif. Real. Prop. J. No. 4, pp.1, 17 n.19 (Fall 1989).

(n37)Footnote 26. Casher, Skelton and Johnson, *Assignments of Rents: Drafting Considerations in Light of Bankruptcy Risks*, presented at A.B.A. Sec. of Real Prop., Prob. and Trust Law, Real Property Programs, Orlando, FL, (March 1991) at 1 (citing cases at app. 3). See P 2.03[3] *infra*.

(n38)Footnote 27. Fla. Stat. § 697.07. However, courts appear to have split over the correct interpretation of the statute, and whether it does, in fact, recognize absolute assignments. Compare *In re Thymewood Apts. Ltd.*, 123 B.R. 969 (Bankr. S.D. Ohio 1991) ; *In re Cardinal Indus., Inc.*, 118 B.R. 971 (Bankr. S.D. Ohio 1990) ; *In re 163rd St. Mini Storage, Inc.*, 22 C.B.C.2d 1410, 113 B.R. 87 (Bankr. S.D. Fla. 1990) ; *In re Aloma Square, Inc.*, 116 B.R. 827 (Bankr. M.D. Fla. 1990) ; *In re Camelot Assocs. L.P.*, 102 B.R. 161 (Bankr. S.D. Mo. 1989) ; with *In re One Fourth St. N., Ltd.*, 103 B.R. 320, 321 (Bankr. M.D. Fla. 1989) ; *In re Growere Prop. No. 56 Ltd.*, 117 B.R. 1015 (Bankr. M.D. Fla. 1990) . M.C.L. §§ 554.231 and 554.232. See *In re P.M.G. Properties*, 55 B.R. 864 (Bankr. E.D. Mich. 1985) .

In most, but not all cases, the states which recognize absolute assignments of rents are states which adhere to the title theory of mortgages. Most lien theory states, which take the view, with respect to a mortgage, that title to the property remains in the mortgagor until the completion of a judicial foreclosure of title, are equally protective of the mortgagor's rights to the rents and profits, and require more than the execution and delivery of an assignment of rents to vest title to the rents in the mortgagee. See, e.g., Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07.

(n39)Footnote 27a. See Carson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1110-1113 (1995).

(n40)Footnote 28. See, e.g., Nelson and Whitman, *Real Estate Finance Law* (2d ed. 1985) at § 4.1 ("Title theory states today generally recognize that the mortgagee holds title for security purposes only, and that, except as between the mortgagor and the mortgagee or one claiming under him, the mortgagor, for practical and theoretical purposes, is to be regarded as the owner of the land"); Powell, 3 *The Law of Real Property* (1991) at P 439 ("In some parts of the United States the title theory found acceptance as part of the inherited common law. Even in these states, however, the results reached in litigation show recognition of the true lien character of the mortgage"); and Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 1.6 ("Even in title states the 'title' that is vested in the mortgagee tends to be rather shadowy for most purposes. For example, no one but the mortgagee can avail himself of the 'title' vested in the mortgagee").

(n41)Footnote 29. *Id.*

(n42)Footnote 30. See Geiger & Frobes, *Lenders and Leases*, 7 Calif. Real. Prop. J. No. 4, p.17 n.19 (Fall 1989) (questioning the viability of the cases upholding absolute assignment theory under California law); Conti, *Assignment of Rents: There's Hope for Secured Creditors*, 3 Bankr. Counsellor No. 21 (Oct. 22, 1990); Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 Comm. L.J. 516, 524-26 (Winter 1988).

(n43)Footnote 30a. See Carson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1110-11 (1995).

(n44)Footnote 31. Cf. Nelson & Whitman, *Real Estate Finance Law* (2d ed. 1985); Kratovil & Werner, *Modern Mortgage Law and Practice*, § 20.02 (2d ed. 1987).

(n45)Footnote 32. See note 28 *supra*; Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 Comm. L.J. 516, 524-26 (Winter 1988). Uniform Commercial Code § 2-401 provides that "each provision of this Article with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other

third parties applies irrespective of title to the goods except where the provision refers to such title." This provision furthers the basic policy of the Uniform Commercial Code that "known purpose and reason should govern interpretation" of commercial transactions, rather than arcane rules divining the location of "title." *Uniform Commercial Code* § 2-401, Off. Unif. Comment. See *In re Guardian Realty Group*, 205 B.R. 1 (Bankr. D.C. 1997); *Lyons v. Federal Sav. Bank (In re Lyons)*, 193 B.R. 637 (Bankr. D. Mass 1996).

(n46)Footnote 33. Conti, *Assignment of Rents: There's Hope for Secured Creditors*, 3 Bankr. Counsellor No. 21 (Oct. 22, 1990).

(n47)Footnote 34. See text at ns.18-21 *supra*.

(n48)Footnote 35. *In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986); *In re Village Prop., Ltd.*, 723 F.2d 441, 10 C.B.C.2d 224 (5th Cir. 1984), cert. denied, 466 U.S. 974, 104 S. Ct. 2350, 80 L. Ed. 2d 823 (1984); *In re Executive Square, Ltd.*, 77 B.R. 303 (Bankr. S.D. Fla. 1987); *In re Pine Lake Vill. Apt. Co.*, 6 C.B.C.2d 83, 17 B.R. 829 (Bankr. S.D.N.Y. 1982); *In re Shoppers Paradise, Inc.*, 3 C.B.C.2d 484, 495-96, 8 B.R. 271, 280 (Bankr. S.D.N.Y. 1980); *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 C.B.C. 474 (Bankr. S.D.N.Y. 1978); cf. *In re Riverside Nursing Home*, 11 C.B.C.2d 502, 43 B.R. 682 (Bankr. S.D.N.Y. 1984) (holding that an assignee of rents does not have standing as a "party" to compel the trustee of the debtor-lessee under the underlying lease to reject or assume the lease under section 365(d)(2) as in effect prior to the amendments enacted in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised)).

(n49)Footnote 36. *Casher II*, note 7 *supra*, at 4; see cases cited in note 35 *supra*.

(n50)Footnote 37. See note 35 *supra*.

(n51)Footnote 38. In *Saline State Bank v. Mahloch*, 834 F.2d 690 (8th Cir. 1987), the court, applying Nebraska law, held that no lien arose under a duly recorded assignment of rents until "perfection" occurred under state law by means of a petition to sequester rents. The opinion in *In re Greenhaven Village Apts. of Burnsville Phase II L.P.*, 100 B.R. 465 (Bankr. D. Minn. 1989), discusses the priorities and rights arising from recordation of an assignment of rents, as distinguished from the acts required for enforcement of the assignment.

It should be noted that in some cases, such as hotel room receipts, restaurant receipts, race track gate receipts and nursing home revenues, it is not always clear what action is necessary to perfect the assignment under state law. *Casher*, Day and DeSieno, *Assignments of Rents in Bankruptcy*, ABA Sec. of Real Prop., Prob. & Tr. Law, Real Property Programs, 1991 Spring CLE Meeting, Vol. III, Sec. B, Tab 3, (March 1991) at 6-8; Heidt, *The Effect of the 1994 Amendments on Commercial Secured Creditors*, 69 Am. Bankr. L.J. 395, 414-15 (1995); Averch, *The Heartbreak Hotel for Secured Lenders: When Postpetition Revenue From a Hotel Is Not Subject to a Prepetition Security Interest*, 107 Banking L.J. 484 (1990). Whenever the correct method of perfection is unclear, the assignment should be recorded in the proper real estate records and a Uniform Commercial Code financing statement should be filed in all appropriate filing locations.

(n52)Footnote 39. See P 2.03[1][c][iv] *infra*.

(n53)Footnote 40. 11 U.S.C. § 362(a). *In re Gotta*, 47 B.R. 198, B.L.R. P 70,322 (Bankr. W.D. Wis. 1985); cf. *In re Shoppers Paradise, Inc.*, 8 B.R. 271 (Bankr. S.D.N.Y. 1980), 8 B.R. 271.

(n54)Footnote 41. 11 U.S.C. § 362(a); Fed. R. Bankr. P. 4001(b).

(n55)Footnote 42. *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 C.B.C. 474 (Bankr. S.D.N.Y. 1978); accord *In re Rief*, 83 B.R. 626 (Bankr. S.D. Iowa 1988); *In re Di Toro*, 22 B.R. 392 (Bankr. E.D. Pa. 1982) (Pennsylvania law). One court has gone so far as to hold that a mere demand against the trustee for sequestration, and not a formal petition, is

sufficient to activate a collateral assignment. *In re Southern Gardens, Inc.*, (Bankr. S.D. Ill. 1982), 39 B.R. 671 . *In re Anderson*, 50 B.R. 728 (D. Neb. 1985) , holds that if state law requires for perfection the appointment of a receiver and a showing that the mortgage loan is undersecured, the bankruptcy court should devise a procedure which omits the receivership requirement and permits the assignee to demonstrate the value of the collateral. *Accord*, *In re Seville Entertainment Complex, Inc.*, 73 B.R. 213 (Bankr. N.D. Fla. 1986) .

(n56)Footnote 43. See cases cited in note 66 *infra*.

(n57)Footnote 44. 11 U.S.C. § 1112; *Fed. R. Bankr. P.* 1007.

(n58)Footnote 45. 11 U.S.C. § 362(d); *Fed. R. Bankr. P.* 4001(d).

(n59)Footnote 46. 11 U.S.C. § 1121(b).

(n60)Footnote 47. 11 U.S.C. § 1104; *Fed. R. Bankr. P.* 2012(a).

(n61)Footnote 48. 11 U.S.C. § 506(b)

(n62)Footnote 49. See P 2.03[1][b][vii] *infra*.

(n63)Footnote 49a. See *Gold Coast Asset Acquisition, L.P. v. 1441 Veteran St. Co.* (In re 1441 Veteran St. Co.), 144 F. 3d 1288 (9th Cir. 1998) , and *In re Woodfield Gardens Assocs.*, 1998 Bankr. LEXIS 734 (Bankr. N.D. Ill. 1998) for examples of cases in which the debtor sought to recover its attorney's fees from postpetition rentals constituting case collateral.

(n64)Footnote 49b. See P 2.03[1][c][vii] *infra*

(n65)Footnote 50. *Uniform Commercial Code* §§ 9-203 and 9-303.

(n66)Footnote 51. *In re DeCespedes*, 241 B.R. 260, 262 & n.1 (Bankr. S.D. Fla. 2000) (Florida law); *In re Fairview-Takoma Ltd. Pshp.*, 206 B.R. 792, 797-98 (Bankr. D. Md. 1997) ; Conti, *Assignment of Rents: There's Hope for Secured Creditors*, 3 Bankr. Counsellor No. 21 (Oct. 22, 1990); Randolph, *When Should Bankruptcy Courts Recognize Lenders' Rent Interests*, 23 U. Cal. Davis L.R. 833, 860 (1990). Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1091-92 (1995).

(n67)Footnote 52. *The Prudential Ins. Co. of Am. v. Boston Harbor Marina Co.*, 159 B.R. 616 (D. Mass. 1993) ; *Vienna Park Props. v. United Postal Sav. Ass'n* (In re Vienna Park Props.), 976 F.2d 106 (2d Cir. 1992) ; *Sears Sav. Bank v. Tucson Indus. Partners* (In re Tucson Indus. Partners), 25 C.B.C.2d 523, 528, 129 B.R. 614, 617-18 (9th Cir. 1991) ; Randolph, *When Should Bankruptcy Courts Recognize Lenders' Rent Interests*, 23 U. Cal. Davis L.R. 833, 859-60 (1990). It should be noted, however, that some language is in the authorities and the literature to the effect that the mortgagee's lien is "inchoate," or does not "attach," until an assignment of rents has been activated. *Saline State Bank v. Mahloch*, 834 F.2d 690 (8th Cir. 1987) ; Weg, *The Secured Creditor's Rights to Rents From Real Property*, 17 Real Est. L.J. 29, 32 (1988); Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07. See *In re Park at Dash Point L.P.*, 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990) .

(n68)Footnote 53. Conti, *Assignment of Rents: There's Hope for Secured Creditors*, 3 Bankr. Counsellor No. 21 (Oct. 22, 1990); Randolph, *When Should Bankruptcy Courts Recognize Lenders' Rent Interests*, 23 U. Cal. Davis L.R. 833, 859-60 (1990).

(n69)Footnote 54. Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07. "The assignment of leases and rents owes its existence to the experience of lenders during the Great Depression. At every turn courts sought to block the lender's access to rents and to keep the mortgagor in possession. This was particularly true in the lien-farmer states."

(n70)Footnote 55. See, e.g., *Sniadach v. Family Fin. Corp.*, 395 U.S. 337, 89 S. Ct. 1820, 23 L. Ed. 2d 349 (1969); *Fuentes v. Shevin*, 407 U.S. 67, 92 S. Ct. 1983, 32 L. Ed. 2d 556 (1972); *North Georgia Finishing, Inc. v. Di-Chem, Inc.*, 419 U.S. 601, 95 S. Ct. 719, 42 L. Ed. 2d 751 (1975).

(n71)Footnote 56. 11 U.S.C. § 547; *In re Metro Square*, 106 B.R. 584, 588 (Bankr. D. Minn 1989); Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 Comm. L.J. 516, 523 (Winter 1988); Randolph, *When Should Bankruptcy Courts Recognize Lenders' Rent Interests*, 23 U.C. Davis L. Rev. 833, 861-62 (1990). See P 2.03[4] *infra* for a discussion of preference issues relating to an activated assignment of rents.

(n72)Footnote 56a. *In re Wheaton Oaks Office Partners L.P.*, 27 F.3d 1234, 1244 n.6 (7th Cir. 1994); *In re Woodfield Gardens Assocs.*, 1998 Bankr. LEXIS 640 (Bankr. N.D. Ill, May 29, 1998). But see Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1136-38, arguing that the temporary superiority of the right to collect rents of a purchaser of real property that is subject to a mortgage and an unactivated assignment of rents gives rise to an avoidance right for a trustee under section 544(a) as a hypothetical *bona fide* purchaser as of the petition date. Section 544(a) deals with the rights and powers of, and the right to avoid and transfer of property by the debtor or any obligation incurred by the debtor, that is voidable by among other persons, a hypothetical *bona fide* purchaser of real property that obtains such status as of the petition date. A bona fide purchaser of real property has neither the right to cut off the lien of a duly recorded assignment or rents nor the right of the holder of such lien to realize on the rents.

(n73)Footnote 57. See P 2.03[1][c][v] *infra*; see also *Commerce Bank v. Mountain View Vill., Inc.*, 5 F.3d 34, 39, 29 C.B.C.2d 1241, 1247 (3d Cir. 1993) (citing this conclusion with approval). But see Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1136-38.

(n74)Footnote 58. E.g., *In re Colter, Inc.*, (Bankr. D. Colo. 1984), 46 B.R. 510.

(n75)Footnote 59. *Vienna Park Props. v. United Postal Sav. Ass'n (In re Vienna Park Props.)*, 976 F.2d 106 (2d Cir. 1992); *In re Park at Dash Point L.P.*, 121 B.R. 850, 860 (Bankr. W.D. Wash. 1990) ("[i]t follows that an unenforced assignment of rents constitutes an interest in rents sufficient to render the rents cash collateral when paid"); *Sears Sav. Bank v. Tucson Indus. Partners*, 129 B.R. 614, 617-18 (9th Cir. 1991).

(n76)Footnote 60. [Reserved]

(n77)Footnote 61. 11 U.S.C. § 362(b)(3).

(n78)Footnote 62. 11 U.S.C. § 546(b). The Bankruptcy Reform Act of 1994 amended section 546(b) as previously in effect by adding the provision in subsection (b)(1)(B) that addresses the "maintenance or continuation of perfection." Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised). The legislative history indicated that the purpose of the amendment was to confirm that the actions which a secured creditor takes during the case pursuant to the Uniform Commercial Code in order to maintain its position as it was at the commencement of the case, such as the filing of a continuation statement or financing statement, do not violate the automatic stay. 140 Cong. Rec. H 10,674 (daily ed. October 4, 1994) *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n79)Footnote 63. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 371-72 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 95-989, 95th Cong., 2d Sess. 86-87 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised).

(n80)Footnote 64. 11 U.S.C. § 544(a)(1) provides:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of

property of the debtor or any obligation incurred by the debtor that is voidable by--

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists.

(n81)Footnote 64a. See P 2.03[1][c][i] *supra*

(n82)Footnote 65. Compare *In re Westport-Sandpiper Assoc. Ltd. Partnership*, 116 B.R. 355, 358-59 (Bankr. D. Conn. 1990), discussing "relation-back" as dealing with the question whether postpetition activation of an assignment of rents reaches back to the prepetition period, with *Federal Home Life Ins. Co. v. American Continental Corp.* (In re *American Continental Corp.*), 105 B.R. 564, 574-75 (Bankr. D. Ariz. 1989), distinguishing between the retroactive effect of the lien and of the right to directly collect the rents.

(n83)Footnote 65a. See P 2.03[1][c][i] *supra*.

(n84)Footnote 66. *In re American Continental Corp.*, 105 B.R. 564, 576 (Bankr. D. Ariz. 1989); *Virginia Beach Sav. & Loan Ass'n v. Wood*, 97 B.R. 71, 73 (N.D. Okla. 1988); *Chausee v. Morning Star Ranch Resorts Co.* (In re *Morning Star Ranch Resorts*), 64 B.R. 818, 822 (Bankr. D. Colo. 1986); *Consolidated Capital Income Trust v. Colter, Inc.*, 47 B.R. 1008, 1011 (Bankr. D. Colo. 1984); *United States v. Farrell* (In re *Fluge*), 57 B.R. 451 (D. N.D. 1985).

The following cases have held that the following actions are also sufficient to perfect an assignment of rents under section 546(b): motion to lift the automatic stay: *In re Casbeer*, 793 F.2d 1436, 1443 (5th Cir. 1986); *In re Gelwicks*, 81 B.R. 445, 448 (Bankr. N.D. Ill. 1987); motion for sequestration of rents: *Chausee v. Morning Star Ranch Resorts Co.* (In re *Morning Star Ranch Resorts*), 64 B.R. 818, 821; *In re Rief*, 83 B.R. 626 (Bankr. S.D. Iowa 1988); complaint to determine validity and priority of assignment of rents: *In re Sampson*, 57 B.R. 304, 309 (Bankr. E.D. Tenn. 1986); notice of perfection based on showing of entitlement to appointment of receiver: *In re 1301 Connecticut Ave. Assoc.*, (Bankr. D.D.C. 1990), 117 B.R. 2, 10-11.

In addition, the following cases, without discussing the applicability of section 546(b), have held that the following actions will perfect an assignment of rents: motion for sequestration of rents: *In re Center of Mo. Ltd.*, 116 B.R. 138, 140-41 (Bankr. E.D. Mo. 1990); *Saline State Bank v. Mahloch*, 834 F.2d 690 (8th Cir. 1987); *Santa Fe Fed. Sav. & Loan Ass'n v. Oak Glen R-Vee* (In re *Oak Glen R-Vee*), 8 B.R. 213, 216 (Bankr. C.D. Cal. 1981); demand to Trustee to set aside rents: *In re Southern Gardens, Inc.*, 39 B.R. 671, 673, 11 B.C.D. 1273 (Bankr. S.D. Ill. 1982); application of leave to foreclose and to obtain appointment of receiver: *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 Collier Bankr. Cas. (MB) 474, 480-81 (Bankr. S.D.N.Y. 1978).

(n85)Footnote 67. *In re Polo Club Apartments Assocs. L.P.*, 28 C.B.C.2d 501, 150 B.R. 840 (Bankr. N.D. Ga. 1993); *In re Rancourt*, 123 B.R. 143, 149 (Bankr. D.N.H. 1991); *In re Raleigh/Spring Forest Apts. Assocs.*, 118 B.R. 42, 46 (Bankr. E.D.N.C. 1990); *In re Park at Dash Point, L.P.*, 121 B.R. 850 (Bankr. W.D. Wash. 1990); *In re Multi-Group III L.P.*, 99 B.R. 5, 10 (Bankr. D. Ariz 1990).

(n86)Footnote 68. *In re Somero*, 122 B.R. 634, 638-39 (Bankr. D. Me. 1991); *In re Foxhill Place Assoc.*, 119 B.R. 708, 713-14 (Bankr. W.D. Mo. 1990); *In re Gould*, 78 B.R. 590 (D. Idaho 1987); *In re Fry Rd. Assocs., Ltd.*, 64 B.R. 808 (Bankr. W.D. Tex. 1986); *In re P.M.G. Prop.*, 55 B.R. 864, 867-69 (Bankr. E.D. Mich. 1985); *In re Winslow Center Assocs.*, 50 B.R. 679 (Bankr. E.D. Pa. 1985).

(n87)Footnote 68a. 140 Cong. Rec. H 10,764 (daily ed. October 4, 1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9 (b) (Matthew Bender 15th Ed. Revised) (emphasis added).

(n88)Footnote 68b. See Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1145.

(n89)Footnote 68c. *See P 2.03[1][c][vii] infra.*

(n90)Footnote 68d. *See P 2.03[1][c][iv] supra.*

(n91)Footnote 68e. *See note 56a supra.*

(n92)Footnote 68f. Section 547(b) requires for preferential transfer avoidance that the transfer be made for or on account of an antecedent debt of the debtor, within the 90-day or one-year period prior to the filing date, as applicable, that enables the creditor to receive more than it would receive in a liquidation, and while the debtor was insolvent. It has been argued that in a typical single asset real estate chapter 11 case involving a nonrecourse mortgage, the debtor can never be insolvent inasmuch as the nonrecourse secured creditor's claim does not exceed the value of the collateral and the small group of recourse creditors will have recourse to the assets of the general partner. Carlson, *Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1152-53. The issue is whether the statutory grant of recourse for undersecured creditors under section 1111(b)(1)(A), which creates a deficiency claim for the undersecured nonrecourse creditor, is to be read into the insolvency definition set forth in section 101(32).

It has also been argued that the hypothetical liquidation value test in section 547(b) will not be satisfied in the case of preferential transfers involving single asset real estate entities. *See Carlson, Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1154-56.

(n93)Footnote 68g. *Cf. In re Madrid*, 10 B.R. 795 (5th Cir. 1981) , cert. denied, 469 U.S. 833, 105 S. Ct. 125, 83 L. Ed. 2d 66 (1982) .

(n94)Footnote 68h. This is the term employed in the legislative history excerpted above. *See* 140 Cong. Rec. H 10,764 (daily ed. October 4, 1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9 (b) (Matthew Bender 15th Ed. Revised) (emphasis added).

(n95)Footnote 68i. *See P 2.03[1][c][i] supra.*

(n96)Footnote 68j. *In re DeCespedes*, 241 B.R. 260 (Bankr. S.D. Fla. 2000) . The legislative history of the 1994 amendments to section 552(b) is set forth in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised) (see discussion of section 214 of Bankruptcy Reform Act of 1994)

(n97)Footnote 68k. *See P 2.03[1][c][i] supra.*

(n98)Footnote 69. *Butner v. United States*, 440 U.S. 48, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979) .

(n99)Footnote 70. *Compare N.Y. Life Ins. Co. v. Fulton Dev. Corp.*, 265 N.Y. 348, 193 N.E. 169 (1934) ("the receiver appointed in foreclosure may be authorized to collect such rents as have theretofore accrued but not yet come into the hands of the [mortgagor]") with *Hartford Realization Co. v. Travellers Ins. Co.*, 117 Conn. 218, 167 A. 728 (1933) .

(n100)Footnote 71. Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07; Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 Hastings L.J. 1433, 1442-46 (1980).

(n101)Footnote 72. Nelson, *Real Estate Finance Law* (2d ed. 1985) at § 4.35; Kratovil and Werner, *Modern Mortgage Law and Practice* (2d ed. 1987) at § 20.07; Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 Hastings L.J. 1433, 1442 (1980); Weg, *The Secured Creditor's Rights to Rents From Real Property*, 17 Real Est. L.J. 29, 34, 39-40 (1988).

(n102)Footnote 73. Of course, rents collected and held by the assignee of rents or by a custodian at the time of

filing are subject to the turnover provisions of section 542(a) and 543(b)(1), respectively, in each case subject to the provisions of section 363(c)(4).

(n103)Footnote 74. See P 2.03[1][c][i] *supra*.

(n104)Footnote 75. 11 U.S.C. § 506(c). *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 43 C.B.C.2d 861 (2000) ; see also *Contractors v. M & S Grading, Inc.* (In re M & S Grading, Inc.), 541 F.3d 859, 60 C.B.C.2d 364 (8th Cir. 2008) . Although a discussion of the cases seeking to define "preservation expenses" and the types of benefits to the secured party which warrant a deduction from the rents payable to the secured party are beyond the scope of this book, the following cases should be considered in any analysis of those issues: *Daniel v. AMCI* (In re Ferncrest Court Partners), 66 F.3d 778 (6th Cir. 1995) ; *In re Visual Indus., Inc.*, 57 F.3d 321, 33 C.B.C.2d 1110 (3d Cir. 1995) ; *Treasurer of Shohomish County v. Seattle-First Nat'l Bank* (In re Glasply Marine Indus., Inc.), 971 F. 2d 391, 393 (9th Cir. 1992) ; *In re P.C. Ltd.*, 929 F.2d 203 (5th Cir. 1991) ; *In re Flagstaff Foodservice Corp.*, 762 F.2d 10, 12 C.B.C.2d 1019 (2d Cir. 1985) ; *Brookfield Prod. Credit Ass'n v. Borion*, 738 F. 2d 951, 952, 10 C.B.C.2d 1314, 1315 (8th Cir. 1984) ; *In re Trim-X, Inc.*, 695 F.2d 296, 7 C.B.C.2d 955 (7th Cir. 1982) ; *In re Great Northern Forest Prods., Inc.*, 26 C.B.C.2d 411, 431-32, 135 B.R. 46, 63 (Bankr. W.D. Mich. 1991) ; *In re Bob Grisset Golf Shoppes, Inc.*, 50 B.R. 598 (Bankr. E.D. Va. 1985) ; *In re Afco Enter., Inc.*, 9 C.B.C.2d 1127, 35 B.R. 512 (Bankr. D. Utah 1983) ; *In re Wiltwyck School*, 34 B.R. 270 (Bankr. S.D.N.Y. 1983) .

The amount recoverable from a rent stream by an assignee of rents is also affected by section 506(b), which provides in substance that a fully secured creditor is entitled to receive postpetition interest and "reasonable fees, costs or charges" to the extent provided for in the security agreement. The secured creditor's recovery under section 506(b) is subject to the trustee's claims under section 506(c). 11 U.S.C. § 506(b). Recovery of a mortgage lender's attorney's fees may be limited to work performed to protect the security, rights or powers of the mortgagee. *Pasatiempo Prop. v. LeMarquis Assoc.* (In re Le Marquis Assoc.), 65 B.R. 719, 15 B.C.D. 238 (Bankr. E.D. Cal. 1986) . This may be difficult to demonstrate when the mortgagee is oversecured, which is the only circumstance in which section 506(b) will operate to permit allowance of such fees.

(n105)Footnote 76. *In re National Real Estate Ltd. Partnership-II*, 104 B.R. 968, 972-73 (Bankr. E.D. Wis. 1989) ; *In re One Fourth St. N., Ltd.*, 103 B.R. 320, 322 (Bankr. M.D. Fla. 1989) .

(n106)Footnote 77. *In re Bethesda Air Rights L.P.*, 117 B.R. 202, 209-10 (Bankr. D. Md. 1990) ; *In re Gaslight Vill.*, 6 B.R. 871, 875 (Bankr. D. Conn. 1980) .

(n107)Footnote 78. *Confederation Life Ins. Co. v. Beau Rivage Ltd.*, 126 B.R. 632, 639 (N.D. Ga. 1991) ; see also *In re Wrecclesham Grange, Inc.*, 221 B.R. 978 (Bankr. M.D. Fla. 1997) and *In re Princeton Square Assocs., L.P.*, 37 C.B.C.2d 55, 201 B.R. 90 (Bankr. S.D.N.Y. 1996) denying adequate protection for rental cash collateral.

(n108)Footnote 79. *In re Grant Broad. of Philadelphia, Inc.*, 71 B.R. 376, 386 (Bankr. E.D. Pa. 1987) , *aff'd*, 75 B.R. 819 (E.D. Pa. 1987) ; *In re Heath*, 79 B.R. 616, 618 (Bankr. E.D. Pa. 1987) . See Flaschen, *Adequate Protection for Secured Creditors*, 61 Am. Bankr. L. J. 341 (1987).

(n109)Footnote 80. *In re Princeton Square Assocs., L.P.*, 37 C.B.C.2d 55, 201 B.R. 90 (Bankr. S.D.N.Y. 1996) holds that notwithstanding the mortgagee's "ownership" of postpetition rents under applicable state law, the debtor in possession may continue to apply the rents to the expenses of the real property in the same manner as would a receiver appointed at the behest of the mortgagee. The court stated that no monetary protection respecting the rents must be provided by the debtor in possession to the mortgagee to the extent the rents are employed to pay property expenses. 37 C.B.C.2d 55, 201 B.R. 90, 96 . See P 2.03[1][c][viii] *infra* for additional discussion of this point.

(n110)Footnote 81. See P 2.03[1][c][viii] *infra*.

(n111)Footnote 82. See P 2.03[1][c][i] *supra*.

(n112)Footnote 82a. *Catton Farms, Inc. v. First Nat'l Bank of Chicago*, 779 F.2d 1242, 1246-7 (7th Cir. 1985) . See *In re Village Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984) ; *Delbridge v. Prod. Credit Assoc. & Fed. Land Bank*, 104 B.R. 824, 826 (E.D. Mich. 1989) ; *Oliver v. MBank Dallas, N.A. (In re Oliver)*, 16 C.B.C.2d 1096, 1100, 66 B.R. 426, 428 (Bankr. N.D.Tex. 1986) ; *In re Crouch*, 51 B.R. 331, 332 (Bankr. D. Ore. 1985) .

Certain legislative history relating to the part of the 1994 amendments to section 552(b) relating to hotel revenues sets forth a comment on the equities exception stating that the equities exception is intended to "prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors generally." 140 Cong. Rec. H10,764, H10,768 (daily ed. Oct. 4, 1994). This view, which does not have support in case precedent, appears to advocate full discretion on the part of the bankruptcy courts to deprive holders of enforceable rent assignments and other creditors with similar collateral (such as postpetition hotel revenues) of the benefits of their liens without adequate protection.

(n113)Footnote 82b. *Stanziale v. Finova Capital Corp. (In re Tower Air, Inc.)*, 397 F.3d 191 (3d Cir. 2005) ; *Catton Farms, Inc. v. First Nat'l Bank of Chicago*, 779 F.2d 1242, 1246-7 (7th Cir. 1985) ; *In re Ceron*, 2009 Bankr. LEXIS 2380 (Bankr. E.D.N.Y. Sept. 1, 2009) ; see *In re Village Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984) ; *Delbridge v. Prod. Credit Assoc. & Fed. Land Bank*, 104 B.R. 824, 826 (E.D. Mich. 1989) ; *Oliver v. MBank Dallas, N.A. (In re Oliver)*, 16 C.B.C.2d 1096, 1100, 66 B.R. 426, 428 (Bankr. N.D.Tex. 1986) ; *In re Crouch*, 51 B.R. 331, 332 (Bankr. D. Ore. 1985) .

(n114)Footnote 82c. See *Carson, Rents in Bankruptcy*, 46 S.C. L. Rev. 1075, 1131. (1995).

(n115)Footnote 82d. 976 F.2d 106 (2d Cir. 1992) .

(n116)Footnote 82e. 976 F. 2d 106, 113 .

(n117)Footnote 82f. *Id.*; see also *In re Carmania Corp.*, 154 B.R. 160 (S.D.N.Y. 1993) ; cf. *United Sav. Assoc. v. Timbers of Inwood Forest*, 484 U.S. 365, 375-76, 108 S. Ct. 626, 632-33, 98 L. Ed. 2d 740, 749-51, 17 C.B.C.2d 1368, 1373 (1988) .

(n118)Footnote 83. *In re Morning Star Ranch Resorts*, 64 B.R. 818, 822-23 (Bankr. D. Colo. 1986) ; *In re Parham*, 72 B.R. 604, 606 (Bankr. M.D. Fla. 1987) ; *In re Oak Glen R-Vee*, 8 B.R. 213, 216 n.4 (Bankr. C.D. Cal. 1981) .

(n119)Footnote 84. 11 U.S.C. § 506(b). *United States v. Ron Pair Enters.*, 489 U.S. 235, 242-43, 109 S. Ct. 1026, 1030, 103 L. Ed. 2d 290, 298-99 (1989) , holding that section 506(b) provides that all oversecured claims are entitled to postpetition interest, but that reasonable fees, costs or charges on oversecured claims are allowed only to the extent that the agreement under which the claim arises provides for such fees, costs or charges.

(n120)Footnote 85. *Fortgang & Mayer, Valuation in Bankruptcy*, 32 U.C.L.A. L. Rev. 1061, 1088 (1985).

(n121)Footnote 86. *United States v. Ron Pair Enters.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989) .

(n122)Footnote 86a. 11 U.S.C. § 502(b)(2).

(n123)Footnote 87. *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 377-80, 108 S. Ct. 626, 633-35, 98 L. Ed. 2d 740, 752-54, 17 C.B.C.2d 1368, 1374-77 (1988) .

(n124)Footnote 87a. *Fortgang & Gardner, Recent Developments in Post-Petition Interest*, at 9 (N.Y.U. Workshop on Bankruptcy and Business Reorganization (1998)).

(n125)Footnote 88. 484 U.S. 365, 371-72, 108 S. Ct. 626, 630-31, 98 L. Ed. 2d 740, 748-49, 17 C.B.C.2d 1368, 1372-73 .

(n126)Footnote 89. *In re Gramercy Twins Assocs.*, 187 B.R. 112 (Bankr. S.D.N.Y. 1995) ; *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995) ; *In re Vermont Inv. L.P.*, 27 C.B.C.2d 374, 142 B.R. 571 (Bankr. D.C. 1992) ; *In re Flagler-at-First Assocs.*, 114.B.R. 297 (Bankr. S.D. Fla. 1990) .

(n127)Footnote 90. *In re Gramercy Twins Assocs.*, 187 B.R. 112, 122 (Bankr. S.D.N.Y. 1995) . In *Financial Security Assurance Inc. v. T-H New Orleans L.P.* (*In re T-H New Orleans L.P.*), 116 F. 3d 790, 38 C.B.C.2d 458 (5th Cir. 1997) , the court rejected the subtraction cases, and held that postpetition interest began to accrue at the moment during the pendency of the case when the value of the collateral first exceeded the secured creditor's claim. The court rejected the argument that the collateral should be valued at confirmation and postpetition interest awarded retroactively to the petition date. 116 F. 3d 790, 799, 38 C.B.C.2d 458, 466-67 .

(n128)Footnote 91. *In re Union Meeting Partners*, 178 B.R. 664, 667 n.9 (Bankr. E.D. Pa. 1995) .

(n129)Footnote 92. *In re Flagler-at-First Assocs.*, 114 B.R. 297, 303 (Bankr. S.D. Fla. 1990) ; see also *In re 680 Fifth Ave. Assocs.*, 28 C.B.C.2d 1314, 154 B.R. 38 (Bankr. S.D.N.Y. 1993) But see *In re Princeton Square Assocs., L.P.*, 37 C.B.C.2d 55, 201 B.R. 90 (Bankr. S.D.N.Y. 1996) , holding that there is to be no adequate protection for section 552(b)(2) rents expended in the same manner as would a state court receiver.

(n130)Footnote 93. *In re Kalian*, 31 C.B.C.2d 595, 169 B.R. 503 (Bankr. D.R.I. 1994) ; *In re IPC Atlanta L.P.*, 27 C.B.C.2d 553, 142 B.R. 547 (Bankr. N.D. Ga. 1992) ; *Confederation Life Ins. Co. v. Beau Rivage Ltd.*, 126 B.R. 632 (N.D. Ga. 1991) ; *In re Oaks Partners, Ltd.*, 26 C.B.C.2d 721, 135 B.R. 440 (Bankr. N.D. Ga. 1991) ; *In re Reddington/Sunarrow L.P.*, 24 C.B.C.2d 663, 119 B.R. 809 (Bankr. D.N.M. 1990) . Accord, *In re Mullen*, 31 C.B.C.2d 1765, 172 B.R. 473, 476 (Bankr. D. Mass. 1994) .

(n131)Footnote 94. *United Savs. Ass'n. of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) ; see *In re Reddington/Sunarrow Ltd. Partnership*, 24 C.B.C.2d 663,--, (Bankr. D.N.M. 1990) ; *In re Kalian*, 31 C.B.C.2d 595, 169 B.R. 503, 504-06 (Bankr. D.R.I. 1994) .

(n132)Footnote 95. *In re IPC Atlanta Ltd. Partnership*, 27 C.B.C.2d 553 (Bankr. N.D. Ga. 1992) ; *In re Oaks Partners, Ltd.*, 135 B.R. 440, 448-49 (Bankr. N.D. Ga. 1991) .

(n133)Footnote 96. See *In re Union Meeting Partners*, 178 B.R. 664, 676-77 (Bankr. E.D. Pa. 1995) . The Union Meeting decision is one of the so-called "wash cases" discussed *infra*, but analogizes the application of postpetition rents first to the augmentation of an undersecured creditor's secured claim, and then the subtraction therefrom of the amount of such rents paid to the creditor, to the application of proceeds of sale of a portion of equipment collateral that is subject to a security interest. The court stated that the proceeds of the sale would be applied to reduction of the secured debt, but not to reduction of the value of the machinery that had not been sold. *Id.* This analysis points up the fundamental difference between the subtraction cases and the wash cases. In the subtraction cases, the courts do no view section 552(b)(2) rents as additional collateral, but rather as part of one package of real estate collateral as valued as of the petition date. Therefore, in their view, such rents must be applied to reduction of the principal of the secured portion of an undersecured claim, as if the sole item of machinery subject to a security interest were sold in the postpetition period, with the proceeds paid to the estate in installments. The wash cases, on the other hand, characterize postpetition rents to which a secured creditor is entitled under section 552(b)(2) as additional and separate collateral which, when remitted to an undersecured creditor, reduces an augmented claim rather than the amount of the secured portion of the creditor's claim as fixed as of the petition date.

(n134)Footnote 97. *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996) ; *In re Addison Props. L.P.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) ; see *In re The Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990) .

(n135)Footnote 98. *In re Duval Manor Assocs.*, 191 B.R. 622, 633-34 (Bankr. E.D. Pa. 1996) .

(n136)Footnote 99. *United Savs. Ass'n. of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) ; see *In re Reddington/Sunarrow Ltd. Partnership*, 24 C.B.C.2d 663 (Bankr. D.N.M. 1990) ; *In re Kallian*, 31 C.B.C.2d 595, 169 B.R. 503, 504-06 (Bankr. D.R.I. 1994) .

(n137)Footnote 100. *In re Addison Props. L.P.*, 185 B.R. 766, 775 (Bankr. N.D. Ill. 1995) . See P 2.06[2] *infra*.

(n138)Footnote 101. *United Savs. Ass'n. of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n139)Footnote 102. Postpetition rents may constitute the source of such payments if the secured creditor does not hold a valid and enforceable assignment of rents.

(n140)Footnote 103. 11 U.S.C. § 362(d)(1). See generally P 2.06 *infra*.

(n141)Footnote 104. *Daniel v. AMCI (In re Ferncrest Court Partners)*, 66 F.3d 778 (6th Cir. 1995) ; *In re Visual Indus., Inc.*, 57 F.3d 321, 33 C.B.C.2d 1110 (3d Cir. 1995) ; *In re P.C. Ltd.*, 929 F.2d 203 (5th Cir. 1991) ; *In re Flagstaff Foodservice Corp.*, 762 F.2d 10, 12 C.B.C.2d 1019 (2d Cir. 1985) ; *In re Flagstaff Foodservice Corp.*, 739 F.2d 73, 10 C.B.C.2d 1309 (2d Cir. 1984) ; *In re Trim-X, Inc.*, 695 F.2d 296, 7 C.B.C.2d 955 (7th Cir. 1982) ; *In re Colonial Realty Inv. Co.*, 516 F.2d 154 (1st Cir. 1975) ; *First Western Sav. & Loan Ass'n v. Anderson*, 252 F.2d 544 (9th Cir. 1958) ; *Virginia Sec. Corp. v. Patrick Orchards, Inc.*, 20 F.2d 78 (4th Cir. 1927) ; *Bank of Honolulu v. Anderson (In re Anderson)*, 66 B.R. 97 (B.A.P. 9th Cir. 1986) ; *C.I.T. Corp. v. A & A Printing, Inc.*, 70 B.R. 878, 15 B.C.D. 1228 (M.D.N.C. 1987) ; *In re Bob Grisset Golf Shoppes, Inc.*, 50 B.R. 598 (Bankr. E.D. Va. 1985) ; *In re Afco Enter., Inc.*, 9 C.B.C.2d 1127, 35 B.R. 512 (Bankr. D. Utah 1983) ; *In re Wiltwyck School*, 34 B.R. 270 (Bankr. S.D.N.Y. 1983) ; *In re Codesco, Inc.*, 6 C.B.C.2d 395, 18 B.R. 225 (Bankr. S.D.N.Y. 1982) ; *Moister v. Dekalb Sav. & Loan Ass'n (In re Robertson)*, 5 C.B.C.2d 423, 14 B.R. 706 (Bankr. N.D. Ga. 1981) ; *Moister v. The Farmers Bank (In re Truitt)*, 5 C.B.C.2d 532, 11 B.R. 15 (Bankr. N.D. Ga. 1981) ; *In re Hotel Assoc., Inc.*, 2 C.B.C.2d 1162, 6 B.R. 108 , B.R. 108 (Bankr. E.D. Pa. 1980); see also additional cases cited in note 75 *supra*.

(n142)Footnote 105. *Id.*

(n143)Footnote 106. The point may be illustrated by the holdings in *In re 680 Fifth Ave. Assocs.*, 154 B.R. 38, 28 C.B.C.2d 1314 (Bankr. S.D.N.Y. 1993) . The undersecured mortgage creditor in this single asset case opposed the debtor's application for an order permitting it to pay counsel fees from the rents and income of the building. The application was based upon the "equities exception" set forth at the end of section 552(b). The court held that (1) the rents and income of the building, which were conceded to constitute collateral of the mortgage creditor, could not be expended for counsel retention purposes without the provision of adequate protection, (2) the mortgage creditor was undersecured, and therefore the value of the building did not provide adequate protection (no other source value for such protection was offered), (3) the equities exception in section 552(b) might apply to justify the payment of debtors' counsel fees in the circumstance of an oversecured creditor, but not in the circumstance of an undersecured creditor, and (4) the debtor's application was in essence an attempt to use the building's funds to pay professional fees without satisfying the requirements of section 506(c). 154 B.R. 38, 42-43 . The court stated expressly that "... administrative expenses [the counsel fees] are to be paid from the debtor's unencumbered assets. *In re Evanston Beauty Supply, Inc.* 136 B.R. at 175 ." 154 B.R. 38, 43 ; see also *In re Woodfield Gardens Assocs.*, 1998 Bankr. LEXIS 734 (Bankr. N.D. Ill. 1998) ; cf. *In re James Wilson Assoc.*, 965 F.2d 160, 171, 26 C.B.C.2d 1673 (7th Cir. 1992) , in which the court stated that a substantially oversecured creditor had no absolute right to receive payment of its cash collateral arising from the postpetition rental of the building therein involved, and that such funds could be invaded to pay attorneys' fees and to protect the interest of a junior secured creditor.

(n144)Footnote 107. This is the premise of the holdings in both the wash cases and the dual valuation cases. *Financial Security Assurance Inc. v. F H New Orleans L.P. (In re F H New Orleans L.P.)*, 116 F. 3d 790, 38 C.B.C.2d

458 (5th Cir. 1997) ; *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996) ; *In re Addison Props. L.P.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) ; *In re Gramercy Twins Assocs.*, 187 B.R. 112 (Bankr. S.D.N.Y. 1995) ; *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995) ; *In re Vermont Inv. L.P.*, 27 C.B.C.2d 374, 142 B.R. 571 (Bankr. D.C. 1992) ; *In re Flagler-at- First Assocs.*, 114 B.R. 297 (Bankr. S.D. Fla. 1990) ; *In re The Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990) ; see also *Liberty Nat'l Enters. v. Ambanc La Mesa L.P. (In re Ambanc La Mesa L.P.)*, 115 F. 3d 650 (9th Cir. 1997) .

(n145)Footnote 108. See note 96 *supra*.

(n146)Footnote 109. See generally P 2.07[2] *infra*. Cf. *Dewsnup v. Timm*, 502 U.S. 410, 417, 112 S. Ct. 773, 116 L. Ed. 2d 903 (1992) ("[a]ny increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor and not to the benefit of other unsecured creditors ... ").

(n147)Footnote 110. However, a secured creditor cannot elect fully secured status under section 1111(b)(2) if its security interest in the collateral is of inconsequential value. 11 U.S.C. § 1111(b)(1)(B)(i). Under Bankruptcy Rule 3014, the election of application of section 1111(b)(2) in a chapter 11 cases must be made at any time prior to the conclusion of the hearing on the disclosure statement of within such later time as the court may fix. Thus the issue involving the application of postpetition rents to an undersecured claim must be resolved before the election is made.

(n148)Footnote 111. See generally P 2.07[2] *infra*.

(n149)Footnote 111a. *Financial Security Assurance Inc. v. F H New Orleans L.P. (In re F H New Orleans L.P.)*, 116 F. 3d 790, 798, 38 C.B.C.2d 458, 465-66 (5th Cir. 1997) ; Fortang & Gardner, note 87a *supra*, at 13 .

(n150)Footnote 112. *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996) ; *In re Addison Props. L.P.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) ; *In re Gramercy Twins Assocs.*, 187 B.R. 112 (Bankr. S.D.N.Y. 1995) ; *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995) ; *In re Vermont Inv. L.P.*, 27 C.B.C.2d 374, 142 B.R. 571 (Bankr. D.C. 1992) ; *In re Flagler-at- First Assocs.*, 114.B.R. 297 (Bankr. S.D. Fla. 1990) ; *In re The Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990) .

(n151)Footnote 113. "It is clear ... post-petition payments to a secured creditor who possesses a security interest in rents are payments on account of a separate and distinct item of collateral, apart from the underlying real estate which also secures the creditor's claims and which generates such rents." *In re Vermont Inv. Ltd. Partnership*, 27 C.B.C.2d 374 (Bankr. D.C. 1992) .

(n152)Footnote 114. *In re Duval Manor Assocs.*, 191 B.R. 622, 633-34 (Bankr. E.D. Pa. 1996) .

(n153)Footnote 115. *In re Addison Props. L.P.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) ; see also note 106 *supra*.

(n154)Footnote 116. *In re Addison Props. L.P.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) ; see also note 106 *supra*.

(n155)Footnote 117. *In re Duval Manor Assocs.*, 191 B.R. 622, 633-34 (Bankr. E.D. Pa. 1996) .

(n156)Footnote 118. See P 2.03[1] *supra*.

(n157)Footnote 119. See P 2.03[1][c][iii] *supra*.

(n158)Footnote 120. See *In re Kent*, 5 Bankr. Ct. Dec. (LRP) 47, 19 C.B.C. 474 (Bankr. S.D.N.Y. 1978) .

(n159)Footnote 121. It has been held that an assignee of rents had standing to move to compel the debtor-lessor to perform its postpetition obligations under the assigned lease. *In re Lansing Clarion L.P.*, 132 B.R. 845 (Bankr. W.D. Mich. 1991) .

(n160)Footnote 122. *See P 2.51 infra.*

(n161)Footnote 123. *See P 2.03[1][b] supra.*

(n162)Footnote 124. *See P 2.03[1], [2] supra.*

(n163)Footnote 125. Rogers, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 *Hastings L.J.* 1433, 1452-53 (1980).

(n164)Footnote 126. *In re Galvin*, 120 B.R. 767 (Bankr. D. Vt. 1990) .

(n165)Footnote 127. *See P 2.03[2] supra.*

(n166)Footnote 128. *See P 2.03[2] supra.*

(n167)Footnote 129. *See discussion in P 2.03[1][b], [2] supra.*

(n168)Footnote 130. *See P 2.03[1][c][iii], [2] supra.*

(n169)Footnote 131. *See P 2.03[2] supra.*

(n170)Footnote 131a. *Fed R. Bankr. Proc.* 3001(e)(3), (e)(4).

(n171)Footnote 131b. 1983 Advisory Committee Note to *Fed. R. Bankr. P.* 3001.

(n172)Footnote 132. 11 U.S.C. § 547(b).

(n173)Footnote 133. 11 U.S.C. § 547(e)(3).

(n174)Footnote 134. 11 U.S.C. § 547(f).

(n175)Footnote 135. *Diversified World Inv., Ltd. v. Omni Int'l, Ltd. (In re Diversified World Inv., Ltd.)*, 12 B.R. 517 (Bankr. S.D. Tex. 1981) .

(n176)Footnote 136. 12 B.R. 517, 519 (Bankr. S.D. Tex. 1981) ; *see P 2.02 [2] supra.*

(n177)Footnote 137. If the transferee were an "insider" the period of vulnerability is one year prior to the date of filing of the petition. 11 U.S.C. §§ 547(b)(4)(B) and 101(31). The one-year period may, in certain circumstances, also apply to transfers made to noninsider creditors on account of obligations guaranteed by an insider. *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio)*, 874 F.2d 1186 (7th Cir. 1989) . *See P 2.08 infra.*

(n178)Footnote 138. *See P 2.03[1][c][iv] supra.*

(n179)Footnote 139. 417 F.2d 1277 (9th Cir. 1966) .

(n180)Footnote 140. 408 F.2d 209 (7th Cir.) , cert. denied, 396 U.S. 827, 90 S. Ct. 75, 24 L. Ed. 2d 78 (1969) .

(n181)Footnote 141. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 374 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n182)Footnote 142. *See P 2.02[2][a] supra.*

(n183)Footnote 143. *Diversified World Inv., Ltd. v. Omni Int'l, Ltd. (In re Diversified World Inv., Ltd.)*, 12 B.R. 517 (Bankr. S.D. Tex. 1981) . *But see SLC Ltd. V v. Bradford Group W, Inc. (In re SLC Ltd. V)*, 152 B.R. 755 (Bankr.

D. Utah 1993) (activation of rent assignment did not give rise to preference since "perfection" occurred under state law when rent assignment recorded).

(n184)Footnote 144. *See P 2.03[1][c][i] supra.*

(n185)Footnote 145. *See text accompanying notes 50-58 supra; cf. Beck v. Int'l Harvester Credit Corp. (In re E.P. Hayes, Inc.), 8 C.B.C.2d 872, 29 B.R. 907 (Bankr. D. Conn. 1983) .*

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

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P 2.04 Fraudulent Conveyance Issues

[1] The *Durrett* Problem and the *BFP* Holding

Although the potential reach of its holding has been considerably limited by a decision of the United States Supreme Court,ⁿ¹ the case of *Durrett v. Washington National Insurance Co.* ^{n1a} and its progeny highlight the ramifications of fraudulent conveyance laws on the exercise of remedies by a mortgagee. In *Durrett*, the Court of Appeals for the Fifth Circuit held under the former Bankruptcy Act that a debtor in possession could avoid a prepetition transfer of real property to an unrelated third party by means of a nonjudicial foreclosure of a deed of trust when the property was sold for 57.7 percent of its fair market value. The transfer of the property, which was deemed to occur at the foreclosure sale, was found to be made for less than "fair equivalent" consideration within the meaning of Section 67(d) of the former Bankruptcy Act, and therefore constituted a fraudulent conveyance. The holding in *Durrett* was reaffirmed by the Court of Appeals for the Fifth Circuit in *Abramson v. Lakewood Bank & Trust Co.*,ⁿ² a case also decided under the former Bankruptcy Act. The bankruptcy court and thereafter the district court for the District of Alaska, in *In re Alsop*,ⁿ³ held under section 548 of the Code that the transfer of the property at foreclosure sale under a defaulted deed of trust did not occur within one year of the debtor's petition under chapter 11 of the Bankruptcy Code since such transfer under Alaska law is deemed to relate back to the date of execution and recordation of the deed of trust (which was more than one year prior to the date of the chapter 11 petition). The Court of Appeals for the Ninth Circuit, in *Madrid v. Lawyers Title Insurance Corp. (In re Madrid)*,ⁿ⁴ held that as a matter of federal bankruptcy law the transfer of mortgaged property to the mortgagee occurs at the time of perfection of the mortgage or deed of trust, and not at the foreclosure sale.ⁿ⁵ The court therefore found that no fraudulent transfer had occurred because the deed of trust, as in the *Alsop* case, was perfected more than one year prior to the filing of the debtor's petition. Both *Madrid* and *Alsop* failed to address the questions arising when a mortgage is perfected within the year prior to the filing of the mortgagor's Bankruptcy Code petition, and the effect of section 544(b), which in substance incorporates state fraudulent conveyance law and the state statute of limitations (usually longer than one year) affecting such conveyances. The Court of Appeals for the Eighth Circuit avoided the pitfalls of the *Madrid* and *Alsop* rationales, and held in *In re Hulm* that a foreclosure sale constitutes a transfer for section 548 purposes and that the price received must constitute reasonably equivalent value.ⁿ⁶

Section 548(a) permits the trustee to avoid a transfer of an interest of the debtor in property made within two years before the date of filing of the petition if the debtor did not receive "reasonably equivalent value" for the transfer and was insolvent on the date of transfer or became insolvent as a result thereof.ⁿ⁷ Under section 546(a), as amended by the Bankruptcy Reform Act of 1994, the trustee may commence an action to avoid a transfer within the earlier of (1) the

later of (A) 2 years after the entry of the order for relief, or (B) 1 year after the appointment or election of the first trustee in the case if such appointment or election occurs before 2 years after the entry of the order for relief; or (2) the time the case is closed or dismissed.ⁿ⁸ A defendant in a fraudulent conveyance action to recover a money transfer who has not filed a claim as a creditor is entitled to a jury trial.^{n8a}

The *Durrett* rule has been abrogated by the decision of the United States Supreme Court in *BFP v. Resolution Trust Corporation*.^{n8b} In *BFP*, the Court held as a matter of federal law that the price in fact received at a real estate foreclosure sale constituted "reasonably equivalent value" for purposes of that section, provided that the sale complied with all of the requirements of the state's foreclosure law.^{n8c} In reaching its decision, the Court stated that the concept of "fair market value" used in *Durrett* and its progeny has no relevance in the context of a forced sale that complies with the particular requirements of local law^{n8d} and expressed concern with the cloud placed on title to real property by the *Durrett* rule.^{n8e}

BFP does not eliminate the possible application of fraudulent conveyance laws to foreclosure sales of real property. The Court emphasized the significance of compliance with state foreclosure laws and noted that if these laws were not followed, the sales price would no longer have conclusive effect in a federal bankruptcy proceeding; in that situation, reasonably equivalent value "would be the price that would have been received if the foreclosure sale had proceeded according to law."^{n8f} The decision also does not address the application of section 548 to tax sales and other forced sales.^{n8g}

Moreover, as noted, the decision was based on the federal fraudulent conveyance statute in *section 548 of the Bankruptcy Code* and did not discuss the possible application of state fraudulent conveyance statutes pursuant to section 544(b)(1).^{n8h} However, since section 544(b)(1) is dependent on state law, if that law upholds the foreclosure the trustee should obtain no greater rights of avoidance under section 544(b)(1). Under section 544(b)(1), the trustee may avoid a transfer by a debtor that is voidable under state law by an unsecured creditor.ⁿ⁹ Accordingly, in states which have enacted the Uniform Fraudulent Conveyance Act or similar laws, a trustee may under the *Durrett* holding invoke section 544(b)(1) to avoid foreclosure sales that took place at any time prior to the expiration of the applicable state statute of limitations. If the Court of Appeals for the Second Circuit were to follow the *Durrett* holding in interpreting the provisions of the New York Debtor and Creditor Law (which is derived from the Uniform Fraudulent Conveyance Act), this would permit a challenge to a New York foreclosure sale that occurred within six years of the date of challenge.ⁿ¹⁰ If the Second Circuit were to follow the *Madrid* holding, this would permit a challenge to a mortgage recorded in New York within the six-year period. Nevertheless, given the rule that a fraudulent conveyance occurs only in the absence of reasonably equivalent value, the *Alsop* and *Madrid* definitions of "transfer" seems to preclude a finding of fraudulent conveyance in any customary mortgage transaction in which a loan is made against a contemporaneous transfer to the lender of a lien on the property.

The Bankruptcy Amendments and Federal Judgeship Act of 1984^{n10a} contained two amendments to the Code that, at first blush, may have appeared to have codified the holding of *Durrett*. First, the definition of the term "transfer," set forth in *section 101(54) of the Code*, was amended to include "foreclosure of the debtor's equity of redemption." Secondly, section 548(a) was amended to expressly cover voluntary and involuntary transfers. Although the Supreme Court in *BFP* specifically rejected the suggestion that these amendments codified *Durrett*,^{n10b} neither *BFP* nor these amendments deal with the question concerning the date on which the transfer is deemed to have occurred for purposes of determining whether a fraudulent transfer has taken place.ⁿ¹¹

The Uniform Fraudulent Transfer Act, in the form approved by the National Conference of Commissioners on Uniform State Laws, provides in Section 3(b) that reasonably equivalent value will be deemed given in the context of a regularly conducted nonconclusive foreclosure sale or exercise of power of sale under a defaulted mortgage, deed of trust or security agreement. In states where it has been enacted,^{n11a} this provision greatly limits utilization of section 544(b) to avoid mortgage foreclosure sales that occurred prior to the expiration of the applicable state statute of limitations.ⁿ¹² However, section 544(b) would still be available to avoid foreclosure sales in states that have not adopted Section 3(b)

of the Uniform Fraudulent Transfer Act and in which the courts have adopted a *Durrett* type rule in connection with its fraudulent conveyance laws, notwithstanding the decision in *BFP*, which, as mentioned, addressed *section 548 of the Bankruptcy Code* only.

A complete discussion of the issues presented by *BFP*, *Durrett*, *Abramson* and *Madrid* is beyond the scope of this book.ⁿ¹³ Nevertheless, foreclosing lenders and third-party purchasers at a foreclosure sale, and purchasers from such parties, should be aware of the trustee's reach under *section 550 of the Bankruptcy Code* in recovering property or value of property that has been the subject of a fraudulent conveyance.

Under section 550(a), the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from (1) the initial transferee (or the party for whose benefit such transfer was made), or (2) any "immediate" or "mediate" transferee of such initial transferee. However, section 550(b) provides that an immediate or mediate transferee of the initial transferee is not subject to recovery if such transferee takes for value (including satisfaction or securing of a present or antecedent debt), in good faith, and without knowledge of the voidability of the avoided transfer.ⁿ¹⁴ In addition, the trustee may not recover against any immediate or mediate good faith transferee of a transferee described in the preceding sentence.ⁿ¹⁵ Under section 550(e)(1), a good faith transferee from whom the trustee may recover under section 550(a) has a lien on the property so recovered to secure an amount equal to the lesser of: (1) the cost, to such transferee, of any improvements made to the property after the transfer, less the amount of any profit realized by or for the account of such transferee from the property; and (2) any increase in the value of the property resulting from such improvement. Section 550(e)(2) sets forth a definition of an "improvement" to this type of property. Under section 550(f), an action or proceeding under section 550 may not be commenced after the earlier of one year after the avoidance of the transfer on account of which recovery is sought, or the time the case is closed or dismissed.

It should be noted that a transferee, other than the initial transferee, that takes for value is not required to meet the section 548(a)(1)(B)(i) requirement to give reasonably equivalent value in exchange for the transfer. Moreover, any immediate or mediate good faith transferee from a transferee (other than the initial transferee) that has given value is immune from recovery if it is acting in good faith, but there is no value requirement as long as his predecessor in title gave value and otherwise satisfied the requirements of section 550(b)(1). It appears that the term "good faith" means, in this context, that the transferee does not know that the transaction is not a normal trade and that there is reason to believe that the transferor was engaged in defrauding creditors.ⁿ¹⁶

[2] Upstream Guarantees

[a] Bankruptcy Code Issues

An upstream guarantee is a guarantee by a subsidiary of the indebtedness of its direct or indirect parent corporation, or a guarantee by an entity of the indebtedness of its shareholders or the owners of other equity interests therein. In such circumstances, if the guarantor does not receive reasonably equivalent consideration for the value of its guarantee, the guarantee may be subject to avoidance under the Code as a fraudulent transfer. The upstream guarantee problem may also arise in connection with guarantees of obligations of corporate affiliates. These transaction structures and the issues arising therefrom may be found in multi-property real estate financing transactions. If the guarantor becomes a Bankruptcy Code debtor within one year of the incurrence of the obligation or, if *section 544(b) of the Bankruptcy Code* is applicable, within the applicable period under state fraudulent conveyance laws, the following legal considerations will become critical to the enforceability of the guarantee.

In a case commenced under the Bankruptcy Code, the debtor in possession or trustee may, pursuant to section 548, avoid and recover from the recipient any payment, incurrence of indebtedness or other transfer of property made voluntarily or involuntarily by the debtor on or within one year before the date of the filing of the petition commencing the case if:

(1) The transfer was made by the debtor "with actual intent to hinder, delay, or defraud" any creditor of the debtor; *or*

(2) The debtor received "less than a reasonably equivalent value" for such transfer; *and*

(a) was insolvent on the date such transfer was made, or became insolvent as a result thereof;

(b) was engaged or was about to engage in a business or a transaction for which the remaining property of the debtor was "an unreasonably small capital"; *or*

(c) intended to or believed that it would incur debts beyond its ability to pay as such debts matured.ⁿ¹⁷

The Bankruptcy Code provision is derived from, and substantially similar to, the Uniform Fraudulent Conveyance Act, first adopted in 1919 and presently in force in 3 states and the United States Virgin Islands.ⁿ¹⁸ The provisions have been preserved in many respects in the Uniform Fraudulent Transfer Act, which has been adopted in 41 states and the District of Columbia.ⁿ¹⁹ State fraudulent conveyance acts are not generally limited to the bankruptcy context and are generally enforceable by creditors, as well as by a Bankruptcy Code debtor in possession or trustee, under section 544(b).ⁿ²⁰

As described above, even in the absence of actual fraudulent intent a transfer may be avoided if the transferor did not receive reasonably equivalent value (the Act uses the term "fair consideration") for the property transferred and the transferor was or was not rendered insolvent, undercapitalized or incapable of meeting its contemplated debts as they matured. In the context of an upstream or similar guarantee transaction, this means that the guarantor, in incurring the obligation (the transfer), did not receive reasonably equivalent value because the proceeds of the guaranteed loan went to a party other than the guarantor.ⁿ²¹

[b] Drafting Considerations

Drafters may wish to consider limiting the liability of guarantors under upstream and similar guarantees, particularly in instances of doubt as to the guarantor's solvency after giving effect to an unlimited guarantee. One drafting approach is to limit the guarantor's liability to the limit of its "solvency," so that performance of its obligations under the guarantee can never render the guarantor insolvent. This drafting approach employs the concepts utilized in the definition of the term "insolvent" set forth in *section 101(32) of the Code*. The following is an example of such a provision in a guaranty:

(1) *Defined Terms*. All terms defined in the Credit Agreement or in the preamble or recitals hereto and used herein shall have the meanings assigned to them therein except when the context otherwise requires, and the following terms shall have the following meanings:

"Adjusted Net Worth " of any Guarantor, as of any date of determination thereof, shall mean the excess of (x) the amount of the fair saleable value of the assets of such Guarantor as of such date determined in accordance with applicable federal and state laws governing determinations of the insolvency of debtors over (y) the amount of all liabilities of such Guarantor, contingent or otherwise, as of such date, determined on the basis provided in clause (x) above (including liabilities under this Guarantee with respect to Qualifying Transfers referred to in subparagraph (i) of the definition of Maximum Guaranteed Amount appearing in this Section 1 and Extensions of Credit guaranteed under subparagraphs (ii) or (iii) of such definition of Maximum Guaranteed Amount but excluding all other potential liabilities under this Guarantee including liabilities incurred under this Guarantee in connection

with Extensions of Credit in respect of which such determination is being made).

"*Credit Agreement Proceeds* " shall mean the proceeds of any Extension of Credit, including, without limitation, the proceeds of Loans and proceeds of drawings under Letters of Credit.

"*Extension of Credit* " shall mean any extension of credit by any Lender to or for the account of the Company pursuant to the Credit Agreement, including, without limitation, the making of (or, without double counting, any purchase of a participating interest in) any Loan or the issuance of (or, without double counting, any purchase of a participating interest in) any Letter of Credit.

"*Maximum Guaranteed Amount* " of any Guarantor shall mean the sum of the following (without double counting):

(i) the aggregate amount of all Qualifying Transfers made to or for the benefit of such Guarantor and interest on all Credit Agreement Proceeds which are used to make such Qualifying Transfers, *plus*

(ii) with respect to any Extension of Credit made on the Effective Date and not used by the Company to make a Qualifying Transfer, the lesser of (A) the unpaid or unreimbursed amount of such Extension of Credit and interest thereon and (B) the greater of (I) the Adjusted Net Worth of such Guarantor as of the end of the most recently concluded fiscal quarter of such Guarantor ended on or prior to the Effective Date or (II) the highest Adjusted Net Worth of such Guarantor at any time after the date of such quarter and prior to the earlier of the date of the commencement of a case under Title 11 of the United States Code involving the Company or such Guarantor or enforcement hereunder is sought, *plus*

(iii) with respect to any Extension of Credit made subsequent to the Effective Date and not used by the Company to make a Qualifying Transfer, the lesser of (A) the unpaid amount of such Extension of Credit and interest thereon and (B) the greater of (I) the Adjusted Net Worth of such Guarantor as of the end of the most recently concluded fiscal quarter of such Guarantor ended on or prior to the date of such Extension of Credit or (II) the highest Adjusted Net Worth of such Guarantor at any time after the date of such quarter and the earlier of the date of the commencement of a case under Title 11 of the United States Code involving the Company or such Guarantor or enforcement hereunder is sought.

"*Obligations* " shall have the meaning assigned thereto in Section 2 hereof.

"*Qualifying Transfer* " with respect to any Guarantor shall mean (A) all loans, advances or capital contributions made to such Guarantor with Credit Agreement Proceeds, (B) all debt securities of such Guarantor acquired with Credit Agreement Proceeds, (C) the fair market value of all property acquired with Credit Agreement Proceeds and transferred to such Guarantor and (D) all equity securities of such Guarantor acquired with Credit Agreement Proceeds.

(2) *Guarantee*. To induce the Lenders to execute and deliver the Credit Agreement and to make the extensions of credit provided for in the Credit Agreement upon the terms and conditions set forth therein, and in consideration thereof, each of the Guarantors hereby, jointly and severally, unconditionally and irrevocable guarantees to the Collateral Agent, for the ratable benefit of the Lenders, and their respective successors, indorsees, transferees and assigns, the prompt and complete payment when due (whether at the stated maturity, by acceleration or otherwise) of the principal amount of, and unpaid interest on, the Notes, the Loans and all reimbursement obligations with respect to drawings made under the Letters of Credit, and all other indebtedness, obligations and liabilities of the Company to the Lenders and the Collateral Agent now existing or hereafter arising out of or in connection with the Credit Agreement, the Notes, the Loans and the Letters of Credit (and the applications relating thereto) whether for principal, interest, fees, expenses or otherwise, whether now existing or hereafter incurred, direct or indirect, absolute or contingent matured or not matured, joint or several (all such indebtedness, obligations and

liabilities being herein called the "*Obligations*"), and any extensions, renewals or refundings of any of the *Obligations*; *provided, however*, that the maximum liability of each Guarantor hereunder (including any liability of such Guarantor pursuant to the following sentence) shall in no event exceed such Guarantor's Maximum Guaranteed Amount. Each Guarantor further agrees to pay any and all expenses which may be paid or incurred by the Collateral Agent and/or the Lenders in enforcing any rights with respect to, or collecting, any or all of the *Obligations* and/or enforcing any rights with respect to, or collecting from, such Guarantor under this Guarantee.ⁿ²²

Two other and much simplified approaches to the drafting are as follows:

(1) Notwithstanding any other provision of this Guarantee, the amount guaranteed by Guarantor hereunder together with all other obligations of the Guarantor hereunder shall be limited to the extent, if any, required so that all such obligations under this Guarantee shall not be subject to avoidance under *Section 548 of the United States Bankruptcy Code* or to being set aside or annulled under any applicable state law relating to fraud on creditors; or

(2) The obligations of the Guarantor hereunder shall be limited to an aggregate amount equal to the largest amount that would not render its obligations hereunder subject to avoidance under *Section 548 of the United States Bankruptcy Code* or any comparable provisions of any applicable state law.

FOOTNOTES:

(n1)Footnote 1. See text accompanying notes 8b-8g *infra*.

(n2)Footnote 1a. 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980) .

(n3)Footnote 2. 647 F.2d 547, 24 C.B.C. 351 (5th Cir. 1981) , *cert. denied*, 454 U.S. 1164, 102 S. Ct. 1038, 71 L. Ed. 2d 320 (1982) .

(n4)Footnote 3. 5 C.B.C.2d 797, 14 B.R. 982 (Bankr. D. Alaska 1981) , *aff'd*, 6 C.B.C.2d 669, 22 B.R. 1017 (D. Alaska 1982) .

(n5)Footnote 4. 725 F.2d 1197, 10 C.B.C.2d 347 (9th Cir. 1984) , *aff'g on other grounds*, 6 C.B.C.2d 1133, 21 B.R. 424 (B.A.P. 9th Cir. 1982) .

(n6)Footnote 5. Additional cases dealing with the *Durrett* issue (but prior to the *BFP* decision) are cited and discussed in Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 Bus. Law. 1605 (1983). Subsequent holdings (prior to *BFP*) include *In re Winshall Settlor's Trust*, 758 F.2d 1136, 12 C.B.C.2d 605 (6th Cir. 1985) (the reasonable equivalence standard should be based on state law rules as to adequacy of price); *Berge v. Sweet (In re Berge)*, 9 C.B.C.2d 530, 33 B.R. 642 (Bankr. W.D. Wis. 1983) (follows *Durrett*); *Moore v. Gilmore (In re Gilmore)*, 31 B.R. 615 (E.D. Wash. 1983) (regularly conducted judicial foreclosure sale cannot be attacked; follows opinion of bankruptcy appellate panel in *Madrid*, 6 C.B.C.2d 1133, 21 B.R. 424 (B.A.P. 9th Cir. 1982) , *aff'd on other grounds*, 725 F.2d 1197, 10 C.B.C.2d 347 (9th Cir. 1984)); *Calaiaro v. Pittsburgh Nat'l Bank (In re Ewing)*, 9 C.B.C.2d 526, 33 B.R. 288 (W.D. Pa. 1983) , *aff'd*, 746 F.2d 1465 (3d Cir. 1984) (*Durrett* held applicable to sale of pledged securities); *Bundles v. Baker (In re Bundles)*, 856 F.2d 815 (7th Cir. 1988) (conduct of state foreclosure sale must be scrutinized to determine if process resulted in reasonably equivalent value); *Walker v. Littleton (In re Littleton)*, 888 F.2d 90, 21 C.B.C.2d 1158 (11th Cir. 1989) (*Durrett* followed, but 70% rule modified; second lien resulted in debtors having little or no equity).

(n7)Footnote 6. 738 F.2d 323, 11 C.B.C.2d 152 (8th Cir.) , *cert. denied*, 469 U.S. 990, 105 S. Ct. 398, 83 L. Ed. 2d 331 (1984) .

(n8)Footnote 7. 11 U.S.C. § 548(a). The section was amended by the 2005 Act to extend the reachback period

from one year to two years. Pub. L. No. 109-8, § 1402 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). However, this change is effective only in cases commenced on or after April 21, 2006. *Id.* § 1406.

(n9)Footnote 8. 11 U.S.C. § 546(a).

(n10)Footnote 8a. *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 2d 26, 20 C.B.C.2d 1216 (1989) .

(n11)Footnote 8b. 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) .

(n12)Footnote 8c. 511 U.S. 531, 542-43, 114 S. Ct. 1757, 1764, 128 L. Ed. 2d 556, 567-68, 30 C.B.C.2d 345, 354 .

(n13)Footnote 8d. 511 U.S. 531, 114 S. Ct. 1757, 1761-62, 128 L. Ed. 2d 556, 564-65, 30 C.B.C.2d 345, 350-51 .

(n14)Footnote 8e. 511 U.S. 531, 114 S. Ct. 1757, 1764, 128 L. Ed. 2d 556, 567, 30 C.B.C.2d 345, 354 (citing P 5.02[2] of this volume).

(n15)Footnote 8f. 511 U.S. 531, 114 S. Ct. 1757, 1765, 128 L. Ed. 2d 556, 569, 30 C.B.C.2d 345, 354 .

(n16)Footnote 8g. 511 U.S. 531, 114 S. Ct. 1757, 1761 n.3, 128 L. Ed. 2d 556, 564 n.3, 30 C.B.C.2d 345, 349 n.3 ("[w]e emphasize that our opinion today covers only mortgage foreclosures of real estate. The considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different"). Several post-*BFP* cases have held that the price received at a tax foreclosure sale conducted in accordance with state law is "reasonably equivalent value" under section 548. *Kojima v. Grandote Int'l Ltd. Liab. Co. (In re Grandote Country Club Co.)*, 252 F.3d 1146, 1157 (10th Cir. 2001) ; *In re T.F. Stone Co., Inc.*, 72 F.3d 466 (5th Cir. 1995) ; *Case v. TBAC-Prince Gardner (In re Prince Gardner, Inc.)*, 220 B.R. 63 (Bankr. E.D. Mo. 1998) ; *In re Golden*, 190 B.R. 52 (Bankr. W.D. Pa. 1995) ; *In re Hollar*, 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995) ; *In re Comis*, 181 B.R. 145, 149 (Bankr. N.D.N.Y. 1994) ; *In re McGrath*, 31 C.B.C.2d 586, 170 B.R. 78 (Bankr. D.N.J. 1994) .

(n17)Footnote 8h. 11 U.S.C. § 544(b) was amended, effective in cases pending or commenced on or after June 19, 1998. The amendment changed the numbering of section 544(b) to (b)(1) and added (b)(2), an exception to (b)(1), regarding transfers of charitable contributions.

(n18)Footnote 9. 11 U.S.C. § 544(b)(1), as amended, effective in cases pending or commenced on or after June 19, 1998.

(n19)Footnote 10. N.Y. Civil Practice Law and Rules § 213(8) (McKinney's 1982) ("CPLR"); *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968) , *aff'd in part, rev'd in part on other grounds*, 420 F.2d 51 (2d Cir. 1970) , *on remand.*, 329 F. Supp. 1038 (N.D.N.Y. 1971) , *aff'd sub nom. Menter v. Ames*, 445 F.2d 1404 (2d Cir. 1971) . *McNellis* employed that part of CPLR § 213 providing for a six-year period of limitations in case of fraud or mistake. The fraud provision was thereafter transferred to CPLR § 213(9), which was subsequently renumbered CPLR § 213(8). CPLR § 213(1), which is also a six-year provision, is a basket clause for all actions for which no other limitation is specifically prescribed, and would apply to fraudulent conveyance cases if the "fraud" provisions of CPLR § 213(8) are held inapplicable.

(n20)Footnote 10a. Pub. L. No. 98-353, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n21)Footnote 10b. 511 U.S. 531, 114 S. Ct. 1757, 1763 n.7, 128 L. Ed. 2d 556, 30 C.B.C.2d 345, 353 n.7 .

(n22)Footnote 11. See 130 Cong. Rec. S13771-72 (Oct. 5, 1984) (there was no congressional intent to codify *Durrett*--Senators Dole and DeConcini). Although section 101(54) of the Code arguably overrules the *Madrid* finding of a transfer at the time the lien is granted, nothing in the section mandates a holding that the foreclosure sale is the only transfer to be considered under section 548(a).

(n23)Footnote 11a. The Uniform Fraudulent Transfer Act has been adopted in 41 states. See 7A U.L.A. 209 (Supp. 2003).

(n24)Footnote 12. See text accompanying notes 9 and 10 *supra*.

(n25)Footnote 13. See the discussion in Kennedy, *Involuntary Fraudulent Transfers*, 9 *Cardozo L. Rev.* 531 (1987); Zinman, *Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary, Nonfraudulent Transfers*, 9 *Cardozo L. Rev.* 581 (1987); Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 *Bus. Law.* 1605 (1983); Zinman, Houle & Weiss, *Fraudulent Transfer According to Alden, Gross & Borowitz: A Tale of Two Circuits*, 39 *Bus. Law.* 977 (1984); Alden, Gross & Borowitz, *The "Durrett" Controversy and Foreclosure Sales*, N.Y.L.J., Nov. 13, 1984, at 33; Ehrlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 *Va. L. Rev.* 933 (1985). See P 3.06[10] *infra* for a discussion of the fraudulent conveyance issues arising in the context of the surrender or assignment by a tenant to a landlord of a real estate lease. See P 5.02[2] *infra* for a discussion of the title insurance issues arising from the *Durrett* rule.

(n26)Footnote 14. 11 U.S.C. § 550(b)(1).

(n27)Footnote 15. 11 U.S.C. § 550(b)(2).

(n28)Footnote 16. 5 *Collier on Bankruptcy*, P 550.03 (Matthew Bender 15th Ed. Revised).

(n29)Footnote 17. 11 U.S.C. § 548.

(n30)Footnote 18. 7A U.L.A. 155 (Supp. 2005). As of October 1, 2005, the three states in which the Uniform Fraudulent Conveyance Act was still in force were Maryland, New York, and Wyoming.

(n31)Footnote 19. See Internet site of the National Conference of Commissioners on Uniform State Laws. www.nccusl.org.

(n32)Footnote 20. Section 544(a) is the "strong arm" provision granting to the trustee the avoidance powers of certain hypothetical creditors and purchasers under state law. Section 544(b) gives the trustee the rights, if any, actual creditors have to set aside prepetition transfers, e.g., under a state fraudulent conveyance law. One effect of using section 544(b) is that the state law will often have a longer limitations period than the two-year period in section 548. 11 U.S.C. § 544(b) was first amended, effective in cases pending or commenced on or after June 19, 1998. The amendment changed the numbering of section 544(b) to section 544(b)(1) and added subsection (b)(2), an exception to (b)(1), regarding transfers of charitable contributions. The section was also amended by the 2005 Act to extend the reachback period from one year to two years. Pub. L. No. 109-8, § 1402 (2005), *reprinted in* Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The extension of the reachback period to two years applies to cases commenced on or after April 21, 2006. *Id.* § 1406.

(n33)Footnote 21. See P 5.02 [1] *infra* for a discussion of the fraudulent conveyance issues arising from the granting of certain mortgage liens.

(n34)Footnote 22. It should be noted, however, that the net worth limitation may be difficult to apply in particular cases, and may not address every issue arising under section 548. Godshall & Klyman, *Wading "Upstream" in Leveraged Transactions: Traditional Guarantees v. "New Worth" Guarantees*, 46 *Bus. Law.* 391 (1991).

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

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P 2.05 Letters of Credit

Standby letters of credit are frequently employed in mortgage financing transactions when certainty is needed as to the satisfaction of particular obligations. The letter of credit is a particularly attractive mechanism because it assures unconditionally the payment of the obligation by a bank or other solvent entity. However, certain problems have arisen in the context of Bankruptcy Code cases involving the party whose obligation is assured by the letter of credit. Payment of the letter of credit may be enjoined by the court in certain circumstances discussed below. In addition, if prepetition payments received by a mortgagee from the debtor are ultimately recovered as preferences, the letter of credit may have expired prior to the time when the payments are returned to the trustee. In either case, the instrument relied upon by the mortgagee to assure payment may fail in its intended purpose.

[1] The Injunction

After a Bankruptcy Code case has begun, the trustee may commence an action against the letter of credit issuer and payee seeking an order enjoining payment of the letter of credit. This action may be based upon the automatic stay provisions of the Code, under the theory that payment of the letter of credit will affect property of the debtor, or may arise under *section 105 of the Code*, which grants to the bankruptcy court the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." A substantial question remains as to whether the bankruptcy court may enjoin performance of an independent, third party obligation such as payment by an issuer under a letter of credit.

In *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)*, n1 a bank had issued several letters of credit upon the order of the debtor, and taken a security interest in certain of the debtor's assets to secure repayment under the credits, all more than four months prior to the filing of the debtor's petition under the former Bankruptcy Act. The payees under the letters of credit were unsecured creditors of the debtor. After filing a petition under former Chapter XI, the debtor sought to enjoin the bank from honoring the letters of credit, presumably in order to block the substitution of the bank, which was secured, for the payees, who were unsecured, as a creditor in the bankruptcy proceeding. In its decision, the court temporarily restrained payment under the letters of credit on two grounds. First, the contemplated substitution of the secured claim of the bank for the unsecured claim of the payees was deemed potentially to violate former Bankruptcy Rule 11-44, the automatic stay provision operative under former Chapter XI. Second, the contemplated payment from the bank to the payees was apparently viewed by the court as possible preferential treatment of the payees in violation of § 60 of the former Bankruptcy Act. The court stated that the issuance of the injunction "should not be

construed to be a determination of the debtor's ultimate right to stop payment of these letters of credit. ...ⁿ² The court subsequently approved a voluntary dismissal of the complaint in connection with a settlement under which the letters of credit were paid.

Subsequently reported cases have rejected or narrowly construed the *Twist Cap* reasoning and conclusions. In *Westinghouse Credit Corp. v. Page (In re Page)*,ⁿ³ the district court for the District of Columbia reversed the bankruptcy court's grant of a preliminary injunction restraining a bank from honoring a letter of credit. The court reasoned that payment pursuant to the letter of credit, even though the letter of credit was secured, did not "divest the estate of property since neither the letter of credit nor its proceeds are property of the estate" and since the bank had an "independent contractual obligation" to make payment on the letter of credit out of its own assets.ⁿ⁴ The court further rejected the rationale of *Twist Cap* and found that the bank's security interest was immaterial, since at the time of the bankruptcy filing the bank's security interest had already been perfected--i.e., no lien against the debtors' assets would be created or perfected by payment under the letter of credit. The court noted that any attempt by the bank to enforce its security interest against the debtors would be subject to the automatic stay provisions of section 362(a)(4); consequently, no action that could potentially affect the estate could be taken without the prior approval of the court. In addition, the court held that payment under the letter of credit was not a postpetition transfer of property within the meaning of section 549 because the letter of credit and its proceeds represented "property of the bank, not the debtors."ⁿ⁵ The court also rejected the *Twist Cap* approach on policy grounds, stating:

If payment on a letter of credit could be routinely enjoined by the filing of a Chapter 11 petition the intended substitution of a bank for its less creditworthy customer would be defeated. As a consequence the letter of credit would become a dubious device for securing credit. Where, as here, the goals of the Bankruptcy Code can be achieved without producing this unfortunate result there is obviously no reason not to allow the letter of credit to be cashed according to its terms.ⁿ⁶

In another case subsequent to *Twist Cap*, *Printing Dep't, Inc. v. Xerox Corp. (In re Printing Dep't, Inc.)*,ⁿ⁷ the bankruptcy court for the Eastern District of Virginia granted the payee's motion to dismiss a complaint seeking to hold the payee in contempt for pursuing payment of a letter of credit. The court held that the automatic stay provisions of the Code did not apply to the letter of credit transaction since the payee, in submitting its draft to the bank, "was not asserting a claim against the Debtor or against any of the estate's property. It was enforcing a contract which existed between it and [the bank], which was independent of any relationship between [the debtor] and [the bank]."ⁿ⁸ The court also observed that the issuer of a letter of credit "assumes an original primary obligation wholly apart from the underlying contract which exists between the beneficiary and the customer."ⁿ⁹ It is not clear from the opinion in *Printing Dep't, Inc.* whether the letter of credit was secured by any assets of the debtor.

In *In re M.J. Sales & Distrib. Co.*,ⁿ¹⁰ the bankruptcy court for the Southern District of New York refused to enjoin access by the debtor's surety to a letter of credit secured by a treasury bond pledged by the debtor, quoting with approval from the district court's opinion in *Page*. Although not ultimately decided in *M.J. Sales*, the court indicated that the letter of credit issuer's recourse to the collateral would not constitute a prohibited postpetition transfer under section 549(a)(1) of the Code because the transfer was effected prepetition when the bond was pledged to the letter of credit issuer.ⁿ¹¹ Moreover, the court read *Twist Cap* as merely declaring that "a temporary restraining order should issue in order to preserve the status quo pending a determination on the merits."ⁿ¹²

Although it is always possible that a court may decide to enjoin payment of a letter of credit until it has had time to learn and digest the facts concerning the debtor and the letter of credit transaction, letter of credit transactions can be structured to reduce the likelihood of the issuance of an injunction against payment. In *Twist Cap* the court apparently was concerned that payment of the letters of credit would result in the substitution of an unsecured obligation of the debtor to the payee with a secured claim of the issuing bank, with a consequent diminution of the estate of the debtor. Accordingly, it appears preferable that unsecured obligations of a debtor should be assured by unsecured letters of credit, thereby providing merely for the substitution of one unsecured claim (of the letter of credit issuer) for another.

Such substitution would of course have no substantive effect on the estate of the debtor.

Similarly, if the debtor's obligation is secured, as in the case of a mortgage loan, it appears consistent with the *Twist Cap* rationale to permit the issuance of a letter of credit secured by the same collateral as secures the debtor's primary obligation. There also should be no impediment under *Twist Cap* to assuring a secured obligation of the debtor with an unsecured letter of credit. Therefore, the only transaction structures that should possibly be subject to *Twist Cap* difficulties are those in which the letter of credit is secured and the primary obligation is unsecured, or the letter of credit is secured by property of the debtor with a value in excess of the value of the collateral securing the primary obligation. Even in these circumstances it should be recalled that *Twist Cap* stands as an isolated holding that has not been followed by any other court.

One of the salient facts in *Twist Cap* is that the secured letter of credit transaction, albeit for an antecedent debt, was procured outside the four month preference period prescribed under the former Bankruptcy Act. In a Bankruptcy Code case in which the secured letter of credit transaction for the benefit of a holder of antecedent debt occurred within 90 days of the filing of the debtor's Bankruptcy Code petition, it was held that: (1) securing of the letter of credit within the 90-day period constituted a preference for the benefit of the unsecured holders of the antecedent debt who were the beneficiaries of the letter of credit; (2) the beneficiaries could not enforce the letter of credit; and (3) the bank was required to return the collateral to the estate.^{n12a} This remedy left the antecedent debt holders in the same position as though the transaction had not occurred, and eliminated the bank's exposure on what would have otherwise wound up as an unsecured letter of credit. This holding is a questionable interpretation of section 547, in fact, no transfers of the debtor's property would constitute preferences as section 547 is worded. It would appear to be within the province of Congress to rewrite section 547 if the court's ruling is the desirable result.

[2] Return of Preferential Payments

A typical letter of credit assuring payment of a fixed obligation will have an expiration date shortly following the maturity date of the primary obligation. If a debtor pays the primary obligation on or within 90 days of the filing of its petition under the Bankruptcy Code, and if the payment constitutes a preference, the preferred creditor may be required to disgorge these payments at a time after the letter of credit has expired.^{n12b} The creditor as payee under the letter of credit, having believed that payment of the obligation was unconditionally ensured by the letter of credit issuer, will not be able to collect under the expired letter of credit. The two principal methods of dealing with the problem are to (1) structure the transaction to reduce the likelihood that the prepetition payments will be found to be preferential and (2) obtain the agreement of the letter of credit issuer to pay under the letter of credit if the payee is required to return preferential payments received from the debtor.

One possible structure is to bargain for a direct payment letter of credit under which the payee of the letter of credit is paid directly by the letter of credit issuer rather than by the debtor. The letter of credit issuer will then look to the debtor for payment, and any preference problems will belong to the issuer and not the payee. It is important to structure these transactions so that the letter of credit issuer is not deemed to be a mere conduit or agent of the debtor in making the payments. If an agency relationship is found, the payment may be deemed to have been made with the debtor's property and is therefore subject to attack as a preference.ⁿ¹³ In order to avoid the agency issue, the payee should determine that there is no direct correlation between the payments to be made to it under the letter of credit and any payment schedule provided for between the debtor and the issuer. It may be particularly troublesome if the issuer may draw upon an account maintained with it by the debtor before payment under the letter of credit is made to the payee.

Another possible structure might provide for the letter of credit issuer to advance money to the debtor with the funds being earmarked for payment to the payee under the letter of credit. Cases under the former Bankruptcy Act held that when a new creditor advances funds for the purpose of paying an old creditor, there is no preference in the payment of the old creditor (the payee) because the transaction is viewed as if the funds advanced had never become part of the general assets of the debtor and, thus, the estate is not diminished when the payee is paid.ⁿ¹⁴ This arrangement can

work only when the payee and the issuer of the letter of credit are unsecured because, if the arrangement were to result in the replacement of an unsecured creditor with a secured creditor, the estate would be deemed diminished by the value of the security.ⁿ¹⁵ Obviously, some caution is called for in relying upon a rule that was judicially created when prior bankruptcy laws were in effect.

A further possible alternative would be to have the debtor place funds in an amount equal to the required contractual payment in a trust account for the benefit of the payee 91 days prior to the payment date. If no bankruptcy filing occurs on or prior to the payment date, the funds are paid to the payee. If a filing occurs during such period, the letter of credit issuer would make the payment to the payee from its own funds, acquire the payee's rights in the trust account and indemnify the payee against any claim to recover the debtor's payment into the trust account.ⁿ¹⁶

The second general approach is to provide in the letter of credit for payment by the issuer of amounts disgorged by the payee to the trustee. The following is a suggested clause for a letter of credit:

This credit shall expire on; provided, however, that in the event that a case under the Bankruptcy Code, *11 U.S.C. § 101 et seq.*, or any other federal, state or foreign law relating to bankruptcy, insolvency, reorganization or relief of debtors is commenced by or against [the Mortgagor] on or before the date which is ninety days after the date on which any payment is made under the Note, this Letter of Credit shall not expire on and we shall pay to you an amount equal to any and all payments (whether of principal, interest or otherwise) made to you under the Note which are at any time recovered from you upon submission to us at any time, and from time to time, after such commencement, of a statement signed by your duly authorized representative certifying that such recovery has taken place and the amount recovered.

The following provision for a letter of credit is substantively similar to the foregoing clause but deals in greater detail with the procedural aspects of the claim of preference against the mortgagee and of the payment by the letter of credit issuer to the mortgagee:

Issuer will reimburse (the "Reimbursement") to Mortgagee any payment or any portion thereof which payment was made by the Mortgagor, or by anyone else on behalf of the Mortgagor, to Mortgagee pursuant to the Note on or within 90 days prior to the occurrence of the events specified in subparagraph (a) of this paragraph (a "Payment"), together with (i) any other sums ("Additional Amounts") required to be and actually paid by Mortgagee in connection with the judgment entered in the Action (as hereinafter defined) or a settlement of the Action entered into with Issuer's consent, and (ii) an amount equal to the interest which would accrue at the rate of% per annum on the sum of the Payment and any Additional Amounts from the date of payment or reimbursement thereof by Mortgagee to the date of the Reimbursement, if:

(a) The Mortgagor files a petition, or a petition is filed against the Mortgagor, for relief under the Bankruptcy Code, *11 U.S.C. § 101 et seq.*, or the Mortgagor otherwise becomes subject to any bankruptcy, reorganization or liquidation proceeding;

(b) An action ("Action") is filed to avoid the Payment to Mortgagee or to recover the Payment from Mortgagee;

(c) Issuer receives notice in writing of the filing of the Action within thirty days after service of said Action upon Mortgagee;

(d) The amount of the Payment is actually paid or reimbursed by Mortgagee pursuant to a judgment entered in the Action or a settlement entered into with Issuer's consent; and

(e) Mortgagee assigns to Issuer at the closing all rights of Mortgagee to pursue the claim for the reimbursed Payment (the "Claim") against the Mortgagor by executing and delivering to Issuer at the closing the Assignment of Claim in the form attached hereto as Exhibit ".....".

In the event that any Action is commenced against Mortgagee, Issuer (x) shall, at its own expense and by its own counsel, defend such Action and (y) shall have full authority to compromise or settle the Action, provided that Issuer shall pay all costs, expenses and other amounts payable with respect to any such compromise or settlement and that Mortgagee shall be fully released from all liability with respect to the Action. Mortgagee shall cooperate in a reasonable manner with Issuer in connection with any such defense. In furtherance thereof, Mortgagee shall assist Issuer in any defense undertaken by Issuer by furnishing such pertinent information, documents or evidence appropriate to such defense as shall be reasonably requested by Issuer, provided that Mortgagee's out-of-pocket expenses in so doing are borne by Issuer. Mortgagee shall have the right, at its own expense and with its own counsel, but shall not be obligated, to participate in the defense of such Action. The Reimbursement transaction shall be closed at the offices of Mortgagee in at (.....) on a date selected by Mortgagee of which Issuer has received at least thirty days notice; provided, however, that the date selected by Mortgagee shall in no event be more than 60 days after the date of the payment or reimbursement described in clause (d) of this paragraph.

The foregoing suggested structures and provisions constitute substantial departures from the ordinary methods of issuing and drafting letters of credit. It is unlikely that the institutions that generally issue letters of credit will be amenable to effectuating such changes in a typical transaction; however, in substantial transactions, and especially in transactions involving workouts in which the issuing institution may have a stake in the consummation of the transaction, such structures or provisions should be considered.

In addition, a perhaps simpler provision for a letter of credit that will enhance the payee's protections is to set the expiration date at a date 91 days after the underlying due date of the providing obligation, and provide in the letter of credit itself that the account party's bankruptcy filing prior to the expiration date will be a drawing event. Thus, in the event that a primary obligation is paid, but the borrower subsequently files for bankruptcy within the preference period, the payee will be able to draw under the letter of credit and effectively have additional security in the event that the prepetition payment is subsequently avoided. The underlying loan documentation between the account party and the lender/payee can provide for the payee to return the amount of the drawing to the debtor/borrower in the event that no avoidance action is brought in order to prevent a double recovery by the payee. This type of structure might be less objectionable to issuing banks, because it is not uncommon for letters of credit to provide for a drawing upon the bankruptcy of the account party, and the expiration date in the letter of credit can be set as a date certain, without reference to the fact that such date was determined by reference to the due date on the underlying obligation, plus 91 days. In other words, this type of structure can be effectuated without making substantial revisions to the typical letter of credit, and all of the more complicated provisions such as those relating to the return of a double payment can be addressed in the agreements between the account party and the lender only.

FOOTNOTES:

(n1)Footnote 1. 1 B.R. 284 (*Bankr. M.D. Fla.* 1979) .

(n2)Footnote 2. 1 B.R. 284, 286 (*Bankr. M.D. Fla.* 1979) .

(n3)Footnote 3. 6 C.B.C.2d 776, 18 B.R. 713 (*D.D.C.* 1982) .

(n4)Footnote 4. 6 C.B.C.2d 776, 779, 18 B.R. 713, 715 .

(n5)Footnote 5. 6 C.B.C.2d 776, 780, 18 B.R. 713, 716 .

(n6)Footnote 6. 6 C.B.C.2d 776, 780, 18 B.R. 713, 716 .

(n7)Footnote 7. 20 B.R. 677, 9 B.C.D. 211 (Bankr. E.D. Va. 1981) .

(n8)Footnote 8. 20 B.R. 677, 9 B.C.D. 211, 213 (Bankr. E.D. Va. 1981) .

(n9)Footnote 9. 20 B.R. 677, 9 B.C.D. 211, 213 (Bankr. E.D. Va. 1981) .

(n10)Footnote 10. 7 C.B.C.2d 884, 25 B.R. 608 (Bankr. S.D.N.Y. 1982) .

(n11)Footnote 11. 7 C.B.C.2d 884, 893-94, 25 B.R. 608, 615-16 ; accord *In re Hart Ski Mfg. Co.*, 7 B.R. 465, 468 (Bankr. D. Minn. 1980) (transfer of debtor's property, in form of security interest granted to guarantor of standby letter of credit, occurred when guaranties issued). See generally Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. Chi. L. Rev. 130 (1982).

(n12)Footnote 12. *In re M.J. Sales & Distributing Co.*, 25 B.R. 608 (Bankr. S.D.N.Y. 1982) . M.J. Sales was followed in *In re Leisure Dynamics, Inc.*, 33 B.R. 171 (Bankr. D. Minn. 1983) . Other cases rejecting *Twist Cap* include *In re Zenith Laboratories, Inc.*, 104 B.R. 659, B.L.R. 73,176 (Bankr. D.N.J. 1989) ; *In re McLean Trucking Co.*, 74 B.R. 820, B.L.R. P 71,861 (Bankr. W.D.N.C. 1987) ; *In re Guy C. Long, Inc.*, 74 B.R. 939 (Bankr. E.D. Pa. 1987) ; *In re W.L. Mead, Inc.*, 42 B.R. 57 (Bankr. N.D. Ohio 1984) ; *In re Elegant Merch., Inc.*, 41 B.R. 398 (Bankr. S.D.N.Y. 1984) ; and *In re St. Petersburg Hotel Assoc.*, 37 B.R. 380 (Bankr. M.D. Fla. 1984) .

(n13)Footnote 12a. *In re Air Conditioning, Inc.*, 55 B.R. 157 (Bankr. S.D. Fla. 1985) . Gross & Borowitz, *A New Twist on Twist Cap: Invalidating a Preferential Letter of Credit in In re Air Conditioning*, 103 Banking L.J. 368 (1986). In *In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987) , an unsecured creditor who was paid as a beneficiary of a direct pay letter of credit was required to return the payment to the debtor's trustee because the collateralization of the letter of credit issuer (contemporaneously with the issuance of the letter of credit) within the 90-day preference period was for the creditor's benefit and constituted an indirect preferential transfer to the creditor. The transfer of collateral to the letter of credit issuer was, as between the debtor and the issuer, not preferential because the issuance of the letter of credit established a contemporaneous obligation of the debtor. A tripartite analysis of a letter of credit transaction worked to the creditor's benefit in *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 18 C.B.C.2d 462 (5th Cir. 1988) , in which the transfer of commodities and funds to a creditor were held nonpreferential in view of the contemporaneous release to the debtor of collateral held by the issuer of a letter of credit naming the creditor as beneficiary.

(n14)Footnote 12b. This danger is demonstrated by the result in *Committee of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerline Oil Co.)*, 59 F.3d 969, 33 C.B.C.2d 1778 (9th Cir. 1995) .

(n15)Footnote 13. See *First Nat'l Bank v. Blackburn*, 256 F. 527 (3d Cir. 1919) ; *Brush v. Seymore*, 30 F. Supp. 202, 204 (D.N.H. 1939) .

(n16)Footnote 14. See, e.g., *Cheek v. Beverly-Wilshire Prop., Inc.*, 103 F. Supp. 913, 914 (S.D. Cal. 1952) ; *Grubb v. General Contract Purchase Corp.*, 18 F. Supp. 680, 682-83 (S.D.N.Y. 1937) , *aff'd*, 94 F.2d 70, 72-73 (2d Cir. 1938) ; *Chiarovano v. Buttnick*, 57 Wash. 2d 542, 358 P.2d 305, 307 (1961) .

(n17)Footnote 15. See *Virginia Nat'l Bank v. Woodson (In re Decker)*, 329 F.2d 836, 840 (4th Cir. 1964) .

(n18)Footnote 16. The various structuring methods are discussed in Amdursky, *Tax-Exempts Backed by Letters of Credit*, N.Y.L.J., September 29, 1983, pages 21-23.

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

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P 2.06 Relief from the Automatic Stay

[1] Procedure

Section 362(d) of the Code sets forth the statutory basis for terminating the automatic stay. Section 362(d) was amended by the Bankruptcy Reform Act of 1994ⁿ¹ and the 2005 Act to add particular provisions on the scope and length of the stay in the case of an act by a creditor against "single asset real estate."^{n1a} This section provides:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay--

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if--

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization;

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later--

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that--

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the

property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate; or

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a scheme to delay, hinder, and defraud creditors that involved either--

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable state laws governing notices of interests or liens in real property, an order entered under paragraph (4) shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.^{n1b}

Adequate protection is addressed in section 361, which provides:

When adequate protection is required under sections 362, 363, and 364 of this title of an interest of an entity in property, such adequate protection may be provided by--

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease of the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.ⁿ²

A party in interest obtains relief from the automatic stay by filing a motion which initiates a contested matter under Bankruptcy Rule 9014.ⁿ³ Venue is proper in the court where the bankruptcy case is pending.ⁿ⁴ Bankruptcy Rule 7004 provides for a nationwide service of the motion by first-class mail.ⁿ⁵ Under Bankruptcy Rule 4001(a), as amended, in addition to the debtor, counsel to the debtor and the United States trustee, the creditors on the list provided by the debtor under Bankruptcy Rule 1007(d) or, in the alternative, the official committee of creditors holding unsecured claims in the case if one has been appointed, must be served.ⁿ⁶ Pursuant to Bankruptcy Rule 9014, the discovery rules contained in the Federal Rules of Civil Procedure generally apply.ⁿ⁷ No answer or other response to the motions is required unless otherwise ordered by the court pursuant to any applicable local rules.ⁿ⁸ For jurisdictional purposes, stay relief is considered a "core" proceeding and no right to a jury trial exists.ⁿ⁹

The creditor will wish to seek relief from all stays, including any stays that are applicable to the debtor, property of the debtor and property of the estate.ⁿ¹⁰ Accordingly, the motion should name the trustee or debtor in possession and the

debtor as respondents. Unless required by the court or local court rules, the holders of other liens on the property or other parties claiming an interest in the property subject to the stay relief motion need not be notified.ⁿ¹¹ As noted above, however, the 20 largest unsecured creditors or the committee must be notified of the motion. Generally, a junior lienholder will not have an absolute right to intervene in another lienholder's proceeding for relief from the automatic stay as it can file its own motion.ⁿ¹² In order to intervene, the creditor must invoke *Federal Rule of Civil Procedure 24* because *Bankruptcy Rule 9014* does not incorporate *Rule 7024* into contested matters.ⁿ¹³

Bankruptcy Rule 9013 addresses the contents of a motion and requires that "[t]he motion shall state with particularity the grounds therefor, and shall set forth the relief or order sought."ⁿ¹⁴ The motion should also include any relief sought for adequate protection purposes pursuant to section 363(e) which the court may grant if it declines to provide any relief from stay.ⁿ¹⁵ This is especially important because prepetition secured creditors are not entitled to a section 503(b) administrative expense priority to compensate for decline in value of the collateral.ⁿ¹⁶ *Bankruptcy Rule 9014* does not incorporate *Rule 7013*,ⁿ¹⁷ and, therefore, counterclaims against the creditor are generally not considered except in "summary fashion."ⁿ¹⁸ However, when the counterclaim directly contests the validity or the amount of the creditor's lien as opposed to claims which would merely effect a reduction or setoff against the debt, the court may consider the claims with more care.ⁿ¹⁹ In any event, the burden is on the creditor to show the validity, priority and extent of its interest.ⁿ²⁰ Thus, the courts have placed the burden of going forward on the mortgagee to show the amount of the claim and the validity and perfection of its security interest.ⁿ²¹

The Code explicitly provides for the litigation of a stay relief motion to be on a "fast track." Under section 362(e), a motion for relief from the automatic stay against property of the estate will result in termination of the stay against such property unless the court, within 30 days after the request for relief, after the notice and hearing, decides in a preliminary or final hearing to continue the stay.ⁿ²² The hearing under section 362(e) may be a preliminary hearing or may be consolidated with the final hearing contemplated by section 362(d).ⁿ²³ Under section 362(e), if the court holds a preliminary hearing, the court may continue the stay in effect if it concludes that a "reasonable likelihood" exists that the respondent will prevail in the final hearing.ⁿ²⁴ The 30 day period under section 362(e) begins to run when the debtor receives notice of the motion for stay relief.ⁿ²⁵ The inadvertent failure to schedule a preliminary hearing will result in the expiration of the stay under section 362(e).ⁿ²⁶ However, the section 362(e) hearing is not required to be evidentiary so long as the court can determine, based upon the statements of counsel and the offer of proof, whether there is reasonable likelihood that the debtor will prevail at the final hearing.ⁿ²⁷ Section 362(e) was amended by the Bankruptcy Reform Act of 1994 to require that if the hearing under such section is a preliminary hearing, then the final hearing must be "concluded" not later than thirty days after the conclusion of the preliminary hearing, unless the 30-day period is extended "with the consent of the parties in interest or for a specific time which the court finds is required by compelling circumstances."^{n27a} The statute previously only required that the final hearing be "commenced" within thirty days after the conclusion of the preliminary hearing and several courts had held that there was no specific limitation on when the final hearing on the motion to lift the stay must be concluded.^{n27b} The purpose and suggested interpretation of the new language added by the 1994 Act is best summarized by setting forth in full the language used by the House Judiciary Committee in its report accompanying the legislation:

This section provides that the final hearing must conclude within 30 days of the preliminary hearing, unless extended by consent of the parties or for a specific time which the court finds is required by compelling circumstances. Under this standard, for example, an extension should not be available where the debtor was merely seeking to delay the bankruptcy process or had neglected to consummate a pending contract. Compelling circumstances that might justify an extension might include, for example, the bona fide illness of any party or the judge or the occurrence of an event beyond the parties' control. Such a finding must be balance with the legitimate property rights at stake in each particular case. The Committee believes speedy conclusion of hearings on the automatic stay will reduce the time and cost of bankruptcy proceedings by preventing unjustified or unwarranted postponements of final action.^{n27c}

Under certain circumstances, when "irreparable damage" can be shown, the court may grant relief from the automatic

stay without a hearing.ⁿ²⁸ Bankruptcy *Rule 4001(a)(2)* provides that *ex parte* relief may be granted without prior notice only if it clearly appears on specific facts shown by affidavit or verified motion that immediate and irreparable injury, loss or harm will result and the movant's attorney certifies to the court in writing the efforts, if any, which have been made to give notice to the respondent and the reasons why notice should not be required.ⁿ²⁹ The party obtaining relief under *Rule 4001(a)(2)* must immediately give oral notice to the trustee or debtor in possession and to the debtor and must mail or otherwise transmit to the adverse party copies of the order granting relief.ⁿ³⁰ On two days notice to the party who obtained relief from the stay without notice or on shorter notice to the party as the court may prescribe, the adverse party may appear and move for reinstatement of the stay or reconsideration of the order.ⁿ³¹

The creditor has the initial burden of proof before relief can be granted pursuant to section 362(d).ⁿ³² Although section 362(g) provides that once the creditor has met its burden of proof on the issue of the debtor's equity in the property the opposing party has the burden of proof on all other issues, the creditor must carefully prepare its case to show validity of its debt and lien.ⁿ³³ As a matter of trial strategy, the creditor should be prepared to prove and/or rebut all issues raised in the motion.

As indicated above, two general grounds for relief from the automatic stay exist: (1) for "cause"; and (2) when the debtor has no equity in the property *and* such property is not necessary for an effective reorganization. The movant will generally plead alternative grounds for relief from stay which would include both paragraphs (1) and (2) of section 362(d), when applicable.^{n33a}

The Bankruptcy Reform Act of 1994 added, in new section 362(d)(3), a third ground for relief from the stay in the case of a secured creditor's act against "single asset real estate" where the debtor has not, within 90 days after the entry of the order for relief (or 30 days after the court determines that the debtor is subject to the paragraph, whichever is later), either filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time *or* commenced monthly payments in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.^{n33b} With respect to the first alternative--the filing of a plan that has "a reasonable possibility of being confirmed within a reasonable time"--this language is taken directly from the Supreme Court's opinion in *Timbers* that interpreted the "effective reorganization" language in section 362(d)(2)(B).^{n33c} and, accordingly, courts have interpreted this part of section 362(d)(3) under the same principles that have been used under section 362(d)(2).^{n33d} Of course, unlike the general ground for stay relief under section 362(d)(2), section 362(d)(3) does not take into account the question of whether the debtor has any equity in the property.

As amended by the 2005 Act, the term "single asset real estate" means "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmers and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental."^{n33e} In *In re Oceanside Mission Associates*,^{n33f} the bankruptcy court for the Southern District of California addressed two questions arising from the definition of "single asset real estate." First, the court held that the statutory definition did not exclude a project consisting of undeveloped raw land that generates no income. Although the court recognized that the reference in the definition to "substantially all of the gross income of a debtor" could be interpreted to require that there be at least some income, the court reasoned that such an interpretation would not serve the broad congressional purpose underlying the enactment of *section 362(d)(3) of the Bankruptcy Code*, which is to force debtors that do not have substantial operations other than real estate to act expeditiously.^{n33g} The court also addressed the method of determining whether the property or project had "secured debts" in excess of the \$4,000,000 ceiling that was applicable under the then current version of the definition of "single asset real estate," and concluded that the relevant inquiry was the aggregate amount of asserted *claims* secured by the property or project, without regard to the value of the collateral. On this issue, the court reasoned that to base the ceiling amount on the value of the collateral securing the claims would be to invite the type of valuation disputes and other delays that section 362(d)(3) was intended to avoid.^{n33h}

Prior to the 2005 Act, the application of section 362(d)(3) was substantially constrained by the then applicable

definition of single asset real estate, which provided that the debtor's aggregate noncontingent, liquidated secured debts could not exceed \$4,000,000. Pursuant to the Act, Congress removed the limitation, with the result that the single asset real estate provisions are applicable to all debtors which generate substantially all of their income from the operation of real property and incidental activities. The House Report accompanying the 2005 Act is instructive in indicating its sense of Congress with respect to the single asset real estate provisions and the desire for an amendment that removed the \$4,000,000 cap:

Paragraph (5) of section 1201 [*the provision in the Act that eliminated \$4,000,000 cap and made one other change*] concerns single asset real estate debtors. A single asset real estate chapter 11 case presents special concerns. As the name implies, the principal asset in this type of case consists of some form of real estate, such as undeveloped land. Typically, the form of ownership of a single asset real estate debtor is a corporation or limited partnership. The largest creditor in a single asset real estate case is typically the secured lender who advanced the funds to the debtor to acquire the real property. Often, a single asset real estate debtor resorts to filing for bankruptcy relief for the sole purpose of staying an impending foreclosure proceeding or sale commenced by the secured lender. Foreclosure actions are filed when the debtor lacks sufficient cash flow to service the debt and maintain the property. Taxing authorities may also have liens against the property. Based on the nature of its principal asset, a single asset real estate debtor often has few, if any, unsecured creditors. If unsecured creditors exist, they may have only nominal claims against the single asset real estate debtor. Depending on the nature and ownership of any business operating on the debtor's real property, the debtor may have few, if any, employees. Accordingly, there may be little interest on behalf of unsecured creditors in a single asset real estate case to serve on a creditors' committee.

In 1994, the Bankruptcy Code was amended to accord special treatment for single asset real estate debtors. It defined this type of debtor as a bankruptcy estate comprised of a single piece of real property or project, other than residential real property with fewer than four residential units. The property or project must generate substantially all of the debtor's gross income. A debtor that conducts substantial business on the property beyond that relating to its operation is excluded from this definition. In addition, the definition fixed a monetary cap. To qualify as a single asset real estate debtor, the debtor could not have noncontingent, liquidated secured debts in excess of \$4 million. Subparagraph (5)(A) amends the definition of 'single asset real estate' to exclude family farmers from this definition. Paragraph (5)(B) amends *section 101(51B) of the Bankruptcy Code* to eliminate the \$4 million debt limitation on single asset real estate. The present \$4 million cap prevents the use of the expedited relief procedure in many commercial property reorganizations, and effectively provides an opportunity for a number of debtors to abusively file for bankruptcy in order to obtain the protection of the automatic stay against their creditors. As a result of this amendment, creditors in more cases will be able to obtain the expedited relief from the automatic stay which is made available under *section 362(d)(3) of the Bankruptcy Code*.n33i

In addition to removing the secured debt ceiling from the definition of "single asset real estate," the 2005 Act also amended section 365(d)(3) to permit single asset real estate debtors to prevent the secured lender from obtaining relief from stay by commencing monthly payments to the mortgagee in an amount equal to the then applicable nondefault rate of interest on the value of the lender's interest in the real estate. The revised section 365(d)(3) explicitly permits the debtor to make these interest payments out of rents or other income generated from the property notwithstanding the general restriction on the use of cash collateral in section 363(c)(2).n33j

These amendment to section 365(d)(3), especially the modification to the definition of "single asset real estate," which removed the previously applicable \$4,000,000 secured debt ceiling, is likely to make section 365(d)(3) a common ground in which mortgage lenders will seek relief from the stay.

In bankruptcy cases where the definition of "single asset real estate" and the other requirements of section 362(d)(3) are applicable,^{n33k} it is likely that lenders will plead this either as the primary or as an alternative ground to seek relief from the stay.^{n33l}

It should first be noted that relief under section 362(d)(2) provides relief only as to a stay against property of the debtor.ⁿ³⁴ However, as is often the case in the context of real estate-related debt, the creditor claim is nonrecourse and has recourse only against the property itself not against the debtor for any deficiency.ⁿ³⁵ For the purposes of section 362(d)(2), the debtor's equity is the value of the lien property less all encumbrances.ⁿ³⁶ Under certain circumstances, the court may ignore junior liens if those liens are subject to preference or other voidable transfer attack.ⁿ³⁷ In addition, the costs of foreclosure and sale, including brokerage, escrow and title costs, should be considered when determining whether any equity is present in the property.ⁿ³⁸ This should be contrasted with equity under section 362(d)(1) which does not take into account liens junior to that of the movant with respect to an adequate protection analysis.ⁿ³⁹

Once the debtor's lack of equity is established, the issue then focuses on the possibility of the debtor's reorganization.ⁿ⁴⁰ Although the burden shifts to the debtor to show the prospects for a reorganization,ⁿ⁴¹ the creditor/movant should be prepared to show, in its side of the case, that the debtor cannot effectively reorganize. The creditor/movant can attack the debtor's "necessity" defense on two fronts: (1) that the property is unnecessary to the debtor's fundamental business and, accordingly, is not necessary to an effective reorganization; and (2) that the debtor has no reasonable prospect for reorganization. In the case of individual chapter 11 debtors, the courts have held, for example, that the debtor's home is not "necessary" to an effective reorganization.ⁿ⁴² When the debtor has a multitude of properties, the creditor can argue that one particular property is not necessary for the debtor's ultimate reorganization.ⁿ⁴³

However, in the context of a single asset partnership, when the property that is subject to the creditor's lien is the sole income-producing property of the debtor, the creditor must deal directly with the debtor's ability to reorganize. In *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,ⁿ⁴⁴ the Supreme Court interpreted section 362(d)(1) to reject the concept of adequate protection payments as a remedy to compensate the undersecured creditor for the time delay in foreclosing on collateral caused by the automatic stay. In reaching that holding, the Court strongly suggested that the principal remedy for an undersecured creditor facing inordinate delay in foreclosing on its collateral is to seek relief from the automatic stay under section 362(d)(2) in the event that the debtor does not propose a plan, or show that it can successfully propose a plan, within a reasonable period of time.ⁿ⁴⁵ Specifically, Justice Scalia opined:

Once the movant under § 362(d)(2) establishes that he is an undersecured creditor, it is burden of the *debtor* to establish that the collateral at issue is "necessary to an effective reorganization." See § 362(g). What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect*. This means, as many lower courts, including the en banc court in this case, have properly said, that there must be "a reasonable possibility of a successful reorganization within a reasonable time." The cases are numerous in which section 362(d)(2) relief has been provided within less than a year from the filing of the bankruptcy petition. And while the bankruptcy courts demand less detailed showings during the four months in which the debtor is given the exclusive right to put together a plan, see *11 U. S. C. §§ 1121 (b), (c)(2)*, even within that period lack of any realistic prospect of effective reorganization will require section 362(d)(2) relief.ⁿ⁴⁶

Both prior and subsequent to *Timbers*, a number of courts have held that the property cannot be necessary to an effective reorganization if no reasonable likelihood exists that the debtor can, in fact, be rehabilitated or reorganized.ⁿ⁴⁷ A minority of bankruptcy courts have found that the quoted language in *Timbers* is *dictum* and accordingly adopted a so-called "necessity" test,ⁿ⁴⁸ in which property is necessary for a reorganization if any reorganization would be impossible without the property, a standard that is almost always the case where the debtor's primary asset is the lender's collateral. Care must be taken to determine the law in the jurisdiction where the case is pending. If the creditor

is in a "necessity" jurisdiction, section 362(d)(2) may be a trap. In a necessity jurisdiction, the debtor's equity may, at least for the purposes of the initial stages of the case, be irrelevant and at that point a creditor may undercut its adequate protection claim by attempting to prove that the debtor has no equity in the property.ⁿ⁴⁹ However, in a jurisdiction that has adopted the majority test, the use of section 362(d)(2) may be successful when the creditor can show that the debtor cannot successfully propose a feasible plan of reorganization.ⁿ⁵⁰ This is especially true when the creditor can establish that the property cannot cover debt service even in a "cramdown" situationⁿ⁵¹ or that the debtor cannot successfully cram down a plan on the creditor's unsecured deficiency claim.ⁿ⁵²

Generally, the debtor will be given its 120-day exclusive period to propose a plan.ⁿ⁵³ Although the court should not hold a confirmation hearing in the context of a motion for relief from the automatic stay under section 362(d)(2), the court should examine the debtor's plan in sufficient depth to assess its feasibility.ⁿ⁵⁴ For example, when the debtor failed to establish a reasonable prospect for a successful reorganization and the implicit objective of the proposed plan was to delay foreclosure until the debtor could either sell the property or wait for return of favorable economic conditions, relief from the automatic stay was mandated under section 362(d).ⁿ⁵⁵ Under the right circumstances and especially in a jurisdiction which has rejected the new value exception to the absolute priority rule, a motion to lift the automatic stay based upon section 362(d)(2) grounds may be an effective strategy. The mortgagee may decide to wait until the end of the debtor's exclusive period to file its stay relief motion to enhance the *Timbers* argument. In any event, following the reasoning of the *Timbers* Court contained within the discussion of the varying lengths of time before stay relief may be appropriate, most courts have established a sliding scale in which if the relief from stay is requested at the early stages of the bankruptcy case, the burden upon the debtor to show prospects for confirmation of a plan is less stringent. But, if relief from the stay is requested later in the case, the debtor's showing is more closely scrutinized.ⁿ⁵⁶

In contrast to the limited termination of the automatic stay under section 362(d)(2), section 362(d)(1) terminates all stays applicable to the debtor.ⁿ⁵⁷ Relief is based upon "cause" including a lack of adequate protection for the creditor's interest in the debtor's interest in the property subject to the stay.ⁿ⁵⁸ Accordingly, the failure to insure and maintain collateral may be cause to lift the automatic stay. When the debtor fails to comply with court orders requiring insurance and cash collateral use, relief from stay may be appropriate under section 362(d)(1).ⁿ⁵⁹ Failure to comply with state laws may also constitute cause for granting relief from the automatic stay.ⁿ⁶⁰

In the case of a real estate mortgage, however, the lender's primary concern will usually be whether the passage of time resulting from the imposition of the automatic stay will result in a diminution of its interest in the collateral. In the case of an undersecured mortgage, the question will be whether a deficiency will increase as a result of: (1) further decline in value of the collateral; and (2) a decrease in the value of the lien resulting from the imposition of senior liens (which will ordinarily be for past due real estate taxes and penalties).ⁿ⁶¹ As noted, the concept of adequate protection to compensate the undersecured creditor for lost opportunity costs has been rejected by the Supreme Court in *Timbers*.ⁿ⁶² Thus, when the property is not declining in value, the postpetition taxes are being paid and the property insured, it may be difficult to obtain relief from the automatic stay under section 362(d)(1).ⁿ⁶³ However, if during the pendency of the bankruptcy case the value of the encumbered property has declined or will decline, the creditor will be entitled to relief from the automatic stay or adequate protection payments from the debtor to compensate it for such decline.ⁿ⁶⁴ If such adequate protection is insufficient, then the diminution in value during the pendency of the case may give rise to a claim under section 507(b).ⁿ⁶⁵ In that event, the creditor may be able to block confirmation of any proposed plan of the debtor because a section 507(b) superpriority claim must be paid in full at the effective date of the plan.ⁿ⁶⁶ The creditor must carefully consider the valuation issues in the context of the undersecured portion of its claim and the failure of adequate protection. If the court determines that a diminution in value has occurred, all is not lost to the creditor as the ability of the debtor to subsequently confirm a plan of reorganization may be in serious jeopardy.

In the case of an oversecured mortgage, the question will be whether the equity cushion will decrease as a result of: (1) a decrease in the value of the collateral;ⁿ⁶⁷ (2) the interposition of a senior lien, which will erode the equity cushion;ⁿ⁶⁸ and (3) the increase in the amount of the mortgage debt resulting from the accrual of unpaid interest and late charges or from the incurrence of collection costs.ⁿ⁶⁹ Some courts have rejected entirely the premise that an equity

cushion is entitled to protection from erosion and hold that, if the accrual of interest and/or other charges causes a claim to exceed collateral value, the creditor has the option of seeking relief under section 362(d)(2).ⁿ⁷⁰ However, a number of courts have found that because the equity cushion provides adequate protection for the creditor, it may itself be subject to protection from erosion by accruing interest, depreciation or other charges.ⁿ⁷¹ On the other hand, the Court of Appeals for the Eleventh Circuit has held that an oversecured creditor was not entitled to the payment of accruing postpetition interest during the pendency of the case and consequently that the oversecured creditor's interest that must be adequately protected encompasses the decline in the value of the collateral only, rather than perpetuating the ratio of collateral value to the debt.^{n71a} Of course, during the pendency of the case, the oversecured creditor is in the position of claiming accruing interest, fees and other charges.ⁿ⁷²

If a cash flow from a mortgaged property exists that is being applied to the proper maintenance and operation of the property, and the relative values of the mortgage lien and the property are stable, a substantial likelihood exists that the mortgagee will be deemed adequately protected, at least during the initial stages of the case.ⁿ⁷³ On the other hand, if the cash flow from the property has been diverted to other uses, it is less likely that the mortgagee will be deemed adequately protected.ⁿ⁷⁴ However, special care must be taken to address the issue of the mortgagee's separate security interest in the rents generated by the lien property. In certain circumstances under applicable nonbankruptcy law, the mortgagee will be deemed to have a perfected or choate interest in the rents which itself serves as additional security for payment of the mortgage obligation.ⁿ⁷⁵ In these circumstances, some courts have recognized that this separate security should also be adequately protected.ⁿ⁷⁶ Again, depending on the jurisdiction and the ratio of the indebtedness to the collateral package, the creditor may be in a position to argue that the use of the rents simply to maintain the value of the property does not adequately protect the creditor's interest in the collateral package. This is because one portion of the creditor's collateral (the income stream) is being used to maintain the value of another portion (the underlying real property). The mortgagee can argue that this does not benefit the mortgagee as much as it benefits the debtor's attempted reorganization.

Another area of stay litigation, especially in the context of the single asset limited partnership, is the "bad faith" case. A number of courts have held that dismissal of the case and/or termination of the automatic stay is appropriate when the court finds that a case has been filed in bad faith.ⁿ⁷⁷ The dismissal of a chapter 11 case in such circumstances may be viewed as an alternative to terminating the automatic stay. However, in order to avoid the imposition of yet another bankruptcy stay by the filing of a subsequent case, the mortgagee should first seek relief from the automatic stay so that the court may retain jurisdiction over the debtor pending the completion of the foreclosure sale under applicable nonbankruptcy law.ⁿ⁷⁸

Under section 1112(b), the court, on request of a party in interest or the United States trustee, subject to certain limited exceptions,ⁿ⁷⁹ shall convert a chapter 11 to a case under chapter 7 or may dismiss the chapter 11 case for cause, including continuing loss to or the diminution of the estate, the absence of a reasonable likelihood of rehabilitation or the inability to effectuate a plan.ⁿ⁸⁰ The section was extensively amended by the 2005 Act to add a number of enumerated types of nonexclusive "cause," including the unauthorized use of cash collateral substantially harmful to one or more creditors and "gross mismanagement of the estate."^{n80a} Another important revision to the section was to require the court to convert or dismiss a case if the movant establishes such cause, unless there are "unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate." Previously, dismissal and conversion by the court under the section was discretionary.

Although not expressly enumerated in section 1112(b) as a basis for conversion or dismissal, a number of courts have read into this section the authority to dismiss a chapter 11 case under a bad faith filing theory.ⁿ⁸¹ Some cases have articulated a distinction between "subjective bad faith" and "objective bad faith."ⁿ⁸² Subjective bad faith involves some invidious conduct on the part of the debtor or its principals with respect to the filing of the bankruptcy petition. An example of this conduct is the conveyance of the mortgaged real property to the debtor immediately prior to the foreclosure sale and the filing of the debtor's petition, following a number of other legal maneuvers clearly intended to

avoid or delay foreclosure or similar realization by a secured creditor acting in good faith.ⁿ⁸³

The finding of bad faith often requires a consideration of a number of factors, including:

- (1) whether the debtor is a single asset debtor;
- (2) whether the chapter 11 case has been filed immediately prior to or after a foreclosure proceeding has commenced;
- (3) whether the debtor has few or no unsecured obligations;
- (4) whether the debtor has few or no employees;
- (5) whether the value of the debtor's assets is less than the amount of the secured debt;
- (6) whether the case may be characterized as a two-party dispute between the debtor and the mortgagee;
- (7) whether an operating cash shortfall exists;
- (8) whether the debtor has no realistic possibility of an effective reorganization;
- (9) whether evidence is present of the debtor's intent to delay or hinder legitimate efforts by a secured creditor to enforce its rights; and
- (10) whether the debtor was created, or the property was transferred to the debtor, for sole purpose of filing a petition under title 11.ⁿ⁸⁴

The most critical issue in the bad faith filing determination is whether the single asset debtor has a realistic chance for reorganization.ⁿ⁸⁵ In the absence of a realistic prospect for reorganization, the debtor's assertion as to the viability of the project may be characterized as merely speculative and the filing of the debtor's petition found to be an unjustifiable risk of further erosion of the value of the collateral. Congress did not enact chapter 11 to allow the debtor to "throw the dice" with respect to the value of collateralized property.ⁿ⁸⁶

Although the amendments to section 1112(b) by the 2005 Act should lead to more conversions and dismissals, the statute still provides some discretion to the court and it is likely that courts will continue to make reference to the bad faith filing cases in interpreting whether "cause" has been established or whether unusual circumstances are present that weigh against conversion or dismissal.

In the context of the bad faith filing cases, an emerging trend in the context of workout negotiations should also be noted. Oftentimes prior to the initiation of a chapter 11 case, the debtor and the secured creditor will have attempted to have consensually restructured the secured indebtedness. In the restructuring documents, the secured creditor may attempt to "bankruptcy proof" the transaction to avoid the delay, expense and uncertainty of a bankruptcy case following the consummation of the restructuring. The complete waiver of bankruptcy relief by the borrower is unenforceable.ⁿ⁸⁷ However, a number of courts have recognized that a prebankruptcy stipulation pursuant to which the debtor agrees that the creditor was entitled to stay relief, may constitute "cause" for relief from the automatic stay.ⁿ⁸⁸ One court has held that a waiver of the right to contest relief from the stay is a "primary" element to be considered in determining whether cause exists for such relief.^{n88a} Indeed, this stipulation may provide not only a cause basis for relief from the automatic stay but may also bolster the creditor's argument that the filing was in bad faith.

In the context of asserting that the bankruptcy case was filed in bad faith, consideration must be given to the practical

effects of a finding of bad faith. Essentially, the court is being asked to make a determination that the filing violated Bankruptcy *Rule 9011*. *Rule 9011* provides, in pertinent part, that:

By presenting to the court a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, ...

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.ⁿ⁸⁹

Implicit in the finding of bad faith is a determination that the debtor or the debtor's attorneys have violated Bankruptcy *Rule 9011* by signing and filing the bankruptcy petition. Some courts may be reluctant to sanction the attorney and/or the debtor for this conduct and it may be wise to couch the motion not only on bad faith grounds but also under generally applicable section 362(d)(1) or (2) grounds. The underlying factual inquiry, the likelihood of a successful reorganization, is the same and yet the less palatable factual finding of bad faith by the court is not necessary to grant the creditor the requested relief.ⁿ⁹⁰

[2] Valuation Issues

The value of the debtor's assets is at the heart of any bankruptcy case, be it a case under chapter 7, chapter 12 or chapter 13. In a chapter 11 case, the value of debtor's assets is important not only for stay relief litigation but for a number of other purposes including confirmation of plans and for litigation involving voidable transfers.ⁿ⁹¹ Moreover, Bankruptcy *Rule 3012* specifically provides for the valuation of the secured creditor's collateral to determine its secured claim under section 506(a).ⁿ⁹²

The issue of valuation often entails a judicial determination of the merits of competing appraisals and of the appropriateness of the differing methods of appraisal.ⁿ⁹³ Asserting too high or too low of a value may create problems for the lender or the debtor, depending on the stage of the case, i.e., request for relief from the stay and/or adequate protection versus cramdown and plan confirmation.ⁿ⁹⁴ In the context of stay litigation, it may be tempting for the mortgagee seeking relief from the automatic stay to "low ball" the value of the subject property in order to argue that there is no or only a limited equity cushion. However, this may be a trap at confirmation when the secured claim to be addressed under the cramdown provisions of the Code reflects only the value of the collateral.ⁿ⁹⁵ In addition, to the extent that a mortgagee receives payment prior to the initiation of the bankruptcy case and the collateral is the sole asset of the estate, the secured creditor may be opening the door for a preference attack relating to those payments.ⁿ⁹⁶ The undersecured creditor may also find that the postpetition payments made under a cash collateral order are allocated to the creditor's prepetition secured claim.ⁿ⁹⁷

Section 506(a) contemplates differing valuations during the case for different purposes:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to a setoff under section 553 of this title, is a secured claim to the extent of the value of

such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in the light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.ⁿ⁹⁸

The legislative history accompanying section 506(a) provides:

Additionally a determination of what portion of an allowed claim is secured and what portion is unsecured is binding only for the purposes for which the determination is made. Thus determinations for purposes of adequate protection is [*sic*] not binding for purposes of "cramdown" on confirmation in a case under chapter 11.ⁿ⁹⁹

Moreover, the legislative history of section 361 recognizes the competing valuation goals and provides, in part:

The section [section 361] does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development ... flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financings.

Neither is it expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes. In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations [arising from] the facts of the case.ⁿ¹⁰⁰

Notwithstanding the absence of congressional guidance in the area of valuation standards, some conclusions may be inferred from the statute itself. For example, under section 362(d)(2), the court must determine whether the property is necessary for an effective reorganization and thus the court must assess the prospect that a reorganization will occur in valuing the property. This implicates the "going concern" versus liquidation standard for valuation. Some courts have held that collateral value, for the purposes of adequate protection, should be determined to be the wholesale value which is the amount which a creditor would receive by customary or commercially reasonable disposition.ⁿ¹⁰¹ Some courts have found in the context of stay relief that the foreclosure value as opposed to a third party sale value is appropriate.ⁿ¹⁰² Other courts have focused on the realizable value by the creditor in a reasonably commercial disposition as the standard in the context of stay litigation.ⁿ¹⁰³

If the debtor cannot demonstrate that the property is essential to a reorganization or that a reorganization is likely, the secured creditor must still prove that the debtor lacks equity in the property in order to obtain relief from stay to foreclose on the property. The anticipated disposition of the property may well be a liquidation and accordingly the liquidation value may be the most appropriate. This may not be a significant issue in the case of a single asset partnership assuming an orderly disposition of the property. Indeed, in the case of an income producing commercial real estate property, the going concern and liquidation value in the context of an orderly disposition may be nearly identical.ⁿ¹⁰⁴ The distinction between liquidation and going concern values may be more sharply drawn in the case of an industrial enterprise that is a debtor. In these circumstances, the "liquidation value" will ordinarily refer to the piecemeal disposition of the debtor's fixed assets and the going concern value will refer to an analysis based on capitalization of earnings. The methodology for valuing the commercial real estate property must be carefully analyzed to determine the sale concept versus going concern concept. To the extent that the market has declined and there are no comparable sales, the income producing capability of the property, capitalized at an appropriate capitalization rate, may be the most appropriate method for determining the underlying fair market value of the property.

As discussed previously, if liquidation values are being employed, the equity cushion under section 362(d)(1) and (d)(2) will be the same, except that under section 362(d)(2) generally junior liens must be considered in computing the debtor's equity in the property.ⁿ¹⁰⁵ This distinction points out the fact that valuation under section 362(d)(2) deals with the value of the property in the hands of the debtor, while valuation under section 362(d)(1) deals with the protection of the value of the lien encumbering the estate's property. In other words, in the context of a single asset real estate case, section 362(d)(2) is directed to the likelihood of a debtor's reorganization under the Bankruptcy Code, while section 362(d)(1) is directed to the protection of secured party who is seeking to bring the bankruptcy case to an end by obtaining bankruptcy court permission to foreclose the debtor's assets.

This same distinction must be made in the context of valuing the property under section 506(a) and for the purposes of confirmation of a plan under section 1129(b). In the case of a valuation under section 506(a), it may be argued that in the reorganization case, when the debtor is treating the property as part of an ongoing business enterprise, it should, therefore, be estopped from arguing a liquidation value.ⁿ¹⁰⁶ This is especially true in the case of the chapter 11 plan context when, under a cramdown, the debtor will seek to retain the property and restructure the secured indebtedness.ⁿ¹⁰⁷

This analysis has been confirmed by the Supreme Court in *Associates Commercial Corp. v. Rash*,^{n107a} which held that collateral to be retained by a chapter 13 debtor under the cramdown provisions set forth in *section 1325(a)(5)(B) of the Code* is to be valued on a "replacement-value" and not a "foreclosure-value" basis, thereby requiring the debtor to make payments to the secured creditor over the life of the plan equal to the fair market value of the collateral, determined as of the effective date of the plan.

Section 1325(a)(5) of the Code, as in effect at the time of the *Rash* decision, included the following option among the plan confirmation standards for a chapter 13 case: "(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim" The issue resolved in *Rash* was whether the tractor truck to be retained by the debtor for use in his business was to be valued at foreclosure sale or replacement cost prices for the purpose of valuing the allowed secured claim of the lender holding a security interest in the equipment. The debtor asserted that the proper valuation was the net amount that the secured creditor would have received upon foreclosure and sale--determined to be \$31,875. The secured creditor advocated a valuation based on the price the debtor would pay to purchase a like vehicle--determined to be \$41,000.

The debtor's position, supported by Justice Stevens in his lone dissent, was that the purpose of section 1325(a)(5)(B) is to place the secured creditor in the same position as if it had foreclosed its lien, sold the collateral and reinvested the proceeds. Under this view, the plan would establish the amount payable to the secured creditor on the basis of the projected net foreclosure sale proceeds, provide for appropriate interest payments on that amount in order to preserve the present value of the secured claim, and provide for such adequate protection payments as might be necessary to deal with the erosion of collateral value arising from the use and depreciation of the equipment.^{n107b} The statutory basis for this view was asserted to be found in the first sentence of section 506(a), which directs the courts to establish the secured portion of a secured creditor's claim by determining the "creditor's interest in the estate's interest" in the collateral. While acknowledging that the language of section 506(a) is not entirely clear,^{n107c} Justice Stevens opined that this language contemplated that the "creditor's interest" in the collateral was comprised exclusively of its right of foreclosure and sale, thereby mandating valuation of the creditor's secured claim on a foreclosure liquidation basis.^{n107d}

The majority read the first sentence of section 506(a) as a neutral directive to establish a value for the secured creditor's claim (with any deficiency to be allocated to a separate allowed unsecured claim for the creditor), and found better guidance in the second sentence of section 506(a), which provides that "Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property" ^{n107e} The Court determined that inasmuch as the proposed use of the collateral was for the debtor's business, the appropriate valuation should be the cost

the debtor would incur to obtain a like asset for the same proposed use.^{n107f} This value was characterized by the Court as the "replacement value" of the collateral.^{n107g}

The Court also articulated a highly significant policy rationale for its decision, which appears to make *Rash* applicable to cramdown cases under section 1129(b) as well as section 1325. In substance, the Court decided that secured creditors compelled to accept plan cramdown treatment are not sufficiently protected by appropriate interest payments and the adequate protection provisions of the Code, and are therefore entitled to the added protections of a higher valuation standard--the so-called "replacement value" standard:

Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor's choice to surrender the property or retain it From the creditor's perspective as well as the debtor's, surrender and retention are not equivalent acts If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more "adequate protection," 11 U.S.C. § 361, do not fully offset these risks. See 90 F.3d at 1066 (Smith, J., dissenting) ("vast majority of reorganizations fail ... leaving creditors with only a fraction of the compensation due them"; where, as here, "collateral depreciates rapidly, the secured creditor may receive far less in a failed reorganization than in a prompt foreclosure").^{n107h}

Although it may be argued that the foregoing passage is directed to chapter 13 reorganization plans with frequent failure rates, and to security interests in equipment that may suffer rapid deterioration or even abuse at the hands of chapter 13 debtors, the Court did clearly articulate a valuation standard for secured claims in cramdown cases. The Court evidenced a certain hostility toward the notion that appropriate interest rates and adequate protection payments would actually protect secured creditors denied access to their collateral, and imposed on debtors the obligation to pay for the benefits they are receiving under cramdown plans in lieu of imposing on secured creditors the continued risks of compulsory loans with a principal limited to foreclosure value.

Accordingly, it appears that the "replacement value" standard found applicable to sections 506(a) and 1325(a)(5) is also applicable to sections 506(a) and 1129(b) of the Code when a secured creditor is unable to foreclose on its collateral by reason of the operation of the cramdown provisions of chapter 11. Therefore, in the context of a single asset real estate case involving a cramdown plan under chapter 11, the replacement value standard appears to mandate a determination of the fair salable value of the real property involved. The use of the term "replacement value" in this circumstance is not appropriate, inasmuch as the replacement cost of a building is ordinarily viewed as the cost of reconstruction, while the fair market cost of an ongoing project will be determined most often on the basis of comparable sales and the capitalization of income method. Under the holding in *Rash*, the debtor in a single asset real estate case is to pay out a secured claim on the basis of the hypothetical cost to the debtor of acquiring the same real estate asset in the open market on an arm's-length basis.ⁿ¹⁰⁷ⁱ

It is difficult to determine whether the *Rash* valuation standard will apply to valuations under section 362(d) of the Code. Under section 362(d)(1), the secured lender is seeking protection if it is prevented from bringing the bankruptcy case to an end by obtaining relief from the stay in order to foreclose its lien. In seeking relief from the stay, the secured creditor will be tempted to assert a relatively low value for the collateral to demonstrate that its interest therein is in jeopardy and cannot be adequately protected. However, if relief from the stay is denied, *Rash* may require that the collateral be valued on a fair market basis rather than a (lower) foreclosure basis inasmuch as the secured creditor is being denied access to its collateral and is being subjected to the risks of the estate's continued possession and use thereof. Yet, the higher valuation may demonstrate that the secured creditor does not require adequate protection to any significant extent. Similarly, as noted above, stay relief efforts under section 362(d)(2) are directed to the likelihood of a debtor's reorganization under the Code, and may therefore also engender a fair market valuation of the collateral.

In a case of voidable preferences, the valuation methodology may differ, depending on the court's conclusion as to the viability of the enterprise at the time of the transfer. Under section 101, insolvency turns on the question of the ratio of the fair value of the debtor's assets versus the liabilities of the debtor.ⁿ¹⁰⁸ Depending on the circumstances of the debtor, the court may look to liquidation value if the court determines that the entity is "on its death bed."ⁿ¹⁰⁹ However, if at the time of the transfer the entity still appears to be a going concern, the court will use a going concern analysis.ⁿ¹¹⁰

The questions involving value of the debtor's property, especially in the single asset case, must be analyzed very carefully prior to filing a motion for relief from stay in the bankruptcy case. Under certain circumstances proving that the debtor has no equity in the property may be a trap when the debtor has the defense of the reasonable prospect for reorganization. The valuation of the debtor's equity will yield little meaningful advantage under section 362(d)(2) as the debtor has a viable defense and the creditor who attempts to prove a low collateral value in stay litigation may be estopped from arguing a higher value for section 361 adequate protection or for the purposes of plan confirmation. The additional issues of the debtor's ability to reorganize, especially in the context of the new value exception absolute priority rule and classification issues, must also be considered.ⁿ¹¹¹

Note that although valuation issues and relief from stay issues typically occur in bankruptcy cases where the property owner and mortgagor is the debtor, the same analysis is relevant if the debtor is a mortgagee with a second mortgage on real estate for which a first mortgagee seeks to foreclose and terminate the lien of the debtor/second mortgagee. In recent years, there has been a number of bankruptcy cases involving mortgage lenders, and it has become common practice for the nondebtor holders of first mortgages to seek relief from the stay in order to foreclose on the underlying encumbered property. Because the second mortgage would be wiped out by the first mortgage holder's proceeding against the underlying obligor, the holder of the first mortgage should seek relief from the stay before proceeding with the foreclosure. In such a situation, where the underlying property is declining in value or not being maintained, grounds for relief from the stay imposed by the bankruptcy case of the holder of the second mortgage should be warranted for cause under section 362(d)(1). Similarly, where the value of the underlying property is less than the payoff amount of the first mortgage, the debtor's second mortgage has no value, and relief from the stay should be warranted under section 362(d)(2) if the second mortgage is not necessary for a reorganization. A form of motion for the relief from the stay by a first mortgagee under both grounds in a bankruptcy case of a second mortgagee is presented at the end of this chapter.ⁿ¹¹²

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 1a. The term "single asset real estate" is defined as "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto." 11 U.S.C. § 101(51B); see *In re Oceanside Mission Assocs.*, 35 C.B.C.2d 336, 340, 192 B.R. 232, 236 (Bankr. S.D. Cal. 1996) (the definition of single asset real estate includes raw land); *In re Kkemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (marina is not "single asset real estate"); *In re Philmont Dev. Co.*, 33 C.B.C.2d 1126, 181 B.R. 220 (Bankr. E.D. Pa. 1995) (semidetached homes are part of a single project and therefore constitute a single asset). The potential application of this provision was substantially broadened by an amendment to the definition of "single asset real estate" pursuant to the 2005 Act that removed the requirement that the single asset real estate debtor have secured debts of not more than \$4,000,000. Pub. L. No. 109-8, § 1201(5)(B) (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). As a result of the amendment, the provision is applicable to all debtors which generate substantially all of their income from the operation of real property and incidental activities.

(n3)Footnote 1b. Subsection 365(d)(3)(B) was substantially modified and subsection 365(d)(4) added by the 2005

Act. Pub. L. No. 109-8, § 404, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 2. 11 U.S.C. § 361.

(n5)Footnote 3. *See Fed. R. Bankr. P. 4001(a)* and 9014; *see also In re Transleisure Corp.*, 41 B.R. 201 (Bankr. E.D.N.Y. 1984) .

(n6)Footnote 4. *See Fed. R. Bankr. P. 5005(a)*.

(n7)Footnote 5. *See Fed. R. Bankr. P. 7004(b)(4)* and 9014.

(n8)Footnote 6. *Fed. R. Bankr. P. 4001(a)*.

(n9)Footnote 7. *Fed. R. Bankr. P. 9014* incorporates the discovery rules contained in *Fed. R. Bankr. P. 7026 through 7037*, with the exception of 7027. *See, e.g., King v. Fidelity Nat'l Bank*, 712 F.2d 188, 9 C.B.C.2d 179 (5th Cir. 1983) , *cert. denied*, 465 U.S. 1029, 104 S. Ct. 1290, 79 L. Ed. 2d 692 (1984) (*Fed. R. Civ. P. 37* applied to a Rule 205 examination); *Jackson v. Pacific Energy Res. (In re Transcontinental Energy Corp.)*, 683 F.2d 326, 6 C.B.C.2d 1475 (9th Cir. 1982) (the court excluded a nonparty deposition when counsel failed to show that the deponent, who was not present at trial, lived more than 100 miles from the place of hearing). In addition, a number of courts have held that a Rule 2004 examination cannot be used to circumvent the procedural safeguards provided to a litigant by the Federal Rules of Civil Procedure, especially with respect to expert witness examinations. *See In re Valley Forge Plaza Assoc.*, 116 B.R. 420 (E.D. Pa. 1990) ; *In re GHR Energy Corp.*, 35 B.R. 534 (Bankr. D. Mass. 1983) . *But see In re Isis Foods, Inc.*, (Bankr. W.D. Mo. 1983), 33 B.R. 45 (trustee not limited by discovery rules applicable to adversary proceedings in prosecution of a complaint to set aside preferential transfer and court intimated that Rule 2004 may be used by the trustee). In the context of a litigated motion for stay relief, the better practice is to comply with the appropriate discovery rules contained in Rule 26 with respect to expert witness interrogatories and subsequent examination of those experts upon court order after showing good cause. Some district courts have modified their local rules to provide for this result without further court order.

(n10)Footnote 8. *Fed. R. Bankr. P. 9014*. However, the local rules enacted in any particular district may require that an answer be filed. *See Fed. R. Bankr. P. 9029*; *see also* Collier Bankruptcy Practice Guide Local Rules Pamphlets (Matthew Bender).

(n11)Footnote 9. *See 28 U.S.C. § 157(b)*; *see also Baldwin-United Corp. v. Thompson (In re Baldwin-United Corp.)*, 12 C.B.C.2d 378, 48 B.R. 49 (Bankr. S.D. Ohio 1985) (no right to jury trial in "core proceedings"). After the Supreme Court's decision in *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 2d 26, 20 C.B.C.2d 1216 (1989) , one could question the proposition of the availability of a jury trial. However, because the procedure relating to stay relief is uniquely the province of the bankruptcy court and because the movant is requesting relief from the bankruptcy court, the movant is likely not entitled to a jury trial.

(n12)Footnote 10. The stay protecting property of the debtor continues as to abandoned property. *Hickman v. First State Bank (In re Motley)*, 4 C.B.C.2d 36, 10 B.R. 141 (Bankr. M.D. Ga. 1981) . Accordingly, the better practice is to request relief not only against any trustee but also against the debtor so as to ensure that no stay is applicable with respect to any creditor action against the property of the estate. *But see In re D'Annies Restaurant, Inc.*, (Bankr. D. Minn. 1981), 15 B.R. 828 (abandonment by corporate debtor or partnership terminates all stays as to abandoned property).

(n13)Footnote 11. *See, e.g., Bryce v. Stivers (In re Stivers)*, 9 C.B.C.2d 225, 31 B.R. 735 (Bankr. N.D. Cal. 1983) (junior lienholders did not have absolute right to intervene in another lienholder's adversary proceeding for relief from the automatic stay).

(n14)Footnote 12. *Bryce v. Stivers (In re Stivers)*, 9 C.B.C.2d 225, 31 B.R. 735 (Bankr. N.D. Cal. 1983) .

(n15)Footnote 13. *See Fed. R. Bankr. P. 9014*.

(n16)Footnote 14. *See Fed. R. Bankr. P. 9013; see also In re Riding*, 11 C.B.C.2d 859, 44 B.R. 846 (Bankr. D. Utah 1984) (a motion will seldom be found to be too vague to satisfy the particularity requirement and will not be stricken if the court can comprehend the basis of the motion and deal fairly with it).

(n17)Footnote 15. *See Fed. R. Bankr. P. 4001(a)*.

(n18)Footnote 16. *See, e.g., First State Bank v. Advisory Info. & Mgmt. Sys., Inc. (In re Advisory Info. & Mgmt. Sys., Inc.)*, 13 C.B.C.2d 55, 50 B.R. 627 (Bankr. M.D. Tenn. 1985) (a prepetition secured lender is not entitled to a subsection 503(b) administrative expense priority to compensate it for a decline in the value of its collateral due to a depreciation or to the debtor's postpetition use of collateral). *But see In re Prime, Inc.*, 10 C.B.C.2d 725, 37 B.R. 897 (Bankr. W.D. Mo. 1984) (secured creditor is entitled to an administrative expense allowance for the use of its collateral which has benefited the estate). Obviously, the lesson here is to broadly define the motion so as to fully protect the creditor. This may include a request for adequate protection of the creditor's separate perfected security interest in the rents generated by the real property that is subject to the mortgage.

(n19)Footnote 17. *See Fed. R. Bankr. P. 9014*.

(n20)Footnote 18. *See Vale Mills Corp. v. Gellert (In re Gellert)*, 14 C.B.C.2d 8, 55 B.R. 970 (Bankr. D.N.H. 1985) (extraneous grounds will be considered only in a summary fashion).

(n21)Footnote 19. *See, e.g., Cheshire County Sav. Bank v. Pappas (In re Pappas)*, 55 B.R. 658 (Bankr. D. Mass. 1985) (counterclaims are affirmative defenses which directly contest the validity or amount of creditor's lien, as opposed to those which would only affect a reduction or setoff of the debt, should be considered with care during the hearing on the motion for relief from stay).

(n22)Footnote 20. *See 11 U.S.C. § 363(o)*.

(n23)Footnote 21. *See, e.g., In re Irving A. Horns Farms, Inc.*, 42 B.R. 832 (Bankr. N.D. Iowa 1984) (when creditor failed to offer any evidence that it filed a financing statement, stay relief and adequate protection were denied as to certain collateral).

(n24)Footnote 22. *11 U.S.C. § 362(e)*.

(n25)Footnote 23. *11 U.S.C. § 362(e)*.

(n26)Footnote 24. *See Grundy Nat'l Bank v. Looney (In re Looney)*, 823 F.2d 788 (4th Cir.) , *cert. denied*, 484 U.S. 977, 108 S. Ct. 488, 98 L. Ed. 2d 486 (1987) (under section 362(e), it is error for the court to order that the automatic stay remain in effect until final hearing on the merits of the motion seeking relief from the stay, without prior notice to the parties and an opportunity to allow them to request an actual hearing, and the court making the requisite factual finding that the party opposing the motion is reasonably likely to prevail on the merits at the final hearing).

(n27)Footnote 25. *See In re Northwest Aggregate & Constr. Co.*, 16 C.B.C.2d 1051, 72 B.R. 317 (Bankr. N.D. Ill. 1987) .

(n28)Footnote 26. *In re Jones*, 89 B.R. 1 (Bankr. D.D.C. 1988) .

(n29)Footnote 27. *See Satter v. KDT Indus., Inc. (In re Satter)*, 7 C.B.C.2d 916, 28 B.R. 374 (Bankr. S.D.N.Y. 1982) .

(n30)Footnote 27a. 11 U.S.C. § 362(e), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994).

(n31)Footnote 27b. See, e.g., *In re Bogosian*, 112 B.R. 2 (Bankr. D.R.I. 1990) ; *In re ML Barge Pool VII Partners-Series A*, 98 B.R. 957 (Bankr. E.D. Mo. 1989) .

(n32)Footnote 27c. H.R. Rep. No. 103-835, 103rd Cong., 2d Sess. 36 (1994), reprinted in App. Vol. 4 Collier on Bankruptcy, Part XLI (Matthew Bender 15th ed.).

(n33)Footnote 28. See 11 U.S.C. § 362(f).

(n34)Footnote 29. See *In re Montgomery Mall L.P.*, 704 F.2d 1173 (10th Cir.) , cert. denied, 464 U.S. 830, 104 S. Ct. 108, 78 L. Ed. 2d 110 (1983) (emergency relief granted when engineer testified that shopping center needed immediate structural repairs, presented a public hazard and should be closed).

(n35)Footnote 30. See *Fed. R. Bankr. P. 4001(a)(2)*.

(n36)Footnote 31. See *id.*

(n37)Footnote 32. See *In re Texaco, Inc.*, (Bankr. S.D.N.Y. 1988), 81 B.R. 820 ; *In re Planned Sys., Inc.*, 78 B.R. 852 (Bankr. S.D. Ohio 1987) .

(n38)Footnote 33. See, e.g., *First Nat'l Bank v. Turley*, 705 F.2d 1024 (8th Cir. 1983) (court refused relief from stay where alleged secured creditor not perfected); *In re Allstar Bldg. Prods., Inc.*, 834 F.2d 898, 17 C.B.C.2d 1171 (11th Cir. 1987) (secured creditor must establish a *prima facie* case as to its debt and the validity and perfection of its lien); *In re Irving A. Horns Farms, Inc.*, 42 B.R. 832 (Bankr. N.D. Iowa 1984) .

(n39)Footnote 33a. A body of case law has arisen relating to the enforceability of prepetition waivers of the automatic stay. In the context of a single asset real estate case under the Code, enforcement of a prepetition waiver of the stay will be equivalent to a dismissal of the case, and may be viewed as a prepetition waiver of the right to file a case under the Code. Cases upholding enforceability of such waivers include *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908 (Bankr. D.S.C. 1995) (waiver in workout agreement); *In re Powers*, 31 C.B.C.2d 1079, 170 B.R. 480 (Bankr. D. Mass. 1994) (waiver in bankruptcy case settlement agreement); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (waiver clause in forbearance agreement); *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) (same). Cases denying enforceability include *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996) ; *In re Jenkins Assocs., L.P.*, 181 B.R. 33 (Bankr. E.D. Pa. 1995) ; *Farm Credit of Cent. Florida, ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) ; *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (W.D. Pa. 1989) . A stay waiver in a confirmed chapter 11 plan was upheld in *In re Atrium High Point L.P.*, 189 B.R. 599 (Bankr. M.D.N.C. 1995) .

(n40)Footnote 33b. 11 U.S.C. § 362(d)(3).

(n41)Footnote 33c. *United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988) . *Timbers* is discussed in detail *infra* in this section.

(n42)Footnote 33d. *In re Windwood Heights, Inc.*, 385 B.R. 832, 838 (Bankr. N.D. W. Va. 2008) .

(n43)Footnote 33e. 11 U.S.C. § 101(51B). As noted, the 2005 Act amended the definition to remove a requirement that the single asset real estate debtor have secured debts of no more than \$4,000,000. Pub. L. No. 109-8, § 1201(5)(B) (2005), reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n44)Footnote 33f. 35 C.B.C.2d 336, 192 B.R. 232 (Bankr. S.D. Cal. 1996) .

(n45)Footnote 33g. 35 C.B.C.2d 336, 338-39, 192 B.R. 232, 235 .

(n46)Footnote 33h. 35 C.B.C.2d 336, 342, 192 B.R. 232, 238 .

(n47)Footnote 33i. See H.R. Rep. No. 109-031, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), at 10-418 (Matthew Bender 15th Ed. Revised).

(n48)Footnote 33j. 11 U.S.C. § 362(d)(3)(B), as amended by Pub. L. No. 109-8, § 444 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n49)Footnote 33k. This may be a highly contested issue where the property generates meaningful revenues from sources other than the collection of rents. See *In re Scotia Pac. Co. LLC*, 508 F.3d 214 (5th Cir. 2007) (timber business not a single asset real estate debtor), discussed, *supra* at P 1.07[2]; see also *Centofante v. CBJ Dev. (In re CBJ Dev.)*, 202 B.R. 467 (B.A.P. 9th Cir. 1996) (hotel not a SARE); *In re Club Golf Ptnrs., L.P., 2007 Bankr. LEXIS 1225 (Bankr. E.D. Tex. Feb. 15, 2007)* (golf course, citing similar cases).

(n50)Footnote 33l. In *In re Philmont Dev. Co.*, 181 B.R. 220 (Bankr. E.D. Pa. 1995) , the court held that a series of several semi-detached houses owned by a debtor partnership constituted a "single project" within the meaning of the definition of single asset real estate and granted relief from the stay when the debtor failed to file plan of reorganization within 90 days after the filing date.

(n51)Footnote 34. 11 U.S.C. § 362(d)(2).

(n52)Footnote 35. But see 11 U.S.C. § 1111(b), discussed P 2.01[9] *infra* , which changes nonrecourse debt into recourse debt under certain circumstances. Section 1111(b) was intended to preclude a cash-out of the secured creditor at a judicially determined value in the case. Under certain circumstances this recourse treatment will not apply.

(n53)Footnote 36. See *Sutton v. Bank One, Texas Nat'l Ass'n. (In re Sutton)*, 904 F.2d 327, 23 C.B.C.2d 1 (5th Cir. 1990) ; *Nazareth Nat'l Bank v. Trina-Dee, Inc.*, 731 F.2d 170 (3d Cir. 1984) ; *Stewart v. Gurley*, 745 F.2d 1194, 11 C.B.C.2d 435 (9th Cir. 1984) .

(n54)Footnote 37. See, e.g., *In re First Barnstable Corp.*, 108 B.R. 372 (Bankr. D. Mass. 1989) (in undertaking equity analysis under section 362(d)(2), the court refused to take into account a third mortgage which appeared to have been a voidable preference under section 547).

(n55)Footnote 38. See *Harleysville Nat'l Bank & Trust Co. v. Kaufman (In re Kaufman)*, 24 B.R. 498 (Bankr. E.D. Pa. 1982) . But see *In re Beacon Hill Apartments, Ltd.*, 118 B.R. 148 (N.D. Ga. 1990) (disposition costs not considered where debtor proposes to retain property).

(n56)Footnote 39. See *Pistole v. Mellor (In re Mellor)*, 734 F.2d 1396, 10 C.B.C.2d 1353 (9th Cir. 1984) .

(n57)Footnote 40. 11 U.S.C. § 362(d)(2)(B).

(n58)Footnote 41. 11 U.S.C. § 362(g).

(n59)Footnote 42. See, e.g., *In re Sulzer*, 1 C.B.C.2d 451, 2 B.R. 630 (Bankr. S.D.N.Y. 1980) (the fact that the debtor/psychoanalyst maintained an office in his home did not make his residence necessary to an effective reorganization and stay was terminated on request of mortgagee); see also *Vieland v. First Fed. Sav. Bank (In re Vieland)*, 10 C.B.C.2d 1208, 41 B.R. 134 (Bankr. N.D. Ohio 1984) (chapter 13 case).

(n60)Footnote 43. See *In re F M Enterprises, Inc.*, 29 B.R. 115 (Bankr. M.D. Fla. 1983) .

(n61)Footnote 44. 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n62)Footnote 45. 484 U.S. 365, 375, 108 S. Ct. 626, 633, 98 L. Ed. 2d 740, 751, 17 C.B.C.2d 1368, 1374 .

(n63)Footnote 46. 484 U.S. 365, 375-76, 108 S. Ct. 626, 633, 98 L. Ed. 2d 740, 751, 17 C.B.C.2d 1368, 1374 (citations and footnotes omitted).

(n64)Footnote 47. See, e.g., *In re Canal Place Ltd. Partnership*, 921 F.2d 569 (5th Cir. 1991) ; *Anderson v. Farm Credit Bank (In re Anderson)*, 913 F.2d 530 (8th Cir. 1990) ; *Albany Partners, Ltd. v. Westbrook (In re Albany Partners, Ltd.)*, 749 F.2d 670, 12 C.B.C.2d 244 (11th Cir. 1984) ; *In re Richardson Group, Inc.*, 107 B.R. 353 (Bankr. M.D. Fla. 1989) ; *In re 1025 Assocs., Inc.*, 106 B.R. 805 (Bankr. D. Del. 1989) ; *In re Grantsville Hotel Assocs., L.P.*, 103 B.R. 509 (Bankr. D. Del. 1989) .

(n65)Footnote 48. See *In re Rassier*, 18 C.B.C.2d 1148, 85 B.R. 524 (Bankr. D. Minn. 1988) ; see also *First Interstate Bank of Ft. Collins, N.A. v. Baskerville (In re Baskerville)*, 93 B.R. 251 (D. Colo. 1988) (adopting "necessity" test under section 362(d)(2)(B) in a chapter 12 case).

(n66)Footnote 49. 484 U.S. 365, 382, 108 S. Ct. 626, 636, 98 L. Ed. 2d 740, 755, 17 C.B.C.2d 1368, 1378 .

(n67)Footnote 50. *In re Canal Place L.P.*, 921 F.2d 569, 576-79, 24 C.B.C.2d 998, 1007-12 (5th Cir. 1991) ; *In re Anderson*, 913 F.2d 530, 532-33 (8th Cir. 1990) ; *In re Albany Partners, Ltd.*, 749 F.2d 670, 673 n.7, 12 C.B.C.2d 244, 248 n.7 .

(n68)Footnote 51. The cramdown provisions of 11 U.S.C. § 1129(b)(2) are discussed in P 2.07 *infra*.

(n69)Footnote 52. As discussed in P 2.07 *infra*, under certain circumstances a debtor will attempt to cram down the unsecured portion of the secured creditor's deficiency claim through the invocation of the so-called new value exception of the absolute priority rule. The interaction between the absolute priority rule (codified at 11 U.S.C. § 1129(b)(2)(B)(ii) and 11 U.S.C. § 1111(b)) is discussed in P 2.07 *infra*.

(n70)Footnote 53. See 11 U.S.C. § 1121.

(n71)Footnote 54. *In re Ritz-Carlton of D.C., Inc.*, 98 B.R. 170 (S.D.N.Y. 1989) ; *In re Holly's, Inc.*, 140 B.R. 643, 700 (Bankr. W.D. Mich. 1992) .

(n72)Footnote 55. *In re Canal Place L.P.*, 921 F.2d 569, 579, 24 C.B.C.2d 998, 1011 ; see also *Resolution Trust Corp. v. Swedeland Dev. Group (In re Swedeland Dev. Group)*, 16 F.3d 552 (3d Cir. 1994) (granting creditor relief from automatic stay since effective reorganization was not in prospect given the creditor was undersecured by approximately \$20,000,000, the remaining unsecured claims were far less than that amount, and the creditor had asserted that it would oppose any proposed plan); *John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs.*, 987 F.2d 154, 28 C.B.C.2d 440 (3d Cir. 1993) (granting relief from the automatic stay since debtor conceded that it would not have sought confirmation of a plan of reorganization unless it was permitted to classify separately creditor's unsecured deficiency claim, which the court held was impermissible); *In re B&B West 164 St. Corp.*, 147 B.R. 832 (Bankr. E.D.N.Y. 1992) (stay lifted where creditor indicated it would not vote for plan and debtor's plan impermissibly classified deficiency claim); *In re Anderson*, 913 F.2d 530, 532-33 (8th Cir. 1990) (debtor's vague and unsupported allegations that he could contribute money or monies worth under the new value exception to the absolute priority rule were insufficient to show that a reasonable possibility of a successful reorganization was in prospect). But see *In re Con Am Grandview Assocs.*, 179 B.R. 29 (S.D.N.Y. 1995) (in light of early stage of case and debtor's steps to improve cash flow and locate new tenant, determination by bankruptcy court that debtor had a prospect of effectuating a plan of reorganization within a reasonable amount of time was not clearly erroneous).

(n73)Footnote 56. E.g., *In re Holly's, Inc.*, 140 B.R. 643, 700 (Bankr. W.D. Mich. 1992) .

(n74)Footnote 57. 11 U.S.C. § 362(d)(1).

(n75)Footnote 58. 11 U.S.C. § 362(d)(1).

(n76)Footnote 59. See, e.g., *Brand Assocs. v. CGR, Ltd. (In re CGR, Ltd.)*, 56 B.R. 305 (Bankr. S.D. Tex. 1985) (cause existed to terminate stay when debtor failed to comply with court order requiring insurance, submission of a budget prior to using cash collateral, submission of operating reports, and remitting of income in excess of operating expenses to creditor); *Fishman v. Epps (In re Epps)*, 2 C.B.C.2d 97 (Bankr. S.D.N.Y. 1980) (stay terminated for cause, including lack of adequate protection, for failure to pay real estate taxes and where it was questionable whether insurance premiums had been paid).

(n77)Footnote 60. See, e.g., *In re Charles George Land Reclamation Trust*, 8 C.B.C.2d 1307, 30 B.R. 918 (Bankr. D. Mass. 1983) (failure to comply with state laws constituted cause to dismiss case under 11 U.S.C. § 707).

(n78)Footnote 61. See, e.g., *In re Polries Bros.*, 49 B.R. 669 (Bankr. D. N.D. 1985) ; *La Jolla Mortgage Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283 (Bankr. S.D. Cal. 1982) . With respect to accruing postpetition ad valorem taxes, these taxes may not rise to the level of a lien in some jurisdictions. See, e.g., *Lincoln Sav. Bank, FSB v. Suffolk County Treasurer (In re Parr Meadows Racing Ass'n.)*, 880 F.2d 1540 (2d Cir. 1989) , cert. denied, 493 U.S. 1058, 110 S. Ct. 869, 107 L. Ed. 2d 953 (1990) (automatic stay imposed by 11 U.S.C. § 362(a)(4) acted to stay postpetition perfection of a county tax lien even if no action was required on the part of the county to perfect lien under state law); *Makoroff v. City of Lockport*, 916 F.2d 890, 23 C.B.C.2d 1566 (3d Cir. 1990) , cert. denied, 499 U.S. 983, 111 S. Ct. 1640, 113 L. Ed. 2d 735 (1991) (following *Parr Meadows*, the court found that the city and county real estate tax liens which attached postpetition and which did not relate back prepetition were void as violative of the automatic stay); *In re Boerne Hills Leasing Corp.*, 117 B.R. 264 (Bankr. W.D. Tex. 1990) (following *Parr Meadows* in holding that tax lien could not attach postpetition). But see *Equibank, N.A. v. Wheeling- Pittsburgh Steel*, 884 F.2d 80 (3d Cir. 1989) .

(n79)Footnote 62. See 484 U.S. 365, 382, 108 S. Ct. 626, 636, 98 L. Ed. 2d 740, 755, 17 C.B.C.2d 1368, 1378 .

(n80)Footnote 63. See *In re Club Assocs.*, 107 B.R. 385 (Bankr. N.D. Ga. 1989) , aff'd, 956 F.2d 1065 (11th Cir. 1992) .

(n81)Footnote 64. See *Rivia Equip. Corp. v. Wheeler (In re Wheeler)*, 12 B.R. 908 (Bankr. D. Mass. 1981) (cash payment or periodic payments required to compensate creditor for a decrease in value of collateral resulting from imposition of stay); see also *In re Ritz-Carlton of D.C., Inc.*, 98 B.R. 170, 173 (S.D.N.Y. 1989) (bankruptcy court, in ruling on motion for relief from stay, should consider secured creditor's position as of the petition date when deciding whether adequate protection payments are warranted); *Associates Commercial Corp. v. Brock (In re Brock)*, 2 C.B.C.2d 1305, 6 B.R. 105 (Bankr. N.D. Ill. 1980) (section 361(1) is satisfied if a fair relationship between the depreciation in the value of the property and the periodic payments to the creditor is established).

(n82)Footnote 65. See 11 U.S.C. § 507(b).

(n83)Footnote 66. See 11 U.S.C. § 1129(a)(9)(A).

(n84)Footnote 67. See *Layne v. Omni/Co., Inc. (In re Omni/Co., Inc.)*, 17 B.R. 140 (Bankr. S.D. Ohio 1981) ; *In re Stuart Motel, Inc.*, 8 B.R. 50 (Bankr. S.D. Fla. 1980) .

(n85)Footnote 68. See *Ukrainian Sav. & Loan Ass'n v. Trident Corp.*, 22 B.R. 491 (E.D. Pa. 1982) .

(n86)Footnote 69. See *Federal Land Bank v. Carson (In re Carson)*, 34 B.R. 502 (Bankr. D. Kan. 1983) .

(n87)Footnote 70. See, e.g., *In re Lane*, 22 C.B.C.2d 151, 108 B.R. 6 (Bankr. D. Mass. 1989) .

(n88)Footnote 71. See *In re Carson*, 34 B.R. 502, 506-507 ; *Vlahos v. Pitts (In re Pitts)*, 1 C.B.C.2d 241, 2 B.R. 476 (Bankr. C.D. Cal. 1979) .

(n89)Footnote 71a. *Orix Credit Alliance, Inc. v. Delta Res., Inc. (In re Delta Res., Inc.)*, 54 F.3d 722, 729 (11th

Cir. 1995).

(n90)Footnote 72. *See* 11 U.S.C. § 506(b).

(n91)Footnote 73. *See In re Pleasant Valley, Inc.*, (Bankr. D. Nev. 1980), 6 B.R. 13 . *Accord In re Northgate Terrace Apts., Ltd.*, 126 B.R. 762 (Bankr. S.D. Ohio 1991) .

(n92)Footnote 74. *See In re Stuart Motel, Inc.*, 8 B.R. 50, 51 (Bankr. S.D. Fla. 1980) . Diversion of rental income was also referred to, but deemed not dispositive in *In re Hutton-Johnson Co.*, 6 B.R. 855, 859 (Bankr. S.D.N.Y. 1980) .

(n93)Footnote 75. *See Butner v. N.C.*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) .

(n94)Footnote 76. *Compare In re Landing Assocs., Inc.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990) , with *In re Reddington/Sunarrow Ltd.*, 24 C.B.C.2d 663, 119 B.R. 809 (Bankr. D.N.M. 1990) .

(n95)Footnote 77. *See Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989) ; *In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393 (11th Cir. 1988) ; *Little Creek Dev. Co. v. Commonwealth Mortgage Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068, 13 C.B.C.2d 1231 (5th Cir. 1986) ; *In re Natural Land Corp.*, 825 F.2d 296 (11th Cir. 1987) ; *In re Albany Partners, Ltd.*, 749 F.2d 670, 670, 12 C.B.C.2d 244, 248 (11th Cir. 1984) ; *In re Dixie Broadcasting, Inc.*, 871 F.2d 1023 (11th Cir. 1989) , *cert. denied*, 493 U.S. 853, 110 S. Ct. 154, 107 L. Ed. 2d 112 (1989) ; *Rollex Corp. v. Associated Materials, Inc.* (*In re Superior Siding & Window*), 14 F.3d 240 (4th Cir. 1994) (bankruptcy court dismissed the case under bad-faith filing theory because of clear intent to frustrate creditor's efforts and virtually no possibility of successful reorganization; appellate court vacated and remanded to determine whether conversion or dismissal was in the best interests of creditors).

(n96)Footnote 78. In some jurisdictions, a nonjudicial foreclosure can be accomplished with relative ease. In other jurisdictions, however, the foreclosure process may take a significant period of time. Thus, the option to hold the case open pending the completion of the foreclosure process may not be available since the court may be disinclined to retain jurisdiction while the receivership/foreclosure litigation is pending in the state courts. Again, this issue must be analyzed by the mortgagee in connection with the relief sought under a bad faith theory.

(n97)Footnote 79. Under section 1112(c), a chapter 11 case may not be converted to a chapter 7 case if the debtor is a family farmer or a nonbusiness corporation unless the debtor requests conversion.

(n98)Footnote 80. *See* 11 U.S.C. § 1112(b)(1), (2).

(n99)Footnote 80a . 11 U.S.C. § 1112(b)(4), as amended by Pub. L. No. 109-8, § 442 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n100)Footnote 81. *See In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393, 1394-95 (11th Cir. 1988) ; *In re Terra of Am. Trading, Inc.*, 109 B.R. 516 (Bankr. S.D. Fla. 1989) .

(n101)Footnote 82. *See Carolin Corp. v. Miller*, 886 F.2d 693, 700-02 (4th Cir. 1989) (discussing objective and subjective bad faith).

(n102)Footnote 83. 886 F.2d 693, 703-05 .

(n103)Footnote 84. *See* cases cited in notes 81-83.

(n104)Footnote 85. *See id.*

(n105)Footnote 86. *See In re Natural Land Corp.*, 825 F. 2d 296, 299 n.1 (11th Cir. 1987) .

(n106)Footnote 87. *See Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) .

(n107)Footnote 88. *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) ; *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) ; *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908 (Bankr. D.S.C. 1995) ; *In re Citadel Prop.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) ; *In re Orange Park South P'ship*, 79 B.R. 79 (Bankr. M.D. Fla. 1987) ; *see also In re McBride Estates Ltd.*, 154 B.R. 339 (Bankr. N.D. Fla. 1993) (upholding prepetition stipulation regarding waiver of automatic stay and imposing sanctions under a bad-faith filing theory based upon *Phoenix Picadilly*). *But see In re Jenkins Court Assocs., L.P.*, 181 B.R. 33 (Bankr. E.D. Pa. 1995) ; *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) (prepetition agreement not to contest a motion to lift the stay was not enforceable; court distinguished single asset cases from the case at issue and reasoned that the court's enforcing similar prepetition agreement had expressly or impliedly determined that the debtor could not effectively reorganize).

(n108)Footnote 88a. *In re Powers*, 31 C.B.C.2d 1079, 1084, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) . The court further noted that once the existence of the prepetition waiver has been established, the burden is upon the parties opposing relief from the stay to demonstrate that the waiver should not be enforced. In determining whether the debtor has met that burden, the court deemed it relevant to consider (1) the benefit which the debtor received from the workout agreement as a whole, (2) the extent to which the creditor waived rights or would be otherwise prejudiced if the waiver were not enforced, (3) the effect of enforcement and (4) the likelihood of a successful reorganization. *Id.*

(n109)Footnote 89. *Fed. R. Bankr. P. 9011(b)*.

(n110)Footnote 90. In this regard, the distinction between objective and subjective good faith should also be analyzed. Under some circumstances, the court will find a number of the criteria enunciated in the various bad faith cases; however, the court will also look for the "smoking gun" which evidences the particularized intent of the debtor and/or its attorneys to abuse the bankruptcy court's jurisdiction. In the absence of this additional evidence, the court may be reluctant to make the bad faith finding necessary to dismiss the case.

(n111)Footnote 91. For the purpose of preferential transfers under section 547 as well as the avoidance of some fraudulent transfers under section 548, the debtor must be insolvent as that term is defined in section 101. The valuation standards relating to a determination of insolvency are discussed at ns.107 and 108 *infra*.

(n112)Footnote 92. *See Fed. R. Bankr. P. 3012*.

(n113)Footnote 93. *See, e.g., La Jolla Mortgage Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283, 288 (Bankr. S.D. Cal. 1982) .

(n114)Footnote 94. *See, e.g., In re Zellmer*, 3 C.B.C.2d 42, 6 B.R. 497 (Bankr. N.D. Ill. 1980) (when a secured creditor testifies as to the low value of collateral for the purpose of proving the debtor's lack of equity in the property, that low value may be used by the court in determining that the creditor's interest in the collateral is adequately protected even if that is to the creditor's disadvantage); *see also In re Bunn*, 128 B.R. 281 (Bankr. D. Idaho 1991) (creditor must use the same value of property for chapter 13 confirmation as in chapter 7 redemption).

(n115)Footnote 95. Even though a secured creditor may elect fully secured status under section 1111(b), with respect to the present value cramdown under section 1129(b)(2)(A), the debtor need only provide that the present value of the creditor's secured claim under section 506(a) be paid. Accordingly, the low appraisal may actually enhance the debtor's arguments relating to feasibility and debt service capability postconfirmation. This issue is discussed further at P 2.07 *infra* .

(n116)Footnote 96. *See 11 U.S.C. § 547(b)*. To the extent that those payments were made pursuant to the terms of the note, the creditor may find some comfort in the Supreme Court's recent pronouncement in *Union Bank v. Wolas (In re ZZZZ Best Co.)*, 502 U.S. 151, 112 S. Ct. 527, 116 L. Ed. 2d 514, 25 C.B.C.2d 1011 (1991) , which suggests that such payments may be subject to the ordinary course of business defense in section 547(c)(2).

(n117)Footnote 97. See *In re Reddington/Sunarrow Ltd.*, 24 C.B.C.2d 663, 667-68, 119 B.R. 809, 814 (Bankr. D.N.M. 1990) ; *In re Club Assocs.*, 107 B.R. 385, 385-88 (Bankr. N.D. Ga. 1989) , *aff'd*, 956 F.2d 1065 (11th Cir. 1992) ; *In re Sherwood Square Assocs.*, 87 B.R. 388 (Bankr. D. Md. 1988) .

(n118)Footnote 98. See 11 U.S.C. § 506(a).

(n119)Footnote 99. 124 Cong. Rec. H 11,095 (Sept. 28, 1978); S 17,411 (Oct. 6, 1978).

(n120)Footnote 100. Senate Report No. 95-989, 95th Cong., 2d Sess. 54 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th ed.).

(n121)Footnote 101. See *In re George Ruggiere Chrysler-Plymouth, Inc.*, 727 F.2d 1017 (11th Cir. 1984) ; *In re Pennyrich International, Inc.*, 473 F.2d 417 (5th Cir. 1973) ; see also *Estate Constr. Co. v. Miller & Smith Holding Co.*, 14 F.3d 213 (4th Cir. 1994) (in stay litigation context, in order for an appellate court to overturn a lower court's valuation, there must be a definite and firm conviction that a mistake has been committed).

(n122)Footnote 102. See *In re Robbins*, 119 B.R. 1 (Bankr. D. Mass. 1990) .

(n123)Footnote 103. See *In re Turnbow*, 121 B.R. 11 (Bankr. S.D. Tex. 1990) ; *In re Peerman*, 109 B.R. 718 (Bankr. W.D. Tex. 1989) ; *Savloff v. Continental Bank (In re Savloff)*, 2 C.B.C.2d 56, 4 B.R. 285 (Bankr. E.D. Pa. 1980) ; *In re American Kitchen Foods, Inc.*, 1976 Bankr. LEXIS 6 (Bankr. D. Ma. 1976) .

(n124)Footnote 104. See *In re Park Ave. Partners, Ltd.*, 95 B.R. 605 (Bankr. E.D. Wis. 1988) ; *In re Rolanco, Inc.*, 43 B.R. 153 (Bankr. E.D. Mo. 1984) . See generally Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061 (1985).

(n125)Footnote 105. See *Sutton v. Bank One, Texas, Nat'l Assoc. (In re Sutton)*, 904 F.2d 327, 329 (5th Cir. 1990) .

(n126)Footnote 106. See *In re Felten*, 95 B.R. 629 (Bankr. N.D. Iowa 1988) .

(n127)Footnote 107. See 11 U.S.C. § 1129; P 2.07 *infra* .

(n128)Footnote 107a. 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997) .

(n129)Footnote 107b. 520 U.S. 953, 966, 117 S. Ct. 1879, 1887, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 751 .

(n130)Footnote 107c. 520 U.S. 953, 967, 117 S. Ct. 1879, 1887, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 751 .

(n131)Footnote 107d. 520 U.S. 953, 966, 117 S. Ct. 1879, 1887, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 751 .

(n132)Footnote 107e. 520 U.S. 953, 961, 117 S. Ct. 1879, 1885, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 749 .

(n133)Footnote 107f. 520 U.S. 953, 962, 117 S. Ct. 1879, 1886, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 750 .

(n134)Footnote 107g. 520 U.S. 953, 956, 117 S. Ct. 1879, 1885, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 749-50 .

(n135)Footnote 107h. 520 U.S. 953, 962-63, 117 S. Ct. 1879, 1885, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 749 .

(n136)Footnote 107i.

Note 6 in the majority opinion in *Rash* is significant. It first states that in future cases the trier of fact is to determine the best way to establish replacement value, which could be on the basis of retail value, wholesale value, or some other value, depending on the type of debtor and the nature of the property. This appears to mean only that the

court must decide which market the debtor would be functioning in--that is, whether the debtor would be acquiring the collateral as a buyer at retail, wholesale or otherwise. The Court then provides some guidance in determining the retail value of a vehicle for section 506(a) purposes, stating that the creditor should not receive an allocation of value for items that the debtor does not receive when it merely retains the vehicle it already owns, such as warranties, inventory storage and reconditioning. The Court also adds that a secured creditor should not receive value for accessions or additions to the collateral that are not subjected to the lien. 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 37 C.B.C.2d 744, 751 n.6 (1997). This language, applied to a single asset real estate case, could also mean that the creditor is not to be charged with certain expenses of acquisition of the property that will not in fact be incurred by the debtor's mere retention of the asset. Such costs could include the brokerage commissions and transfer taxes that may be reflected in the price paid by a buyer of real property, as well as the hypothetical seller's attorney's fees, title insurance costs and income taxes. See *In re Eugene B. Leedy*, 230 B.R. 678 (Bankr. E.D.Va., 1999) (tax on hypothetical early withdrawal of 401(k) funds for purposes of section 506(a) valuation not to be deducted from value of the account); *Mulvania v. United States (In re Mulvania)*, 214 B.R. 1 (B.A.P. 9th Cir. 1997) (sales costs not to be considered).

(n137)Footnote 108. See 11 U.S.C. § 101.

(n138)Footnote 109. See, e.g., *Bergquist v. Anderson- Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 56 B.R. 339, 387 (Bankr. D. Minn. 1985), *aff'd*, 850 F.2d 1275, 20 C.B.C.2d 19 (8th Cir. 1988); *In re Art Shirt, Ltd.*, 93 B.R. 333, 341 (Bankr. E.D. Pa. 1988) (both indicating that goodwill should not be calculated in the insolvency analysis when business is "on its deathbed").

(n139)Footnote 110. See *Travellers Int'l, AG v. TWA (In re TWA)*, 134 F.3d 188 (3d Cir. 1998); *In re Bellanca Aircraft Corp.*, 56 B.R. 339, 386 (Bankr. D. Minn. 1985), *aff'd*, 850 F.2d 1275, 20 C.B.C.2d 19 (8th Cir. 1988). In addition, the courts generally define fair value to mean the amount the assets would bring if the debtor took a reasonable period of time to collect its debts and sell its property. See *In re Excelllo Press, Inc.*, 96 B.R. 840, 842-43 (Bankr. N.D. Ill. 1989); *In re Sleepy Valley, Inc.*, 93 B.R. 925, 927-28 (Bankr. W.D. Tex. 1988); *In re Joe Flynn Rare Coins, Inc.*, 81 B.R. 1009, 1017 (Bankr. D. Kan. 1988); *In re F & S Cent. Mfg. Corp.*, 53 B.R. 842, 849 (Bankr. E.D.N.Y. 1985). Assets in the nature of disputed or contingent claims must be discounted to an appropriate value. See *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200, 18 C.B.C.2d 711, 713 (7th Cir. 1988); *In re Sierra Steel, Inc.*, 96 B.R. 275, 279 (Bankr. 9th Cir. 1986); *Kepler v. Schmalbach (In re Lemanski)*, 56 B.R. 981, 988-89 (Bankr. W.D. Wis. 1989); *Waldschmidt v. Ranier (In re Fulghum Constr. Co.)*, 7 B.R. 629, 638 (Bankr. M.D. Tenn. 1980), *aff'd*, 14 B.R. 293 (M.D. Tenn. 1981), *aff'd in part, rev'd in part*, 706 F.2d 171, 8 C.B.C.2d 644 (6th Cir.), *cert. denied*, 464 U.S. 935, 104 S. Ct. 342, 104 S. Ct. 343, 78 L. Ed. 2d 310 (1983).

(n140)Footnote 111. See P 2.07 *infra*.

(n141)Footnote 112. See P 2.53A *infra*.

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

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P 2.07 Chapter 11 Plans Affecting Mortgaged Property

[1] Statutory Requirements

The plan confirmation process is at the heart of a chapter 11 case. The proposal, solicitation and confirmation of a plan is discussed in this paragraph. The related issues of classification and disclosure are also discussed. As far as the mortgagee's claim is concerned, the plan confirmation process is likely the most important part of the debtor's bankruptcy case. As indicated below, the debtor may attempt to affect significantly the structure of the mortgagee's claim.

Section 1123 of the Code provides for both mandatory and discretionary portions of a chapter 11 plan. Section 1123(a) provides that a plan must:

- (1) designate, subject to section 1122 of this title, classes of claims, other than ... [administrative and certain governmental priority claims], and classes of interests;
- (2) specify any class of claims or interests that is not impaired under the plan;
- (3) specify the treatment of any class of claims or interests that is impaired under the plan;
- (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest
- (5) provide adequate means for the plan's implementation, such as--
 - (A) retention by the debtor of all or any part of the property of the estate;
 - (B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;
 - (C) merger or consolidation of the debtor with one or more persons;
 - (D) sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having

an interest in such property of the estate;

(E) satisfaction or modification of any liens;

(F) cancellation or modification of any indenture or similar instrument;

(G) curing or waiving any default;

(H) extension of a maturity date or a change in an interest rate or other term of outstanding securities;

(I) amendment of the debtor's charter; or

(J) issuance of securities of the debtor, or any entity referred to in subparagraph (B) or (C) of this paragraph, for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose;

(6) provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in paragraph (5)(B) or (5)(C) of this subsection, of a provision prohibiting the issuance of nonvoting equity securities, and providing, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends; and

(7) contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director, or trustee under the plan and any successor to such officer, director or trustee.

(8) in a case in which the debtor is an individual, provide for the payment to creditors under the plan of all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan.ⁿ¹

Section 1123(b) provides for certain nonmandatory provisions in a chapter 11 plan. Specifically, section 1123(b) provides:

Subject to subsection (a) of this section, a plan may--

(1) impair or leave unimpaired any class of claims, secured or unsecured, or of interests;

(2) subject to section 365 of this title, provide for the assumption, rejection or assignment of any executory contract or an unexpired lease of the debtor not previously rejected under such section;

(3) provide for--

(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or

(B) the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest;

(4) provide for the sale of all or substantially all of the property of the estate, and the distribution of

the proceeds of such sale among holders of claims or interests;

(5) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or the holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;n2

(6) include any other appropriate provision not inconsistent with applicable provisions of this title.n2a

Finally, a plan of reorganization, whether filed by a debtor or a creditor, must comply with the requirements of section 1129, which contains the following general requirements for plan confirmation:

(a) The court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this title.

(2) The proponent of the plan complies with the applicable provisions of this title.

(3) The plan has been proposed in good faith and not by any means forbidden by law.

(4) Any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable;

(5)(A)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy; and

(B) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

(6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such

approval.

(7) With respect to each impaired class of claims or interests--

(A) each holder of a claim or interest of such class--

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

(8) With respect to each class of claims or interests--

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that--

(A) with respect to a claim of a kind specified in section 507(a)(2) or 507(a)(3) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;n3

(B) with respect to a class of claims of a kind specified in section 507(a)(1), 507(a)(4), 507(a)(5), 507(a)(6) or

507(a)(7) of this title, each holder of a claim of such class will receive--

(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim;

(C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim regular installment payments in cash--

(i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;

(ii) over a period ending not later than 5 years after the date of the order for relief under section 301, 302, or 303; and

(iii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b)); and

(D) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim, the holder of that claim will receive on account of that claim, cash payments, in the same manner and over the same period, as prescribed in subparagraph (C).

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

(12) All fees payable under section 1930 of title 28, as determined by the court at the hearing on confirmation of the

plan, have been paid or the plan provides for the payment of all such fees on the effective date of the plan.

(13) The plan provides for the continuation after its effective date of payment of all retiree benefits, as that term is defined in section 1114 of this title, at the level established pursuant to subsection (e)(1)(B) or (g) of section 1114 of this title, at any time prior to confirmation of the plan, for the duration of the period the debtor has obligated itself to provide such benefits.

(14) If the debtor is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, the debtor has paid all amounts payable under such order or such statute for such obligation that first become payable after the date of the filing of the petition.

(15) In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan--

(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.

(16) All transfers of property of the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.ⁿ⁴

Apart from the provisions of section 1129(a), under which the debtor or plan proponent does not have the consent of all classes of creditors in the case, the debtor or plan proponent must invoke section 1129(b), the so-called "cramdown" section of the Code, which provides:

(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides--

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims--

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(C) With respect to a class of interests--

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.ⁿ⁵

In the context of a single asset real estate partnership, the secured creditor will most likely be impaired and will often vote to reject the proposed plan. This rejection implicates a number of issues involving sections 1123 and 1129. This

rejection may also involve the applicability of section 1122 relating to classification and sections 1125 and 1126 relating to solicitation and voting on the plan itself. In the following section on confirmation issues, the interaction between the statutory provisions cited above along with sections 1122, 1125 and 1126 are discussed with respect to the attempted cramdown of mortgage claims held by the mortgagee.ⁿ⁶

[2] Issues Relating to Confirmation

The holder of an allowed secured claim will seek to obtain the best possible treatment and return in the context of the rights and claims of other classes of creditors of and interest holders in the debtor. The holder of a claim will, therefore, seek to (1) preserve its power to contribute to the rejection of an unsatisfactory plan, and (2) avoid an unfair valuation of the mortgaged property which could adversely affect its return under section 1129(b)(2)(A).

There appear to be three sets of circumstances under which the holder of a mortgage claim may be required to accept plan treatment against its wishes. First (and least likely), the claimant may be outvoted by other members of its class under section 1126(c).ⁿ⁷ Second, the claim may be unimpaired under section 1124 and, therefore, may be deemed to have accepted the plan under section 1126(f).ⁿ⁸ Third, the claimant may be subject to cramdown under section 1129(b)(1) and (2).ⁿ⁹ The cramdown provisions that may be applicable to the holder of a mortgage claim may differ depending on whether the creditor is oversecured or undersecured. In the oversecured situation, only section 1129(b)(2)(A) will be applicable. In the case of the undersecured lender, the undersecured creditor will have both a secured and an unsecured claim which may be subject to cramdown.ⁿ¹⁰ The varying scenarios for the mortgage lender are discussed below.

The holder of a mortgage claim will ordinarily prefer to be placed in a separate class in order to eliminate the risk that other members of the class may be sufficient in number and amount to accept a plan notwithstanding the holder's rejection. Under the Code, classification is based on the nature of the claim and not the identity of the holder of the claim.ⁿ¹¹ Section 1122(a) requires that a claim or interest may be included in a particular class only if such claim or interest is "substantially similar" to other claims or interests of such class.ⁿ¹² It is clear that a secured claim may not be classified together with unsecured claims and ordinarily will not be classified with other secured but subordinate claims.ⁿ¹³ Under the former Bankruptcy Act, each secured creditor was usually entitled to separate classification.ⁿ¹⁴ Under certain circumstances, secured claims of equal priority in the same property may be classified together.ⁿ¹⁵ However, secured claims with liens upon the same property but with different priorities must be classified separately.ⁿ¹⁶ The two mortgages will ordinarily secure different amounts due at different times and bear different interest rates and the respective mortgaged properties will likely have different values resulting in varying loan to value ratio for the two mortgages. Indeed, the valuation method for each of the properties may appropriately differ. Thus, separate classification is appropriate.

When the holders are participants in an indenture, they will ordinarily belong to the same class.ⁿ¹⁷ Under section 1126, a class of claims has accepted a plan if it has been accepted by creditors holding at least two-thirds an amount and more than one-half in number of the allowed claims in each such class held by creditors who voted on the plan.ⁿ¹⁸ When the participants are deemed to be creditors of the estate, a binding class vote is possible which would bind a dissenting participant.

The second method under which a mortgage claimant may be unable to vote on a plan is to leave the holder of such claim unimpaired under section 1124. Under that section, the holder of a mortgage claim may be unimpaired if the plan either

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or

interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default--

(A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

(D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.ⁿ¹⁹

Notwithstanding a judgment of foreclosure, a mortgage can be unimpaired if it is restored to its original position on the eve of acceleration.ⁿ²⁰

In the case of an attempt by the debtor to "unimpaired" the creditor, focus must be given on the precise treatment of the plan and any alterations to the agreement between the parties. Under certain circumstances, the debtor can reinstate the obligation at the low interest rate contained in the contract by the payment of the amounts in default plus reasonable attorneys' fees.ⁿ²¹ However, in circumstances under which the collateral is transferred to a new entity, the courts have held that the obligation has been altered and the mortgagee is impaired.ⁿ²² However, the realignment of a first mortgage does not impair the second mortgage when the status of the second mortgage is unaffected.ⁿ²³

By far the most common method to bind a secured creditor under a chapter 11 plan is to invoke the provisions of section 1129(b), commonly referred to as the "cramdown" provision, which allows a plan proponent (most often the debtor) to confirm a plan notwithstanding the dissent of a class or classes of creditors. In the context of a single asset real estate partnership, the cramdown plan involves the consideration of a number of provisions of the Code including impairment, solicitation and classification issues. Moreover, when the creditor has a deficiency claim, the absolute priority rule of section 1129(b)(2)(B) also comes into consideration.ⁿ²⁴

In general, in order to confirm a chapter 11 plan, the plan proponent must obtain the acceptance of each class of claims or interests or leave such classes unimpaired under the plan.ⁿ²⁵ However, section 1129(b)(1) permits confirmation of a plan notwithstanding the dissent of a class of creditors or interest holders if all other requirements of section 1129(a) are met.ⁿ²⁶ Section 1129(a)(10) requires that one class of impaired claims must accept the plan, determined without including any acceptance of the plan by any insider. Prior to the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments"), it was unclear whether the acceptance requirement meant the one class had voted affirmatively for the plan or that one class was deemed to have accepted the plan as the result of being unimpaired under section 1124.ⁿ²⁷ This was an important issue as the debtor could attempt to "unimpaired" a class of small trade creditors and argue that an acceptance had occurred sufficient for section 1129(a)(10) by virtue of the deemed acceptance language of section 1126(f). However, under the 1984 Amendments, it is clear that the debtor or

plan proponent must now obtain the affirmative vote of at least one impaired class of creditors, notwithstanding the vote of any insiders.

This impaired accepting class requirement contained in section 1129(a)(10) provides an interesting strategic area for the secured creditor. In a single asset real estate case, generally only three types of claims will be present: tax claims, unsecured trade claims and the claim of the secured creditor. When the secured creditor has a significant deficiency claim, and does not make the election under section 1111(b)(2),^{n27a} the issue becomes whether that claim should be classified with the trade creditors. If the claim is classified with the trade creditors, the debtor may have great difficulty in obtaining the impaired accepting class.ⁿ²⁸ Some courts have allowed the separate classification of the deficiency claim from the claim of the trade creditorsⁿ²⁹ and, in one 1994 decision, the Court of Appeals for the Seventh Circuit has held that because, in its view, the legal rights of an undersecured mortgagee are substantially different than those of general unsecured claimants by reason of the effect of section 1111(b), the Bankruptcy Code not only permits but "require[s]" separate classification of the unsecured deficiency claim, at least where the debtor is a partnership comprised of a fully encumbered single asset.ⁿ³⁰ However, most recent appellate court decisions on this issue indicate that the debtor cannot classify the unsecured deficiency claim of the secured creditor solely to create an impaired accepting class of trade creditors.ⁿ³¹ "[T]he one clear rule that emerges from otherwise muddled caselaw on § 1122 claims classification [is]: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."ⁿ³²

When the case is a single-debtor/single-creditor case, the debtor may find it very difficult to obtain an impaired accepting class. When, however, multiple classes of secured debt exist, the debtor may attempt to play off one class of secured claims against another in order to obtain at least one impaired accepting class. Under those circumstances, the debtor may attempt to argue that it did not classify the deficiency claim of the mortgagee in a separate class from trade creditors for the purposes of gerrymandering the vote.ⁿ³³ Also, in bankruptcy courts located in the Seventh Circuit as well as in jurisdictions that have not definitively ruled on the issue, the debtor will likely argue that separate classification is justified, if not required, by reason of the mortgagee's rights under section 1111(b).^{n33a}

Another significant area of litigation in the context of a nonconsensual reorganization plan is the appropriate interest rate or discount rate to be applied to the creditor's secured claim. Under section 1129(b)(2)(A), one of the alternatives for the cramdown of a class of secured claims is the retention of the lien on the property and the payment of the claim over time with the stream of payments to be made under the plan equal to the present value of the claim as of the effective date of the plan.ⁿ³⁴ The principal areas of litigation here are the value of the collateral (and hence the determination of the secured claim under section 506(a))ⁿ³⁵ and the appropriate interest rate.

With respect to interest rates, the courts have, until recently, generally looked towards a market rate analysis.ⁿ³⁶ Some courts have implied a cap of the contract rate to avoid a "windfall" to the creditor by virtue of the imposition of a discount rate;ⁿ³⁷ however, an emerging trend appears to be the adoption of the so-called formula approach to the interest rate analysis.ⁿ³⁸ This approach takes a riskless interest rate of interest for an obligation of even maturity (for example, U.S. Treasury Bills) and adds increments of risk for both the implied rate of return and for the quality of the collateral and risk of repayment.ⁿ³⁹ The efficacy of the formula approach has been enhanced considerably by a recent decision of the United States Supreme Court in a chapter 13 case. In *Till v. SCS Credit Corp.*, a plurality of the justices on the Supreme Court rejected the other methods and held that in determining the interest rate under the cramdown provisions of chapter 13, section 1325(a)(5), courts should apply a formula approach starting with "prime" as the base rate.^{n39a} In *Till*, the Supreme Court described the formula approach as follows:

Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then

requires a bankruptcy court to adjust the prime rate accordingly. The appropriate size of that risk adjustment depends, of course, on such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. The court must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment. Some of this evidence will be included in the debtor's bankruptcy filings, however, so the debtor and creditors may not incur significant additional expense. Moreover, starting from a concededly *low* estimate and adjusting *upward* places the evidentiary burden squarely on the creditors, who are likely to have readier access to any information absent from the debtor's filing (such as evidence about the "liquidity of the collateral market. Finally, many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise. Thus, unlike the coerced loan, presumptive contract rate, and cost of funds approaches, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. Moreover, the resulting "prime-plus" rate of interest depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor. For these reasons, the prime-plus or formula rate best comports with the purposes of the Bankruptcy Code.^{n39b}

As noted, *Till* was a chapter 13 case. In an intriguing footnote, most of which is quoted below, the Supreme Court noted that because appropriate market interest rates might be more discernable in the chapter 11 context, the approach to determining the rate in chapter 11 might well be different:

[T]here is no readily apparent Chapter 13 "cram down market rate of interest": Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. [citations to advertising for debtor in possession financing]. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.^{n39c}

Whether or not the *Till* decision mandates a formula approach in chapter 11 cases, in challenging an unsatisfactory plan, the mortgagee should be prepared to present the testimony of an expert witness to discuss the various risk factors involved in a restructured chapter 11 plan. This analysis impacts not only the treatment of the allowed secured claim of the mortgagee but also may provide additional ammunition for the creditor relating to the feasibility of the debtor's proposed plan.ⁿ⁴⁰

In the context of an undersecured claim, the effect of the section 1111(b) election must also be considered. Under section 1111(b), a creditor with a deficiency claim may elect fully secured status provided that such election is made by the close of the hearing on the disclosure statement.ⁿ⁴¹ Under certain circumstances the creditor may wish to take the section 1111(b) election. In that instance, the stream of payments under section 1129(b)(2)(A)(i)(II) must not only equal the present value of the secured claim under section 506(a) but must also arithmetically be equal to or greater than the total prepetition claim of the creditor.ⁿ⁴² Thus, under certain circumstances in which the debtor has proposed an interest-only plan with a short maturity, the arithmetical sum of the interest payments plus the balloon at the end of the plan term may not equal the total amount of the "secured" claim. Generally, however, the creditor must carefully review the dynamics of the case before electing the treatment of section 1111(b). As discussed below, the creditor electing such treatment loses its right to vote its unsecured deficiency claim and thus loses the ability to invoke the absolute priority rule. As noted, the Federal Rules of Bankruptcy Procedure require that such election be made no later than the conclusion of the hearing to approve the disclosure statement, unless the court fixes a later time.^{n42a}

A second alternative for the cramdown of a secured claim under section 1129(b)(2) is the sale of the collateral subject to

section 363(k). This entitles the debtor to sell the collateral subject only to the credit bid rights of the secured creditor under section 363(k). In this event, the creditor is not entitled to take the section 1111(b) election.ⁿ⁴³ However, under this subsection the creditor is entitled to bid the full amount of its allowed claim, not merely its allowed secured claim.ⁿ⁴⁴ A sales plan is rarely utilized for this reason.ⁿ⁴⁵

A third method for the cramdown of a secured claim in chapter 11 is through providing the "indubitable equivalent" of the creditor's claim to such creditor.ⁿ⁴⁶ The most common permutation of this alternative is the land-for-debt swap in which the debtor will attempt to obtain a favorable valuation of its real property and return all or a portion of that property to the creditor in exchange for a partial satisfaction of its obligations to that creditor.ⁿ⁴⁷ The most troubling aspect of the debt swap scenario is that it places the entire risk of valuation on the secured creditor.ⁿ⁴⁸ In this circumstance, the bargained-for cross-collateralization of certain parcels of real property is artificially limited with the consequent increase in risk to the secured creditor.

Another significant issue in the litigation of a chapter 11 plan proposed by a debtor in a single asset case is the absolute priority rule of section 1129(b)(2)(B). Under section 1129(b)(2)(B), with respect to a dissenting class of unsecured claims, the plan must provide: (1) that the creditors in the class receive or retain an account of such claim, property, of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (2) that the holder of any claim or interest junior to the claims of such class will not receive or retain any property under the plan "on account of" such junior claim or interest.ⁿ⁴⁹ The second portion of section 1129(b)(2)(B) is the absolute priority rule which precludes a junior class from retaining any property under the plan if the class of unsecured creditors is unpaid. The importance of the absolute priority rule is that it can be invoked notwithstanding the misclassification of the secured creditor's deficiency claim in a separate class from trade creditors.ⁿ⁵⁰ In this circumstance, the debtors may attempt to invoke the so-called "new value" exception^{n50a} to the absolute priority rule.^{n50b} Under the Bankruptcy Act of 1898, the Supreme Court recognized under certain circumstances the ability of the stockholders of a corporation to retain an interest in the corporation postconfirmation under Chapter X of the Bankruptcy Act.ⁿ⁵¹

Early appellate court decisions in the Sixth and Seventh Circuits appeared to assume that the exception survived the enactment of the Bankruptcy Code.ⁿ⁵² However, following the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*,ⁿ⁵³ the issue was again brought to the forefront of reorganization cases, especially in the context of the single asset real estate partnership. In *Ahlers*, the Supreme Court explicitly found that the debtor's proposed "sweat equity" was insufficient to constitute money or money's worth under the new value exception enunciated in the case.ⁿ⁵⁴ However, notwithstanding the urging of the Solicitor General, the Supreme Court declined to address the viability of the "new value" exception under the Bankruptcy Code.ⁿ⁵⁵

In *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership*,ⁿ⁵⁶ the Supreme Court described the issue before it as "whether a debtor's prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives."ⁿ⁵⁷ The Court declared its holding to be that "old equity holders are disqualified from participating in such a 'new value' transaction by the terms of 11 U.S.C. § 1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder's receipt of any property on account of his prior interest."ⁿ⁵⁸ The Court stated later in its opinion^{n58a} that "We do not decide whether the statute includes a new value corollary or exception, but hold that on any reading respondent's proposed plan fails to satisfy the statute ...".^{n58b} The Court did decide, however, that "it is the exclusiveness or the opportunity [to contribute new value], with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, [that] renders the partners' right a property interest extended 'on account of' the old equity position and therefore subject to an unpaid senior creditor class's objection."^{n58c}

The *LaSalle* case involved a fairly typical single-asset real estate chapter 11 case, in which the bank lender held a nonrecourse mortgage on a piece of commercial real estate, suffered a default on the loan and commenced a foreclosure

action, and was met with a chapter 11 petition by the borrower. The borrower, a limited partnership, proposed a plan under which the bank's secured claim (\$54.5 million) would be paid in full between 7 and 10 years after the original maturity date, the bank's deficiency claim of \$38.5 million would be discharged at an estimated 16% of present value, and the other unsecured claims totaling \$90,000 would be paid in full, without interest, on the effective date of the plan. A new partnership comprised of those existing partners that were prepared to invest \$6.125 million in new capital over a five year period (at a present worth of \$4.1 million), would hold title to the asset.^{n58d} Retention of title in the new partnership comprised solely of partners in the debtor would defer approximately \$20 million in the partners' federal income tax liability that would be otherwise payable as a consequence of foreclosure.^{n58e} The bank rejected the plan but the small unsecured class accepted, satisfying the requirement that one impaired class accept the plan.^{n58f}

The lower courts, including the Court of Appeals for the Seventh Circuit, consistent with prior holdings in the circuit, found the plan confirmable, including the separate classification of the bank's deficiency claim and the unsecured trade claims.^{n58g} The appeal to the Supreme Court raised only the new value issue and not the classification scheme.^{n58h} Justice Souter, joined by five other members of the Court, ruled that the plan failed inasmuch as it provided for an exclusive, rather than a market-tested, new value contribution. Justice Thomas, joined by Justice Scalia, concurred in the judgment, but opined that section 1129(b)(2)(B)(ii) permitted no new value contribution from any source.ⁿ⁵⁸ⁱ Justice Stevens, dissenting, would have affirmed the rulings of the lower courts, arguing that section 1129(b)(2)(B)(ii), together with the exclusivity provisions of the Code, permit old equity to confirm a plan providing for less than full payment to unsecured creditors and retention of title by those equity holders prepared to make a new value contribution.^{n58j}

Section 1129(b)(1) of the Code provides that a plan that has not been accepted by all impaired classes shall be confirmed if it does not discriminate unfairly, and is fair and equitable with respect to each class of dissenting impaired claims and interests. Section 1129(b)(2)(B) provides:

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(B) With respect to a class of unsecured claims--

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

The task before the Supreme Court in *LaSalle* was to decide whether section 1129(b)(2)(B)(ii) means that (1) the absolute priority rule has no exception or corollary and that under no circumstances may a court confirm a plan over the objection of an impaired unsecured class when equity interest holders propose to obtain new equity value in the enterprise without paying the members of the impaired class the full amount of their claims, or (2) the absolute priority rule does not proscribe such a new value investment. The Court was asked to adjudicate this issue by determining whether the phrase "on account of such junior claim or interest" appearing in section 1129(b)(2)(b)(ii) means that the holders of the equity position in an insolvent debtor may not receive a distribution under the plan while senior dissenting classes were not paid in full, but may make a new value investment in the debtor or its successor and retain title to the asset, with the title retention deemed to be "on account of" the contribution of new value rather than "on account of" the existence of the investors' old junior equity position.

The Court first reviewed the *dicta* in *Case v. Los Angeles Lumber Products Co.* ^{n58k} and other cases decided prior to enactment of the Bankruptcy Code to ascertain the state of the law in respect of the absolute priority rule in the

pre-Code context.^{n58l} The Court then traced the relevant legislative history of the Code, including proposed versions of the Code that were not enacted,^{n58m} and concluded that:

The upshot is that this history does nothing to disparage the possibility apparent in the statutory text that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.ⁿ⁵⁸ⁿ

The Court then focused on three possible interpretations of the "on account of" modifier. The first interpretation, offered by the debtor, was that "on account of" means "in exchange for," and that a plan would violate the absolute priority rule only if old equity received or retained an equity position in exchange for its prior interest without making a new and significant contribution.

The Court rejected this view first on textual grounds, inasmuch as subsection (b)(2)(B)(ii) deals alternatively with receipt and retention of property, and it would be "exceedingly odd" to employ a phrase that spoke of retaining property in exchange for the same property interest. The Court also noted that the term "in exchange for" is used elsewhere in the Code, and that it was unlikely that the Code drafters would employ two different terms to communicate the same meaning.^{n58o} Significantly, the Court also rejected this interpretation on the ground that the debtor's formulation would necessitate the making of a substantial new value contribution, that the standard of substantiality is highly amorphous, and that Congress would not have enacted such a "separate priority rule"^{n58p} that was so flexible that "an absolute priority rule so variable would not be much of an absolute."^{n58q}

The second interpretation of the term "on account of" considered by the Court would equate the phrase with the term "because of," meaning that subsection (b)(2)(B)(ii) would proscribe the receipt or retention of any property by the holders of old equity in any case in which there is a causal relationship between holding an old equity interest and the receipt or retention of an equity interest in the reorganized debtor.^{n58r} Although the Court found this interpretation to be superior to the "in exchange for" formulation,^{n58s} it wrestled with (its characterization of) the government's view that any receipt or retention of an interest by old equity was "because of" its prior ownership position, and also questioned why the "on account of" language would have been employed at all if the statute meant that there could never be a new value contribution by old equity.^{n58t} More significantly, the Court also stated that "one would also have to ask why Congress would have desired to exclude prior equity categorically from the class of potential owners following a cramdown."^{n58u}

Accordingly, the Court felt that it had "an obligation to give meaning to the 'on account of' modifier,"^{n58v} and found that the language was intended to reconcile the chapter 11 policies of preserving going concerns and maximizing the return to creditors.^{n58w} The Court determined that these objectives would be served by a "truly full value transaction,"^{n58x} in cash or in realizable money's worth, and would pose no threat to a bankruptcy estate not already posed by the reorganization process.^{n58y}

Nevertheless, the Court stated that it was not selecting any one of the three interpretations of the "on account of" language. Rather, it declared that the debtor's plan had to fail inasmuch as the equity holders were the only persons entitled to make a new value contribution under the plan, and that the exclusive nature of this opportunity itself constituted the receipt of a property right under subsection (b)(2)(B)(ii) that could not be authorized in the fact of an objection by an impaired senior class.^{n58z} The Court asserted, seemingly as a policy matter, that if the exclusive right to invest new value is being given to old equity at a bargain price, then old equity is receiving value. However, if old equity is proposing to invest at the best price obtainable, then it had no need for exclusivity.^{n58aa} The Court added that the market, and not the determination of a bankruptcy judge, should be the measure of the best value for the enterprise, whether for the same interest sought by the holders of old equity or under a competing plan.^{n58bb} Thus, in the Court's

view, it was not deciding whether a new value exception existed, but was merely holding that under any formulation the plan failed by reason of the exclusivity of the right to infuse new value into the enterprise.^{n58cc}

The concurring opinion of Justice Thomas, joined by Justice Scalia, argued in favor of the "because of" interpretation of the phrase "on account of," and asserted that the plan had to fail because the old equity holders were going to receive two forms of property--the exclusive right to invest, and an interest in the new entity--and that subsection (b)(2)(B)(ii) prohibited the receipt or retention of any property over the objection of an impaired senior class.^{n58dd} The concurring Justices viewed the majority's comments concerning the government's argument in the case, as well as "its speculations about the desirability of a 'market test,' " as "dicta binding neither this Court nor the lower federal courts."^{n58ee} The concurring Justices went on to criticize any analysis of the Bankruptcy Code that takes into consideration pre-Code practices or legislative history, and asserted that the only proper methodology is the application to the facts before the Court of the unambiguous provisions of the Code.^{n58ff} In a case in which one of the litigants claim that the statute is ambiguous, their answer was that this usually "means that one of the litigants is simply wrong."^{n58gg}

Justice Stevens, in dissent, argued that old equity could receive or retain property over the objection of an impaired senior class if it made a substantial new equity contribution. Such a contribution and the receipt or retention by old equity of a interest in the debtor or its successor would not be "on account of" their old position, but instead on account of the new value contributed.^{n58hh}

The assertions in the majority opinion that it was not reaching the question whether a new value exception or corollary exists under section 1129(b)(2)(B)(ii) are belied by the words and sense of the opinion. In deciding that competitive bidding was required for the confirmation of a cramdown plan that did not satisfy the absolute priority requirement of the section, the Court was declaring that by following proper procedures, a court could confirm such a plan when some party, whether comprised of existing equity holders, an existing creditor, or a stranger to the case, provided a market-tested new value contribution. Moreover, the language of the opinion seems to squarely reject the classic formulation of the new value corollary, advocated by Justice Stevens in his dissent, which would permit the confirmation of a cramdown plan not satisfying the absolute priority rule upon the investment of substantial and necessary new value by the holders of the equity interests in the debtor. The Court, in enumerating its difficulties with the traditional new value doctrine stated:

The second difficulty is practical: the unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if "on account of" meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds, but permit one whenever substantial funds changed hands. "Substantial" or "significant" or "considerable" or like characterizations of a monetary contribution would measure it by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute [O]ne comes back to the question why Congress could have bothered to add a separate priority rule without a sharper edge.ⁿ⁵⁸ⁱⁱ

Although the concurring opinion characterized as *dictum* the majority's consideration of alternative interpretations of the "on account of" language appearing in section 1129(b)(2)(B)(ii),^{n58jj} the better view of the majority opinion is that it was merely building arguments in support of the very holding it was purporting not to make, that is, the new value corollary to the absolute priority rule survived the enactment of the Bankruptcy Code, but only in the form of a court-supervised market-driven determination of the highest and best bid for the equity position in the reorganized enterprise.

The holding in the *LaSalle* case in one sense appears to disfavor undersecured creditors in single asset real estate cases by permitting confirmation of cramdown plans without adherence to the absolute priority rule, thereby denying to such creditors the right to realize upon their collateral while suffering an immediate loss on their deficiency claims and the inability to realize upon any future appreciation in the value of the collateral. However, the holding will also permit lending institutions and other nonrecourse mortgage creditors to participate in the bidding process for the collateral,

whether through the submission of a competing plan or the entry of a bid directly competing with the bid of the existing equity holders. Although in many instances the holders of existing equity positions may be willing to bid more than a lender in order to avoid the adverse tax consequences of a foreclosure, it is also the case that in many instances the lender will have superior resources with which to bid than will a group of equity holders that may or may not be in disarray. If an undersecured lender's bid is to be used for payment of unsecured claims, including the lender's deficiency claim, the lender will be bidding for its own benefit as though it were bidding-in the mortgage debt upon foreclosure. Where the lender's bid is also to be used for the carrying costs and perhaps the enhancement of the collateral, these expenditures probably would have been made by the lender in any event if it had foreclosed on the collateral and there was no third party bidder willing to offer an amount sufficient to meet the lender's requirements for full or discounted satisfaction of the loan. By assuming control over and title to the collateral, the lender will have the opportunity to realize upon any future appreciation in value of the asset.

However, there are circumstances in which the practical application of the *LaSalle* holding is not clear. The court recognized that the required auction could take the form of either the presentation of competing plans or of competing bids for the equity position held by the debtor.^{n58kk} Each of these scenarios gives rise to certain issues.

In the case of competing plans, the nondebtor plan proponent will be required to prepare a disclosure statement and to solicit acceptances.^{n58ll} Although this may be viewed as a costly and time-consuming process, in a single asset real estate chapter 11 case the preparation of the disclosure statement is a relatively straightforward matter,^{n58mm} and acceptances need be solicited from a relatively small universe of creditors. A lender holding a mortgage on the real estate asset will ordinarily have the financial and personnel resources required to employ a team of professionals needed to prepare a disclosure statement and to solicit acceptances. Moreover, such a lender will often have a good information base from which to prepare the disclosure statement. If, however, the plan proponent is a third party, the *LaSalle* requirement for open-market bidding may mandate an order of the court directing the debtor to afford to the proponent access to the information required to prepare its disclosure statement.

In the case of an auction of the equity position, it is likely that a nondebtor bidder will be seeking a transfer of title to the property rather than a transfer of the ownership interests (such as general and limited partnership interests) in the debtor. A transfer of ownership interests may carry with it undisclosed liabilities that would not be binding upon a successor in title under a deed transfer. Under this scenario, it appears that the bidder will be proceeding under the plan proposed by the debtor, but seeking to substitute itself for the debtor as the party that will emerge from the case as the record owner of the property. The question then arises as to whether a mortgage lender, acting as a competing bidder in a new value plan, may bid-in its debt in payment of the price for the equity position. Assuming that the lender is bidding under the debtor's plan, it will be bidding its deficiency claim only, inasmuch as the secured claim will have been compensated by its treatment under the plan and secured by the value of the collateral.ⁿ⁵⁸ⁿⁿ If the mortgage lender bids the amount of its deficiency claim, it may bid an additional sum to satisfy the other unsecured creditors (usually trade creditors) in the unsecured class.^{n58oo} It is possible that had the mortgage lender been able to foreclose on the property it would have paid these trade creditors in any event to assure the continuation of services to the building. Moreover, even if the court determines that the mortgage lender is not entitled to bid-in its deficiency claim, it would be paying into the estate money that would be returned to it in payment of its claim, with the balance of the funds to be paid to the other unsecured creditors in the same class as the lender in the same manner as though the lender had been permitted to bid-in its deficiency claim.

If, however, the single asset real estate case involves a second mortgage lien subordinate to the position of the mortgage lender that is the competing bidder for the equity, it is possible that in order to prevail in the bidding the lender will be constrained to pay monies to the holder of the second position that it would not have been required to pay had it been permitted to foreclose on the property and cut off the lien of the second mortgage.^{n58pp} Of course, if there is a bidder competing with the lender that is willing to pay an amount sufficient to satisfy the lender's deficiency claim, then perhaps the lender has received all if not more than the compensation to which it is entitled in the circumstance of a nonrecourse mortgage loan.

Another provision relevant to single asset cramdown plans is the unfair discrimination requirement of section 1129(b)(1). Essentially, section 1129(b)(1) prohibits unfair discrimination between classes.ⁿ⁵⁹ If the creditor is dealing with a single asset limited partnership with a viable, solvent general partner, the general partner may attempt to provide for the payment in full of trade claims (which would ordinarily have recourse against that general partner) outside the plan. This additional inducement, of course, may lead the trade creditors to vote in favor of the plan and perhaps give the debtor its much-needed impaired accepting class. If the trade creditors would have recourse against a shell general partner, any additional consideration in the plan to those trade creditors could constitute unfair discrimination.ⁿ⁶⁰

Another issue to be considered is whether the mortgagee can assert that it is entitled to receive postpetition interest on the unsecured portion of its claim which it would have received under section 726(a)(5), which is applicable through incorporation by section 1129(a)(7)(A). A mortgagee in a cramdown situation is entitled to receive not less than what it would have received from the estate in a chapter 7 case.ⁿ⁶¹ Thus, the mortgagee may attempt to argue that it is entitled to interest on its deficiency claim before equity receives any distribution. This theory has not been adopted by the courts.

[3] Drafting a Chapter 11 Plan

A typical chapter 11 plan involving property subject to a mortgage might take the following form:

- (1) Definitions;
- (2) Treatment of administrative expenses and nonclassified priority claims;
- (3) Classification of claims and interests;
- (4) Treatment of claims and interests;
- (5) Covenants of the debtor;
- (6) Events of default and acceleration;
- (7) Amendments and waivers;
- (8) Executory contracts; and
- (9) Miscellaneous provisions including retention of jurisdiction, vesting of property and other issues.

One of the purposes of the Bankruptcy Code was to encourage negotiations in connection with the formulation of a chapter 11 plan. As a part of this process, the holder of a mortgage claim should freely comment upon the form and substance of any chapter 11 plan presented for consideration by the debtor in possession or trustee. Indeed, it is not uncommon that counsel for the mortgagee, especially in a single-asset case, will prepare and submit a draft plan to counsel for the debtor and other interested parties. Moreover, chapter 11 plans involving restructuring of mortgage debt often require an amendment to the existing mortgage and preparation of new ancillary documents; the preparation of such amendments and documents should be handled by counsel to the mortgagee. The plan itself would incorporate (as exhibits or otherwise) the terms and conditions of the loan documents, as amended.

Under the plan format set out above, counsel to the mortgagee will be concerned with the formulation of each article inasmuch as all of the plan's provisions will affect the amounts available for payment to the mortgagee. Thus, the amount of administrative expenses, including counsel fees for the debtor or trustee, will bear upon the amount of cash, if any, available for an initial payment to the mortgagee. These expenses may not be liquidated before confirmation but it will be important to negotiate reasonable ceilings for inclusion in the plan.ⁿ⁶² Other types of priority claims should

be similarly reviewed by mortgagee's counsel. With respect to covenants of the debtor, there may be an opportunity for a mortgagee's counsel to strengthen the provisions of the existing mortgage instrument by adding new obligations to the covenant section. These might include such affirmative covenants as the establishment and maintenance of a tax and insurance premium reserve, repair reserve and financial reporting requirements. Among the negative covenants that may be used include restrictions on disposition of the property, on additional liens and encumbrances and/or on additional indebtedness and capital expenditures. The events of default and acceleration provisions of a plan may improve upon the default provisions in the existing mortgage, and will also relate to the performance by the debtor under the plan and the admitted mortgage instruments. This is similar to the "clean-up" of the loan documents that often occurs in the context of workout negotiations prior to any bankruptcy filing.

It will likewise be necessary to negotiate and prepare provisions for waivers under the plan in order to avoid returning to the bankruptcy court for a postconfirmation modification or the commencement of a new chapter 11 case. One approach often used is to permit amendments and waivers based upon agreement by the holders of specified percentages of obligations under the plan. This section of a plan is particularly significant in view of the provisions of section 1127(b), which permits postconfirmation modification of a plan only until a substantial consummation has occurred. Substantial consummation is defined in section 1101(2) to mean: (1) transfer of all or substantially all of the property to be transferred under the plan; (2) assumption by the debtor or successor of the business or management of substantially all of the property dealt with in the plan; or (3) commencement of distribution under the plan. Substantial consummation may occur soon after confirmation.ⁿ⁶³

It may also be necessary to provide in the plan for retention of jurisdiction by the bankruptcy court to decide specified matters notwithstanding the confirmation of the plan. These matters will ordinarily include disposition of unresolved litigation and of disputed claims.ⁿ⁶⁴ In addition, to the extent that the court will retain jurisdiction during the pendency of the plan, this would effectively preclude refiling of the plan in another jurisdiction or before another court.ⁿ⁶⁵

A form of chapter 11 plan relating to a single asset case is provided at the end of this chapter.ⁿ⁶⁶ This plan reflects a compromise between the debtor on its principal creditor, as the holder of a mortgage on the debtor's principal asset. The plan provides for payment in full of priority and general unsecured claims, for the payment of certain expenses incurred by the mortgagee and for cash payments to cover accrued and unpaid interest. The plan also provides for restructuring of the amortization schedule, with interest, and for the disposition of monies which have been turned over to the debtor by a state court receiver upon filing pursuant to section 543. Article X of the plan sets forth additional negative covenants binding on the debtor which were not contained in the original mortgage, and Article XI provides for an expanded events of default. The persons holding partnership interests in the debtor are identified as holding an "allowed interest" and will remain in place under the plan and, therefore, are unimpaired under the Code.

A second form of chapter 11 plan in a single asset real estate case is also provided at the end of this chapter.ⁿ⁶⁷ This form provides for a liquidating plan under which the property will be sold, the mortgage claims will be satisfied and unsecured claims and available partnership interests will be given the right to receive available and unencumbered proceeds in a specified order of priority.

The mortgagee may also want to consider filing a creditor plan. The courts are showing increasing reluctance to extend exclusivity.ⁿ⁶⁸ The viability of creditor plans have been increased substantially by reason of key amendments to the Code by the 2005 Act. Under amendments to section 1121(d), the debtor's exclusive rights to file a plan and solicit acceptances thereto may not be extended beyond a date that is 18 months and 20 months, respectively, following the order for relief.^{n68a} Moreover, in cases which meet the definition of "single asset real estate," the 2005 Act has removed the \$4,000,000 secured debt limitation with the result that relief from the automatic stay under section 362(d)(3) may come into play if the debtor fails to file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable period of time within 90 days of the order for relief.^{n68b} Filing a creditor plan may be an effective first step in negotiating any plan a creditor hopes to receive. Accordingly, after the end of exclusivity, or if the period is reduced for cause, the creditor may be in a position to file a competing plan which would provide for a greater

return to unsecured creditors. The creditor's plan could provide for the sale of the debtor's asset or foreclosure by the creditor in the event a sale does not occur within a specified time. The major advantage of a sale plan is the ability to avoid valuation and feasibility issues. The cash flow of the property can be utilized to fund unsecured claims during the period between the confirmation date and the sale date under the terms of the plan. Classification is a problem for the creditor and special care must be given to the treatment of insider claims. In the event that the equity holders advance funds to the debtor, allegedly as loans, some thought should be given to recharacterization of this alleged debt as equity.ⁿ⁶⁹

[4] Preparation of the Disclosure Statement

Section 1125(b) provides that solicitation of plan acceptances may not occur unless and at or prior to the time of such solicitation there is submitted to the holder of a claim or interest the plan or summary of the plan, and a written disclosure statement.ⁿ⁷⁰ The disclosure statement must be approved by the bankruptcy court, after notice and a hearing, as containing "adequate information."ⁿ⁷¹ The term "adequate information" is defined in section 1125(a)(1) as:

information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information.ⁿ⁷²

The determination whether a disclosure statement contains adequate information is made with reference only to the Bankruptcy Code and not to any nonbankruptcy law, rule or regulation.ⁿ⁷³ Thus, the disclosure requirements of the Securities Act of 1933, as amended, and of the Securities and Exchange Act of 1934, as amended, are inapplicable.ⁿ⁷⁴ The Securities and Exchange Commission and any other agency in power to administer or enforce a nonbankruptcy disclosure law may be heard on the issue of whether a disclosure statement contains adequate information; however, such agency may not appeal from, or otherwise seek review of, a court order approving a disclosure statement.ⁿ⁷⁵ Under section 1125(a), a person that solicits acceptance or rejection of a plan, or that participates in the offer, issuance, sale or purchase of a security offered or sold under a plan, in good faith and in compliance with the provisions of the Bankruptcy Code, is not liable for violation of any applicable nonbankruptcy law, rule or regulation governing the offer, issuance, sale or purchase of securities or the solicitation of such acceptances or rejections.ⁿ⁷⁶

It is clear that the Bankruptcy Code provides for flexibility in the preparation of the required disclosure statement and creates a safe harbor for persons acting in good faith in connection with the preparation of a disclosure statement. Although no form of disclosure statement is prescribed, it appears that certain types of information should be included to satisfy the requirement for "adequate information." Set forth at the end of this chapter is a disclosure statement for a debtor that owns a commercial office building subject to existing first mortgage and a purchase by a second mortgage.ⁿ⁷⁷ The type of information required in a disclosure statement includes the following: (1) a description of the business, including competitive conditions; (2) a history of the debtor prior to filing, including the reasons for filing; (3) financial information, including balance sheets, income statements and information regarding liens, encumbrances and other financial obligations which may impair the debtor or its assets; (4) a description of the plan; (5) a description of how the plan is to be executed; (6) a liquidation analysis; (7) a description of management and compensation; (8) projections of operations; (9) a description of pending and contemplated litigation; (10) a description of transactions with insiders; and (11) a description of probable tax consequences.ⁿ⁷⁸

The disclosure statement should not be approved when it is clear from the face of the plan that it is nonconfirmable.ⁿ⁷⁹

The courts have held that it is a waste of time and effort to transmit to creditors for voting a plan in the accompanying disclosure statement, which is nonconfirmable.ⁿ⁸⁰

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 1123(a)*.

(n2)Footnote 2. This paragraph was added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994) (*reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised)) and was intended to "conform [] the treatment of residential mortgages in chapter 11 to that in chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence." *See* H.R. Rep. No. 103-835, 103rd Cong., 2nd Sess. 46 (1994), *reprinted in* App. Vol. 4 Collier on Bankruptcy, Part XLI (Matthew Bender 15th ed.).

(n3)Footnote 2a. *11 U.S.C. § 1123(b)*.

(n4)Footnote 3. The administrative priority claim requirements should be reviewed carefully by a secured creditor with an adequate protection claim entitled to priority under section 507(b). If the debtor is the plan proponent, this superpriority claim must be paid in full.

(n5)Footnote 4. Subsection 1129(a)(9)(C) was amended and subsections (a)(9)(D) and (a)(14) through (16) were added by the 2005 Act, Pub. L. No. 109-8, §§ 213(1), 321(c)(1), 710(2)-(3), 1221(b) (2005).

(n6)Footnote 5. *11 U.S.C. § 1129(b)*.

(n7)Footnote 6. Objections to confirmation are governed by *Fed. R. Bankr. P. 3020* which requires that objections be filed and served on the debtor, the trustee, the proponent of the plan, any committee appointed under the Code and any other entity designated by the court within the time fixed by the court. Objections to confirmation are governed by *Fed. R. Bankr. P. 9014* which incorporates, for the most part, the discovery rules contained in *Fed. R. Bankr. P. 7026 through 7037*.

(n8)Footnote 7. *See* section 1126(c) which provides that for a class to accept a plan the creditors in that class that hold at least two-thirds in amount and more than one-half in number of the allowed amount of claims of such class held by creditors that have voted must vote to accept such plan.

(n9)Footnote 8. *11 U.S.C. § 1126(f)*. The concept of impairment is discussed in this subsection as it impacts the mortgage lender. The creditor should insure that a class of creditors that is designated as impaired under a plan is truly impaired so as to be eligible to vote and constitute the impaired accepting class required by section 1129(a)(10). Any misdesignation of a class should be corrected at the disclosure statement stage.

(n10)Footnote 9. *11 U.S.C. § 1129(b)(2)*.

(n11)Footnote 10. *See 11 U.S.C. § 506(a)*. Under section 1111(b), the nonrecourse secured lender has a recourse unsecured claim to the extent of its deficiency. The deficiency claim may be subject to classification in a class other than the class containing the trade creditor claims. *See* notes 30 and 31 *infra*. In addition, the secured creditor may elect fully secured status under section 1111(b)(2) which would preclude the use of the deficiency claim to invoke the absolute priority rule but would require the payment in full of that claim. The invocation of the absolute priority rule may be subject to a "new value corollary" within the meaning of *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999), discussed at text accompanying note 56 *et seq. infra*.

(n12)Footnote 11. *11 U.S.C. § 1122(a)*.

(n13)Footnote 12. 11 U.S.C. § 1122(a).

(n14)Footnote 13. *In re Sullivan*, 7 C.B.C.2d 513, 26 B.R. 677 (Bankr. W.D.N.Y. 1982) ; 7 Collier on Bankruptcy, P 1122.03[4][c] (Matthew Bender 15th Ed. Revised).

(n15)Footnote 14. See *Mokava Corp. v. Dolan*, 147 F.2d 340 (2d Cir. 1945) ; *Seidel v. Palisades-on-the-Desplaines (In re Palisades-on-the-Desplaines)*, 89 F.2d 214, 217-18 (7th Cir. 1937) .

(n16)Footnote 15. See *In re Martin's Point L.P.*, 12 B.R. 721 (Bankr. N.D. Ga. 1981) .

(n17)Footnote 16. See *In re Holthoff*, 14 C.B.C.2d 620, 58 B.R. 216 (Bankr. E.D. Ark. 1985) .

(n18)Footnote 17. See *In re Palisades-on-the-Desplaines*, 89 F.2d 214, 217 (7th Cir. 1937) .

(n19)Footnote 18. 11 U.S.C. § 1126(c).

(n20)Footnote 19. 11 U.S.C. § 1124. The provision regarding compensation for pecuniary losses arising from the debtor's failure to perform nonmonetary obligations was added by the 2005 Act. Pub. L. No. 109-8, § 442 (2005), reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Section 1124 of the Bankruptcy Code formerly provided a third method by which a holder of a mortgage claim may be unimpaired, namely, if the mortgagee received on the effective date of the plan, cash equal to the allowed amount of its claim. This "cashout" option was eliminated by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n21)Footnote 20. See *In re Madison Hotel Assocs.*, 749 F.2d 410, 11 C.B.C.2d 771 (7th Cir. 1984) ; *Pierre v. Taddeo (In re Taddeo)*, 685 F.2d 24, 6 C.B.C.2d 1201 (2d Cir. 1982) (chapter 13 case); *In re Orlando Tennis World Dev. Co., Inc.*, 9 C.B.C.2d 816, 34 B.R. 558 (Bankr. M.D. Fla. 1983) ; *Valente v. Savings Bank of Rockville*, (Bankr. D. Conn. 1983), 34 B.R. 362 ; *In re Hewitt*, 5 C.B.C.2d 1626, 16 B.R. 973 (Bankr. D. Ala. 1982) . In addition, reinstatement is allowed in a nonjudicial foreclosure context prior to the actual sale which would extinguish the debtor's interest in the property. See *In re Rolling Green Country Club*, 26 B.R. 729 (Bankr. D. Minn. 1982) ; *In re Masnorth Corp.*, 28 B.R. 892 (Bankr. N.D. Ga. 1983) .

(n22)Footnote 21. See *In re Masnorth Corp.*, 28 B.R. 892, 892 (Bankr. N.D. Ga. 1983) ; 36 B.R. 335 (Bankr. N.D. Ga. 1984) ; see also *In re Forest Hills Assocs.*, 40 B.R. 410 (Bankr. S.D.N.Y. 1984) (upon cure and reinstatement of a mortgage under section 1124, the applicable interest rate is the predefault rate); *In re Rolling Green Country Club*, 26 B.R. 729, 730-33 (Bankr. D. Minn. 1982) (loss of market rate of interest not compensable under section 1124(2)(C)). The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), added section 1123(d), which provides that plans providing for the cure of defaults must provide for cure payments in amounts determined under nonbankruptcy law. This provision implicates contractual provisions requiring payment of default rate interest and late charges.

(n23)Footnote 22. See *In re Barrington Oaks Gen. P'ship*, 5 C.B.C.2d 969, 15 B.R. 952 (Bankr. D. Utah 1981) (transfer of property to new obligor constitutes impairment).

(n24)Footnote 23. See *In re Kizzac Mgt. Corp.*, 11 C.B.C.2d 1106, 44 B.R. 496 (Bankr. S.D.N.Y. 1984) .

(n25)Footnote 24. See 11 U.S.C. § 1129(b)(2)(B)(ii) and discussion at notes 49-58 *infra*.

(n26)Footnote 25. See 11 U.S.C. § 1129(a)(8).

(n27)Footnote 26. See 11 U.S.C. § 1129(b)(1).

(n28)Footnote 27. See *In re Polytherm Indus.*, 9 C.B.C.2d 758, 33 B.R. 823 (W.D. Wis. 1983) (affirmative vote of

impaired class required); *In re Barrington Oaks Gen. P'ship*, 5 C.B.C.2d 969, 15 B.R. 952 (Bankr. D. Utah 1981) (affirmative vote of impaired class is required); *In re Marston Enters.*, 13 B.R. 514 (Bankr. E.D.N.Y. 1981) (one class must affirmatively accept plan, but unimpaired class may also reject plan); *In re Victory Constr. Co.*, 11 C.B.C.2d 243, 42 B.R. 145 (Bankr. C.D. Cal. 1984) (allowing "deemed" acceptance).

(n29)Footnote 27a. See P 2.01[9] *supra*.

(n30)Footnote 28. It is unlikely that the tax claims will provide any basis for the impaired accepting class requirement. For example, the court in *In re Bryson Properties*, XVIII, 961 F.2d 496 (4th Cir. 1992), opined that priority tax claimants, which received preferential treatment under section 1129(a)(9)(C), are not an impaired class that can accept a plan and bind truly impaired creditors to a cramdown. See also *In re Perdido Motel Group, Inc.*, 101 B.R. 289 (Bankr. N.D. Ala. 1989); *Pennbank v. Winters (In re Winters)*, 99 B.R. 658, 663-64 (Bankr. W.D. Pa. 1989). Of course, to the extent that the tax claims accrued prepetition and are secured by a lien on the property under applicable nonbankruptcy law, the plan proponent may attempt to treat those creditors as secured creditors under section 1129(b). But see *Lincoln Sav. Bank v. Suffolk County Treasurer (In re Parr Meadows Racing Ass'n, Inc.)*, 880 F.2d 1540 (2d Cir. 1989), cert. denied, 493 U.S. 1058, 110 S. Ct. 869, 107 L. Ed. 2d 953 (1990) (automatic stay imposed by section 362(a)(4) acted to stay postpetition perfection of a county tax lien even if no action was required on the part of the county to perfect the lien under state law). Under the *Parr Meadows* analysis, unless the lien has fully attached prebankruptcy, the creditor may be entitled only to an unsecured claim in the case which may be accorded administrative priority. The Bankruptcy Reform Act of 1994 overruled *Parr Meadows* by amending section 362 to permit the "making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment" notwithstanding the automatic stay. 11 U.S.C. § 362(b)(9), added by Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n31)Footnote 29. See, e.g., *In re Club Assocs.*, 107 B.R. 385 (Bankr. N.D. Ga. 1989), *aff'd*, 956 F.2d 1065 (11th Cir. 1992).

(n32)Footnote 30. *In re Woodbrook Assocs.*, 19 F.3d 312, 319, 30 C.B.C.2d 551, 559-60 (7th Cir. 1994). Other cases which have permitted separate classification include; *In re Gato Realty Trust Corp.*, 33 C.B.C.2d 1660, 183 B.R. 15 (Bankr. D. Mass. 1995); *In re University Creek Plaza, Ltd.*, 176 B. R. 1011 (S.D. Fla. 1995); *In re Krisch Realty Assocs*, 174 B.R. 914 (Bankr. W.D. Va. 1994); *In re Baldwin Towne Ctr., Ltd.*, 31 C.B.C.2d 1606, 171 B.R. 374 (Bankr. C.D. Cal. 1994). In *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999), discussed *infra* in connection with the new value corollary to the absolute priority rule, the Court noted that the single asset real estate debtor's plan provided for four classes--the secured portion of the undersecured mortgagee's claim, the unsecured portion of the mortgagee's claim, trade creditors and equity. The Court noted that both the *Woodbrook* case, *supra*, as well as the lower court opinions in the *LaSalle* case, mandated separate classification of the undersecured mortgagee's deficiency claim and the claims of other unsecured creditors. 526 U.S. 434, 119 S. Ct. 1411, 1415 n.7, 143 L. Ed. 2d 607, 41 C.B.C.2d 526, 529-30 n.7 (1999). The mortgagee did not appeal this holding to the Supreme Court, which stated that the issue was not before it. *Id.*

(n33)Footnote 31. See *Boston Post Road L.P. v. FDIC (In re Boston Road L.P.)*, 21 F.3d 477, 483, 30 C.B.C.2d 1528, 1535 (2d Cir. 1994) (following *Greystone* in finding that separate classification of deficiency claim would effectively nullify the option that Congress gave to creditors to vote the deficiency claim as unsecured debt); *John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs.*, 987 F.2d 154, 28 C.B.C.2d 440 (3d Cir. 1993) (granting relief from automatic stay since debtor conceded that it would not have sought confirmation of a plan of reorganization unless it was permitted to classify separately creditor's unsecured deficiency claim, which the court held was impermissible); *Lumber Exch. Bldg. Ltd. v. The Mutual Life Ins. Co. of New York (In re Lumber Exch. Bldg. Ltd.)*, 968 F.2d 647 (8th Cir. 1992); *In re Bryson Prop.*, XVIII, 961 F.2d 496, 502, 26 C.B.C.2d 1290, 1296 (4th Cir. 1992); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 948 F.2d 134, 137-39 (5th Cir. 1991), modified on petition for rehearing, 995 F.2d 1274 (5th Cir.), cert. denied, 506 U.S. 822, 113 S. Ct. 72,

121 L. Ed. 2d 37 (1992). *Olympia & York Fla. Equity Corp. v. Bank of N.Y. (In re Holywell Corp.)*, 913 F.2d 873, 880, 24 C.B.C.2d 69, 76 (11th Cir. 1990); *Hanson v. First Bank of S.D.*, 828 F.2d 1310 (8th Cir. 1987). But see *In re Woodbrook Assocs.*, 19 F.3d 312, 30 C.B.C.2d 551 (7th Cir. 1994) (questioning *Greystone* analysis that separate classification of unsecured deficiency claim created under 11 U.S.C. § 1111(b) is nearly conclusive of evidence of a debtor's attempt to gerrymander an affirmative vote for confirmation).

(n34)Footnote 32. *In re Greystone III Joint Venture*, 948 F.2d 134, 139, 26 C.B.C.2d 220, 224 (5th Cir. 1991).

(n35)Footnote 33. With respect to the impaired accepting class requirement, the secured creditor should also be aware of the potential for purchasing claims sufficient in number to block confirmation. See, e.g., *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989) (creditor's purchase of claims to protect its interest is not in bad faith and will not result in designation of its vote under section 1126(e)). *Accord Insigner Mach. Co. v. Federal Support Co. (In re Federal Support Co.)*, 859 F.2d 17, 19 (4th Cir. 1988) (creditor may not act with ulterior or coercive purpose); *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990) (when creditor had an ulterior motive and acted in aid of an interest other than as creditor, the court designated vote).

(n36)Footnote 33a. *In re Woodbrook Assocs.*, 19 F.3d 312, 30 C.B.C.2d 551 (7th Cir. 1994).

(n37)Footnote 34. 11 U.S.C. § 1129(b)(2)(A)(i).

(n38)Footnote 35. The issues relating to valuation of the property are discussed at P 2.06[2] *supra*, with particular reference to *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997). As indicated in that discussion, special care must be taken to avoid a "low ball" valuation in the early stages of the case in the context of stay litigation which may undermine the creditor's efforts to argue a higher value in the context of plan confirmation. Although section 506(a) expressly recognizes that valuation for different purposes during the pendency of the case will not be *res judicata*, it may be difficult to disabuse the court of its prior finding.

(n39)Footnote 36. See *GMAC v. Jones*, 999 F.2d 63 (3d Cir. 1993); *United States v. Camino Real Landscape Maint. Contr., Inc. (In re Camino Real Landscape Maint. Contr.)*, 818 F.2d 1503, 1506, 16 C.B.C.2d 1341, 1345 (9th Cir. 1987); *In re Monnier Bros.*, 755 F.2d 1336 (8th Cir. 1985); *United States v. Southern States Motor Inns, Inc. (In re Southern States Motor Inns, Inc.)*, 709 F.2d 647, 8 C.B.C.2d 1283 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022, 104 S. Ct. 1275, 79 L. Ed. 2d 680 (1984); *Memphis Bank & Trust v. Whitman*, 692 F.2d 427, 7 C.B.C.2d 727 (6th Cir. 1982), *In re McKean*, 178 B.R. 637 (Bankr. M.D. Pa. 1994).

(n40)Footnote 37. See *In re Colgrove*, 771 F.2d 119, 13 C.B.C.2d 575 (6th Cir. 1985) (chapter 13 case); *In re Corley*, 83 B.R. 848 (Bankr. S.D. Ga. 1988); *Mitchell v. Frankford Const. Co. (In re Mitchell)*, 77 B.R. 524 (Bankr. E.D. Pa. 1987) (dealing with a chapter 12 and 13 case, respectively).

(n41)Footnote 38. See, e.g., *Farm Credit Bank v. Fowler (In re Fowler)*, 903 F.2d 694, 22 C.B.C.2d 1659 (9th Cir. 1990) (court adopted formula approach in chapter 12 case); *United States v. Doud*, 869 F.2d 1144, 1145 (8th Cir. 1989) (court took yield on treasury bonds and added two percent for overall risk associated for a chapter 12 case); *In re River Village Assocs.*, 161 B.R. 127 (Bankr. E.D. Pa. 1993) (discussing different approaches to determining appropriate interest rate); *In re Oaks Partners, Ltd.*, 135 B.R. 440 (Bankr. N.D. Ga. 1991) (treasury bill rate of even maturity plus risk factor adopted); *In re Computer Optics, Inc.*, 24 C.B.C.2d 1812, 1820, 126 B.R. 664, 672 (Bankr. D.N.H. 1991) (court adopted two percent over prime and four percent over treasury bond of like maturity); *In re Guilford Telecasters, Inc.*, 128 B.R. 622, 626 (Bankr. M.D.N.C. 1991) (prime rate plus one and one-half percent); *In re Koch*, 25 C.B.C.2d 666, 131 B.R. 128 (Bankr. N.D. Iowa 1991) (2 percent above 30-year Treasury Bond adopted in chapter 12 case); *In re E.I. Parks I L.P.*, 122 B.R. 549, 555 (Bankr. W.D. Ark. 1990) (riskless rate plus two percent); *In re LLL Farms*, 22 C.B.C.2d 1182, 111 B.R. 1016, 111 B.R. 1016 (Bankr. M.D. Ga. 1990) (court used yield on treasury bonds plus two percent in chapter 12 case).

(n42)Footnote 39. *In re Oaks Partners, Ltd.*, 135 B.R. 440, 446-47 (Bankr. N.D. Ga. 1991).

(n43)Footnote 39a. 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787, 51 C.B.C.2d 643 (2004) . Only four justices joined in this holding, while Justice Thomas joined in the judgment of the plurality on other grounds.

(n44)Footnote 39b. 541 U.S. 465, 478-80, 124 S. Ct. 1951, 1961-62, 158 L. Ed. 2d 787, 800 (citations and footnotes omitted).

(n45)Footnote 39c. 541 U.S. 465, 476 n.14, 124 S. Ct. 1951, 1959 n.14, 158 L. Ed. 2d 787, 798 n.14 (citations omitted). Since the decision, the courts have been inconsistent in applying the reasoning to chapter 11 cases. Compare *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American Homepatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005) (refusing to apply *Till* in the chapter 11 context where there exists an efficient market to determine market interest rates), *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239, 256 (Bankr. M.D. Fla. 2006) (using rate under debtor's unsecured exit facility as appropriate market rate) with *In re Prussia Assocs.*, 322 B.R. 572, 585 (Bankr. E.D. Pa 2005) (finding that the degree to which *Till* is controlling in chapter 11 context is uncertain, but its reasoning is instructive and relevant), and *In re Deep River Warehouse, Inc.*, 2005 Bankr. LEXIS 1793 (Bankr. M.D.N.C. September 22, 2005) (applying formula methodology to chapter 11 case before it while leaving open the question of whether method applies to all chapter 11 cases). See also S. Fawkes & S. Hartmann, *Revisiting Till: Has a Consensus Emerged in Chapter 11s?*, Am. Bankr. Instit. J., July/August 2008, at 28.

(n46)Footnote 40. See 11 U.S.C. § 1129(a)(11). The impact of the debt service requirements on the debtor's cash flow will affect the feasibility analysis.

(n47)Footnote 41. See *Fed. R. Bankr. P. 3014*. For cause shown, the court may extend the time to make the election under section 1111(b). The creditors should seek an extension of the time to take the election if, by the time of the disclosure statement hearing, the court has not made a final determination as to the value of the underlying collateral. See 7 *Collier on Bankruptcy*, P 1111.03 (Matthew Bender 15th Ed. Revised); 9 *Collier on Bankruptcy*, P 3014.01[3] (Matthew Bender 15th Ed. Revised).

(n48)Footnote 42. See, e.g., *In re Southern Mo. Towing Serv., Inc.*, 35 B.R. 313, 314 (Bankr. W.D. Mo. 1983) .

(n49)Footnote 42a. *Fed. R. Bankr. P. 3014*.

(n50)Footnote 43. See 11 U.S.C. § 1111(b)(1)(B). In the event that the debt is nonrecourse, the deficiency is not converted to a recourse claim if the property is sold pursuant to section 363 or pursuant to a plan. See 11 U.S.C. § 1111(b)(1)(A)(ii).

(n51)Footnote 44. See 11 U.S.C. § 363(k); see also *In re Realty Inv. Ltd. V.*, 16 C.B.C.2d 1128, 1128, 72 B.R. 143, 146 (Bankr. C.D. Cal. 1987) (second priority secured lender allowed to bid its entire claim without reference to value of the property); 3 *Collier on Bankruptcy*, P 363.09 (Matthew Bender 15th Ed. Revised).

(n52)Footnote 45. Consideration must be given to the type of treatment offered the secured creditor by a debtor's proposed sales plan. In *In re Broad Assocs. L.P.*, 125 B.R. 707 (Bankr. D. Conn. 1991) , the court held that sections 363(k) and 1129(b)(2)(A)(ii) did not apply to a plan which provided for the ultimate sale of the property subject to the creditor's lien. See also *In re Constitution Plaza Assocs. Ltd. Partnership*, 161 B.R. 563 (B Ct., D. Conn. 1993) (§ 1111(b) protection unavailable when plan provides for transfer of property to creditor by lifting the stay or by direct transfer).

(n53)Footnote 46. 11 U.S.C. § 1129(b)(2)(A)(iii); see also *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935) .

(n54)Footnote 47. See, e.g., *In re Sun Country Dev., Inc.*, 764 F.2d 406 (5th Cir. 1985) (single tract of land subdivided into 21 separate parcels to secure 21 separate notes which the court found was the indubitable equivalent of creditor's claim). But see *Arnold Baker Farms v. United States*, 33 C.B.C.2d 31, 177 B.R. 648 (9th Cir. B.A.P. 1994) ,

holding that the indubitable equivalence standard is not satisfied by a distribution to a secured creditor of part of its real estate collateral because the plan left the creditor with no recourse in the event of a deficiency and increased the creditor's risk. The indubitable equivalence standard was deemed satisfied by the distribution to the secured creditor of all of its collateral in *In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346 (5th Cir. 1989), *reh'g en banc denied*, 889 F.2d 663 (5th Cir. 1989).

(n55)Footnote 48. For example, the court in *In re Walat Farms, Inc.*, 70 B.R. 330, 336 n.7 (Bankr. E.D. Mich. 1987), noted that more than three years after confirmation in *Sun Country Dev.*, nine of the 21 trust deeds had been foreclosed and the value of the property had declined. In the case of multiple tracts of real property, the debtor is thus able to peel off the value over the judicially determined claim on particular parcels and leave the risk of valuation for the balance of the parcels on the creditor. See *Arnold Baker Farms v. United States*, 33 C.B.C.2d 31, 177 B.R. 648 (B.A.P. 9th Cir. 1994).

(n56)Footnote 49. 11 U.S.C. § 1129(b)(2)(B).

(n57)Footnote 50. As discussed previously, a plan proponent will often attempt to classify the deficiency claim of the trade creditor in a class separate from the deficiency claim of the nonrecourse undersecured mortgagee in order to obtain an impaired accepting class as required by section 1129(a)(10). However, even if this is allowed by the court, the creditor can invoke the absolute priority rule by declining to take the section 1111(b) election and voting to reject the plan specifically in that unsecured creditor class. See notes 29-32 *supra*.

(n58)Footnote 50a. Some courts prefer to use the term "new value precept" rather than the term "new value exception" under the theory that the concept is a corollary rather than an exception to the absolute priority rule. *In re Woodbrook Assocs.*, 19 F.3d 312, 30 C.B.C.2d 551 (7th Cir. 1994). The court in *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1994), *appeal dismissed as moot*, 513 U.S. 18, 115 S. Ct. 386, 130 L. Ed. 2d 233 (1994), described the concept as "a set of conditions under which former shareholders may lawfully obtain a priority interest in the reorganized venture" and preferred the term "new capitalization doctrine."

(n59)Footnote 50b. See generally Warren, *A Theory of Absolute Priority*, 1991 Annual Survey of Am. Law 9 (1991).

(n60)Footnote 51. See *Case v. Los Angeles Lumber Prods. Co., Ltd.*, 308 U.S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939); *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 46 S. Ct. 549, 70 L. Ed. 1028 (1926).

(n61)Footnote 52. See, e.g., *In re Potter Material Service, Inc.*, 781 F.2d 99 (7th Cir. 1986); *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.)*, 800 F.2d 581, 15 C.B.C.2d 553 (6th Cir. 1986).

(n62)Footnote 53. 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2d 169, 18 C.B.C.2d 262 (1988).

(n63)Footnote 54. 485 U.S. 197, 206, 108 S. Ct. 963, 968, 99 L. Ed. 2d 169, 179, 18 C.B.C.2d 262, 267-68; see also *In re 8315 Fourth Ave. Corp.*, 172 B.R. 725 (Bankr. E.D.N.Y. 1994) (promise to perform future services is not money or money's worth).

(n64)Footnote 55. 485 U.S. 197, 203 n.3, 108 S. Ct. 963, 967 n.3, 99 L. Ed. 2d 169, 176 n.3, 18 C.B.C.2d 262, 266 n.3. A number of cases after *Ahlers* split on the issue. Some cases held or, without deciding the issue, strongly suggested that no new value exception to the absolute priority rule existed. See *In re Bryson Prop.*, XVIII, 961 F.2d 496, 26 C.B.C.2d 1290 (4th Cir. 1992) (holding that even if exception existed it was not satisfied where old equity had exclusive right to contribute new value and fully recover such value prior to payment in full of mortgagee); *Piedmont Assoc. v. CIGNA Prop. & Cas. Ins. Co.*, 132 B.R. 75 (N.D. Ga. 1991); *In re Drimmel*, 108 B.R. 284 (Bankr. D. Kan. 1989), *aff'd*, 135 B.R. 410 (D. Kan. 1991); *In re Winters*, 99 B.R. 658 (Bankr. W.D. Pa. 1989). A number of courts

held that the new value exception exists. See *In re Bonner Mall P'ship*, 2 F. 3d 899, 29 C.B.C.2d 668 (9th Cir. 1994) ; *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. 702 (E.D. Pa. 1992) ; *In re Elmwood, Inc.*, 182 B.R. 845 (Bankr. D. Nev. 1985) ; *In re One Times Square Assocs.*, 30 C.B.C.2d 69, 159 B.R. 695 (Bankr. S.D.N.Y. 1993) , *aff'd*, 165 B.R. 773 (S.D.N.Y. 1994) ; *In re Triple R Holdings, L.P.*, 26 C.B.C.2d 356, 134 B.R. 382 (Bankr. N.D. Cal. 1991) ; *In re Tallahassee Assoc.*, 25 C.B.C.2d 1314, 132 B.R. 712 (Bankr. W.D. Pa. 1991) . Some courts recognized that the issue was unresolved. See, e.g., *In re Woodbrook Assocs.*, 19 F.3d 312 (7th Cir. 1994) ; *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*, 908 F. 2d 1351, 23 C.B.C.2d 1118 (7th Cir. 1990) . The issue was reviewed thoroughly in *BT/SAP Pool C Assocs. v. Celotex Loop Cent. Three Partners*, 138 F. 3d 39, 39 C.B.C.2d 656 (2d Cir. 1998) , holding that new value exception exists but debtor does not have exclusive right to make new value contribution and retain equity interest in the property). The cases recognize the new value doctrine did require that the value be new, substantial, reasonably equivalent in value to the interest being received, in money or money's worth and necessary to the enterprise. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121, 60 S. Ct. 1, 10, 84 L. Ed. 110 (1939) ; *In re Snyder*, 967 F. 2d 1126, 27 C.B.C.2d 285 (7th Cir. 1992) ; *In re Woodmere Investors Ltd. Partnership*, 178 B.R. 346 (Bankr. S.D.N.Y. 1995) . In *In re Woodbrook Assocs.*, 19 F.3d 312, 321 (7th Cir. 1994) , the court held that even if the new value precept survived the enactment of the Bankruptcy Code, the proposed new capital infusion of \$100,000, which it characterized as "token", could not be considered substantial since it constituted at most 3.8% of the approximately \$2.6 million of total unsecured debt. See also *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*, 908 F. 2d 1351, 23 C.B.C.2d 1118 (7th Cir. 1990) (holding that guaranty could not constitute new value); *In re Yasparro*, 100 B.R. 91 (Bankr. M.D. Fla. 1989) (contribution of promissory notes not new value).

(n65)Footnote 56. 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) .

(n66)Footnote 57. 526 U.S. 434, 437, 119 S. Ct. 1411, 1414, 143 L. Ed. 2d 607 .

(n67)Footnote 58. 526 U.S. 434, 437, 119 S. Ct. 1411, 1414, 143 L. Ed. 2d 607 .

(n68)Footnote 58a. 526 U.S. 434, 443, 119 S. Ct. 1411, 1417, 143 L. Ed. 2d 607, 616, 41 C.B.C.2d 526, 531 .

(n69)Footnote 58b. 526 U.S. 434, 443, 119 S. Ct. 1411, 1417, 143 L. Ed. 2d 607, 616, 41 C.B.C.2d 526, 531 .

(n70)Footnote 58c. 526 U.S. 434, 456, 119 S. Ct. 1411, 1423, 143 L. Ed. 2d 607, 624, 41 C.B.C.2d 526, 539 .

(n71)Footnote 58d. 526 U.S. 434, 440, 119 S. Ct. 1411, 1415, 143 L. Ed. 2d 607, 614, 41 C.B.C.2d 526, 529-30 .

(n72)Footnote 58e. 526 U.S. 434, 438, 119 S. Ct. 1411, 1414, 143 L. Ed. 2d 607, 613, 41 C.B.C.2d 526, 529 .

(n73)Footnote 58f. 526 U.S. 434, 438-39, 119 S. Ct. 1411, 1415-16, 143 L. Ed. 2d 607, 614-16, 41 C.B.C.2d 526, 529-31 .

(n74)Footnote 58g. 526 U.S. 434, 439 n.7, 119 S. Ct. 1411, 1415 n.7, 143 L. Ed. 2d 607, 614 n.7, 41 C.B.C.2d 526, 529 n.7 .

(n75)Footnote 58h. 526 U.S. 434, 439 n.7, 119 S. Ct. 1411, 1415 n.7, 143 L. Ed. 2d 607, 614 n.7, 41 C.B.C.2d 526, 529 n.7 .

(n76)Footnote 58i. 526 U.S. 434, 458-63, 119 S. Ct. 1411, 1424-26, 143 L. Ed. 2d 607, 625-29, 41 C.B.C.2d 526, 540-43 .

(n77)Footnote 58j. 526 U.S. 434, 463-72, 119 S. Ct. 1411, 1426-30, 143 L. Ed. 2d 607, 628-34, 41 C.B.C.2d 526, 542-47 .

(n78)Footnote 58k. 308 U.S. 106, 118, 60 S. Ct. 1, 8, 84 L. Ed. 110 (1939) ; see 526 U.S. 434, 445-46, 119 S. Ct. 1411, 1417, 143 L. Ed. 2d 607, 617, 41 C.B.C.2d 526, 532 .

(n79)Footnote 58l. 526 U.S. 434, 442-46, 119 S. Ct. 1411, 1416-18, 143 L. Ed. 2d 607, 615-19, 41 C.B.C.2d 526, 531-33 .

(n80)Footnote 58m. 526 U.S. 434, 446-48, 119 S. Ct. 1411, 1418-19, 143 L. Ed. 2d 607, 618-20, 41 C.B.C.2d 526, 533-35 .

(n81)Footnote 58n. 526 U.S. 434, 449, 119 S. Ct. 1411, 1419, 143 L. Ed. 2d 607, 619-20, 41 C.B.C.2d 526, 534-35 .

(n82)Footnote 58o. 526 U.S. 434, 449-50, 119 S. Ct. 1411, 1419-20, 143 L. Ed. 2d 607, 619-21, 41 C.B.C.2d 526, 534-36 .

(n83)Footnote 58p. 526 U.S. 434, 450, 119 S. Ct. 1411, 1420, 143 L. Ed. 2d 607, 621, 41 C.B.C.2d 526, 535 .

(n84)Footnote 58q. 526 U.S. 434, 450, 119 S. Ct. 1411, 1420, 143 L. Ed. 2d 607, 621, 41 C.B.C.2d 526, 535 .

(n85)Footnote 58r. 526 U.S. 434, 450-51, 119 S. Ct. 1411, 1420, 143 L. Ed. 2d 607, 620-21, 41 C.B.C.2d 526, 535-36 .

(n86)Footnote 58s. 526 U.S. 434, 450-51, 119 S. Ct. 1411, 1420, 143 L. Ed. 2d 607, 621, 41 C.B.C.2d 526, 535 .

(n87)Footnote 58t. 526 U.S. 434, 452, 119 S. Ct. 1411, 1421, 143 L. Ed. 2d 607, 622, 41 C.B.C.2d 526, 536-37 . The majority opinion characterized the government's position as "starchy," citing to the government's brief in the *Bonner Mall* case. 526 U.S. 434, 451, 119 S. Ct. 1411, 1420 n.23, 143 L. Ed. 2d 607, 621 n.23, 41 C.B.C.2d 526, 536 n.23 . It was necessary to so dismiss the government's view if the Court were going to rule that old equity could participate in a competitive bidding process to contribute new value. See 526 U.S. 434, 452-53, 119 S. Ct. 1411, 1421, 143 L. Ed. 2d 607, 622, 41 C.B.C.2d 526, 536-37 . ("Although we have some doubt about the Court of Appeals's [sic] assumption [citation omitted] that prior equity is often the only source of significant capital for reorganizations [citations omitted], old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.").

It is clear that the Court was not prepared to accept any reading of the section 1129(b)(2)(B)(ii) that eliminated the possibility confirmation of a new value plan in the face of an objection by a senior impaired class. In addition to the juxtaposition of views of the majority and concurring opinions, the unwillingness to foreclose the confirmation of all new value plans in the absence of creditor consent is apparent from the following language set forth in a footnote to the majority opinion:

It is possible ... to argue on the basis of the immediate text that the prohibition against receipt of an interest "on account of" a prior unsecured claim or interest was meant to indicate only that there is no per se bar to such receipt by a creditor holding both a senior secured claim and a junior unsecured one, when the senior secured claim accounts for the subsequent interest. This reading would of course eliminate the phrase "on account of" as an express source of a new value exception, but would leave open the possibility of interpreting the absolute priority rule itself as stopping short of prohibiting a new value transaction.

526 U.S. 434, 453 n.24, 119 S. Ct. 1411, 1421 n.24, 143 L. Ed. 2d 607, 622 n.24, 41 C.B.C.2d 526, 536 n.24 .

It may be argued that the elimination of the phrase "on account of" as a source of a new value exception gives rise to a neutral interpretation of the statute which certainly does not expressly or implicitly provide for a new value exception. This is even more the case under the Court's finding that the drafting history of section 1129(b)(2)(b)(ii) is "equivocal." 526 U.S. 434, 119 S. Ct. 1411, 1419, 143 L. Ed. 2d 607, 619, 41 C.B.C.2d 526, 534-35 . Under the Court's determination

that neither the legislative nor drafting history of this section resolved the issue presented to it, the gleanings, from a phrase that is arguably otherwise explained in the above-quoted footnote, of a major exception or corollary to the otherwise explicit language of the Code, is highly questionable.

- (n88)Footnote 58u. 526 U.S. 434, 453, 119 S. Ct. 1411, 1421, 143 L. Ed. 2d 607, 622, 41 C.B.C.2d 526, 536-37 .
- (n89)Footnote 58v. 526 U.S. 434, 453 n.25, 119 S. Ct. 1411, 1421 n.25, 143 L. Ed. 2d 607, 622 n.25, 41 C.B.C.2d 526, 536 n.25 .
- (n90)Footnote 58w. 526 U.S. 434, 453, 119 S. Ct. 1411, 1421, 143 L. Ed. 2d 607, 622, 41 C.B.C.2d 526, 536-37 .
- (n91)Footnote 58x. 526 U.S. 434, 453-54, 119 S. Ct. 1411, 1421-22, 143 L. Ed. 2d 607, 622-24 .
- (n92)Footnote 58y. 526 U.S. 434, 454, 119 S. Ct. 1411, 1421-22, 143 L. Ed. 2d 607, 622-24 .
- (n93)Footnote 58z. 526 U.S. 434, 454-56, 119 S. Ct. 1411, 1422-23, 143 L. Ed. 2d 607, 623-25, 41 C.B.C.2d 526, 537-39 .
- (n94)Footnote 58aa. 526 U.S. 434, 454-56, 119 S. Ct. 1411, 1422-23, 143 L. Ed. 2d 607, 623-25, 41 C.B.C.2d 526, 537-39 .
- (n95)Footnote 58bb. 526 U.S. 434, 457-58, 119 S. Ct. 1411, 1423-24, 143 L. Ed. 2d 607, 624-27, 41 C.B.C.2d 526, 538-41 .
- (n96)Footnote 58cc. 526 U.S. 434, 454-56, 119 S. Ct. 1411, 1422, 143 L. Ed. 2d 607, 623-24, 41 C.B.C.2d 526, 537-38 .
- (n97)Footnote 58dd. 526 U.S. 434, 460-62, 119 S. Ct. 1411, 1424-25, 143 L. Ed. 2d 607 .
- (n98)Footnote 58ee. 526 U.S. 434, 460, 119 S. Ct. 1411, 1425, 143 L. Ed. 2d 607, 627, 41 C.B.C.2d 526, 541 .
- (n99)Footnote 58ff. 526 U.S. 434, 461-62, 119 S. Ct. 1411, 1425-26, 143 L. Ed. 2d 607, 627-29, 41 C.B.C.2d 526, 541-42 .
- (n100)Footnote 58gg. 526 U.S. 434, 461, 119 S. Ct. 1411, 1425, 143 L. Ed. 2d 607, 627, 41 C.B.C.2d 526, 541 .
- (n101)Footnote 58hh. 526 U.S. 434, 463-64, 119 S. Ct. 1411, 1428-29, 143 L. Ed. 2d 607, 631-33, 41 C.B.C.2d 526, 544-46 .
- (n102)Footnote 58ii. 526 U.S. 434, 450, 119 S. Ct. 1411, 1420, 143 L. Ed. 2d 607, 621, 41 C.B.C.2d 526, 535 .
- (n103)Footnote 58jj. 526 U.S. 434, 460, 119 S. Ct. 1411, 1425, 143 L. Ed. 2d 607, 627, 41 C.B.C.2d 526, 541 .
- (n104)Footnote 58kk. 526 U.S. 434, 456, 119 S. Ct. 1411, 1423, 143 L. Ed. 2d 607, 624, 41 C.B.C.2d 526, 538 .
- (n105)Footnote 58ll. 11 U.S.C. § 1125.
- (n106)Footnote 58mm. See P 2.56 *infra*.
- (n107)Footnote 58nn. 11 U.S.C. § 1129(b)(2)(A); see P 2.06[2] *supra*.

(n108)Footnote 58oo. The foregoing assumes a classification scheme in which the undersecured mortgage lender's deficiency claim is placed in the same class as the other unsecured claims in the case. In the *LaSalle* case, the mortgage

lender's deficiency claim was placed in a class separate from the claims of other unsecured creditors in accordance with the practice and law of the Seventh Circuit, but the classification issue was not raised as part of the appeal to the Supreme Court. *See* note 58h *supra*.

(n109)Footnote 58pp. The existence of this possibility may present an additional reason why first mortgage lenders will not consent to the imposition of a second mortgage lien on the asset.

(n110)Footnote 59. *11 U.S.C. § 1129(b)(1)*.

(n111)Footnote 60. In the context of unfair discrimination and the ability to fund alleged new value, creditors should be aware of the provisions of *Fed. R. Bankr. P. 1007(g)*. *Fed. R. Bankr. P. 1007(g)* requires that the general partners of a debtor file verified statements with the court of personal assets and liabilities upon court order. A number of courts have held that in the context of a chapter 11 reorganization, disclosure is inadequate in the absence of this information. *See In re M. Long Arabians*, 103 B.R. 211, 215 (B.A.P. 9th Cir. 1989) ; *In re Diversified Investors Fund XVII*, 91 B.R. 559, 561-62 (Bankr. C.D. Cal. 1988) .

(n112)Footnote 61. *See Fortgang & King, 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148, 1149-65 (1981).

(n113)Footnote 62. The plan proponent should consider whether any cap should be placed on administrative claims. In *In re Oaks Partners Ltd.*, 141 B.R. 453 (Bankr. N.D. Ga. 1992) , the court found that a competing creditor plan which arbitrarily limited administrative claims to \$75,000.00 technically violated *11 U.S.C. § 1129(a)(9)(A)*.

(n114)Footnote 63. In a cramdown situation, the secured creditor should also be wary of the doctrine of substantial consummation as it affects any appeal of the confirmation order. Under certain circumstances, when the reorganization plan has been so substantially consummated that effective relief is no longer available, the appellate court may dismiss an appeal of the confirmation order as moot. *See In re Continental Airlines*, 91 F.3d 553 (3d Cir. 1996) (en banc) (discussing bankruptcy doctrine of equitable mootness as distinguished from constitutional Article III mootness); *In re Manges*, 29 F.3d 1034, 31 C.B.C.2d 1247 (5th Cir. 1994) , *cert. denied*, 513 U.S. 1152, 115 S. Ct. 1105, 130 L. Ed. 2d 1071 (1995) ; *In re Club Assocs.*, 956 F.2d 1065 (11th Cir. 1992) ; *Miami Ctr. L.P. v. Bank of N.Y.*, 820 F.2d 376, 379 (11th Cir. 1987) .

(n115)Footnote 64. *See 5 Collier Bankruptcy Practice Guide*, P 90.05 (Matthew Bender), discussing each of the subjects ordinarily covered in the chapter 11 plan involving a reorganization of a substantial enterprise.

(n116)Footnote 65. *In re Colony Square Co.*, 779 F.2d 653 (11th Cir. 1986) (when the court retained jurisdiction over the debtor's plan, debtor could not refile bankruptcy in another district).

(n117)Footnote 66. *See P 2.55 infra*.

(n118)Footnote 67. *See P 2.55A infra*.

(n119)Footnote 68. *See, e.g., In re Mid-State Raceway, Inc.*, 323 B.R. 63 (Bankr. N.D. N. Y. 2005) ; *In re Southwest Oil Co. of Jourdanon, Inc.*, 84 B.R. 448 (Bankr. W.D. Tex. 1987) ; *In re Sharon Steel Corp.*, 78 B.R. 762 (Bankr. W.D. Penn. 1987) .

(n120)Footnote 68a. *11 U.S.C. § 1121(d)(2)*, added by Pub. L. No. 109-8, § 411 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n121)Footnote 68b. *11 U.S.C. § 362(d)(3)*, as amended by Pub. L. No. 109-8, § 1201(5)(B) (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n122)Footnote 69. *See Bayer Corp. v. Mascotech, Inc. (In re Auto Style Plastics, Inc.)*, 269 F.3d 726 (6th Cir.

2001); *Bunch v. J.M. Capital Fin., Ltd. (In re Hoffinger Indus., Inc.)*, 327 B.R. 389 (Bankr. E.D. Ark. 2005); *In re B & L Laboratories, Inc.*, 62 B.R. 494 (Bankr. M.D. Tenn. 1986); *In re Carolee's Combine, Inc.*, 3 B.R. 324 (Bankr. N.D. Ga. 1980).

(n123)Footnote 70. 11 U.S.C. § 1125(b).

(n124)Footnote 71. *Id.*

(n125)Footnote 72. 11 U.S.C. § 1125(a)(1). This section was amended by the 2005 Act to require discussion of material federal tax consequences and to permit the court to consider the complexity of the case, the benefit of additional information to creditors and other parties, and the cost of providing additional information. Pub. L. No. 109-8, § 717 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n126)Footnote 73. 11 U.S.C. § 1125(d).

(n127)Footnote 74. *Id.*

(n128)Footnote 75. *Id.*

(n129)Footnote 76. *See* 11 U.S.C. § 1125(e).

(n130)Footnote 77. *See* P 2.56 *infra*.

(n131)Footnote 78. *In re Malek*, 10 C.B.C.2d 189, 35 B.R. 443 (Bankr. E.D. Mich. 1983); *see also In re Jeppson*, 66 B.R. 269, 292 (Bankr. D. Utah 1986); *In re Metrocraft Pub. Serv., Inc.*, 10 C.B.C.2d 1182, 1183-84, 39 B.R. 567, 568-70 (Bankr. N.D. Ga. 1984). As noted, section 1125(e) was amended by the 2005 Act, Pub. L. No. 109-8, § 717 (2005), to require that a disclosure statement contain a discussion of the material federal tax consequences of the plan.

(n132)Footnote 79. *See In re Hirt*, 97 B.R. 981, 983 (Bankr. E.D. Wis. 1989); *In re Atlanta W. VI*, 20 C.B.C.2d 148, 151, 91 B.R. 620, 621 (Bankr. N.D. Ga. 1988); *In re Unichem Corp.*, 72 B.R. 95, 98 (Bankr. N.D. Ill.), *aff'd*, 80 B.R. 448 (N.D. Ill. 1987).

(n133)Footnote 80. *See In re Atlanta W. VI*, 20 C.B.C.2d 148, 151, 91 B.R. 620, 622 (Bankr. N.D. Ga. 1988); *In re Pecht*, 13 C.B.C.2d 973, 975, 53 B.R. 768, 769 (Bankr. E.D. Va. 1985).

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

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P 2.08 *Deprizio* and the Risks of Insider Guaranties

In *Levit v. Ingersoll Rand Financial Corp. (In re V.N. Deprizio Construction Co.)*,ⁿ¹ the Court of Appeals for the Seventh Circuit held that payments by a debtor company to a noninsider lender made after 90 days, but before one year, prior to bankruptcy are recoverable from the lender as a preference if the underlying debt was guaranteed by an insider of the debtor. This holding, although much criticized in the lending community and subsequently questioned by certain other courts,ⁿ² had been advocated by a number of commentators,ⁿ³ and was followed by a number of other courts.ⁿ⁴ Although Congress, by amending *section 550 of the Code* pursuant to the Bankruptcy Reform Act of 1994, eliminated the ability of a trustee to bring a proceeding to recover from the lender benefiting from an insider guaranty the value of the property transferred to it between 90 days and one year before the filing of the petition, the lender in such a case is still a "transferee" of an avoidable transfer within the meaning of *section 547 of the Code* and is, therefore, subject to adverse treatment under certain circumstances. Therefore, lenders should still consider structuring financing transactions in a manner that could minimize the impact of the *Deprizio* holding.

Deprizio involved the following three categories of obligations incurred by the debtor:

- (1) secured and unsecured notes held by a variety of commercial lenders, all of which had either been guaranteed by the company president and other insiders or had been co-signed by the company president;
- (2) obligations to contribute to pension and welfare funds for the company's employees, including notes in favor of the funds that were co-signed by the company's president; and
- (3) obligations to the United States in respect of federal withholding tax payments.

The trustee sought to recover from the lenders, the pension and welfare funds and the United States payments made by the debtor more than 90 days but prior to one year before filing. The bankruptcy court held for the creditors, disallowing recovery,ⁿ⁵ but the district court reversed.ⁿ⁶ The Seventh Circuit held that the trustee could not recover the disputed payments to the funds or to the United States, but could recover the payments made to the lenders.

The two critical issues in *Deprizio* were: (1) did any of the transfers constitute a preference under *section 547 of the Code*?, and (2) if so, did *section 550 of the Code* permit the trustee to recover such payments from the party receiving

the payment?

Section 547(b) authorizes the trustee to avoid, as a preference, any payment made by the debtor "to or for the benefit of a creditor" who is an "insider" if such payment is made between 90 days and one year before the date of filing, provided that the debtor is then insolvent, the payment is made on account of an antecedent debt, the transfer enabled the creditor to receive more than it would receive in a chapter 7 liquidation and certain statutory defenses are unavailable to the creditor.ⁿ⁷ In *Deprizio*, the debtor's president who had guaranteed obligations to the lenders and who had co-signed certain notes to the funds clearly qualified as an "insider." The term "insider," as defined in the Code, includes a director, officer or person in control of the debtor, a relative of such officials and a corporate affiliate of the debtor.ⁿ⁸ In addressing the question of whether any of the payments were for the "benefit" of the insider, the court concluded that:

- (1) Repayments to the lenders were for the "benefit" of the insider because such payments diminished the insider's liability under his guarantees;
- (2) The payments to the funds were for the "benefit" of the insider only with respect to those notes to the funds that were co-signed by the insider (the court, for purposes of its analysis, treated these co-signed notes to the funds in the same manner as the obligations to the lenders); and
- (3) Payments of federal withholding taxes by the debtor company were for the "benefit" of the insider because *section 6672(a) of the Internal Revenue Code* provides that corporate officers may be personally liable for unpaid corporate withholding taxes.

However, for the one-year insider preference period to apply, not only must the payment by the debtor "benefit" an insider but the insider must be determined to be a "creditor" of the debtor with respect to such payment. The Code defines a "creditor" as "an entity that has a claim against the debtor."ⁿ⁹ and "claim" is broadly defined as "a right to payment, whether or not such right is ... liquidated, unliquidated, fixed, contingent, matured [or] unmatured ...".ⁿ¹⁰ Because an insider who is personally liable for corporate withholding taxes has no right, either under the Internal Revenue Code or at common law, to recover such amounts from the debtor company, the court concluded that the insider had no "claim" against the debtor in connection with the withholding tax obligations. Therefore, the insider was not a "creditor" with respect to the payments made by the debtor to the United States, and any such payments made during the expanded preference period were not avoidable by the trustee under section 547. However, because the insider would have a subrogation claim against the debtor were he required to honor his guarantee in favor of the lenders, the court concluded that the insider had a "claim" (albeit a contingent one) against the debtor and, therefore, was a "creditor" with respect to the debtor's obligations to the lenders.

Having determined that the payments to the lenders within the one year insider preference period were avoidable by the trustee, the court then addressed the critical issue of whether such repayments were recoverable not only from the insider but from the noninsider lenders.ⁿ¹¹ Section 550(a)(1) provides:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property from--

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made[.]

Prior to the Seventh Circuit decision in *Deprizio*, a number of courts had held that payments by a debtor company in respect of obligations guaranteed by an insider constituted two "transfers" under the Code, one directly to the lender and the other indirectly to the insider in reduction of his guaranty liability.ⁿ¹² These cases concluded that the one-year preference period applied only to the indirect "transfer" to the insider and not to the direct transfer to the lender. In

addition, various commentators have maintained that the Code requires "linkage" between sections 547 and 550, meaning that the "initial transferee" from whom recovery is permitted under section 550 can only be the transferee (in *Deprizio*, the insider) with respect to whom the transfer was preferential under section 547.ⁿ¹³

The court in *Deprizio* rejected both the "two-transfers" and "linkage" arguments. It instead adopted a literal reading of the statute and concluded that section 550(a)(1), which provides for recovery from the "initial transferee," gives the trustee the right to recover a payment that "benefits" an insider and that is made within the one year insider preference period *either* from the insider itself *or* from the recipient of the payment, the initial transferee. Thus, the court held that payments made by the debtor to the lenders between 90 days and one year prior to the debtor's filing were subject to recovery by the trustee from the lenders, although the lenders were not insiders and appeared to have acted in good faith.

Because of substantial criticism of the result in *Deprizio*, Congress first sought to address the problem by amending section 550 pursuant to the Bankruptcy Reform Act of 1994 by adding section (c), which reads as follows:

- (c) If a transfer made between 90 days and one year before the filing of the petition--
 - (1) is avoided under section 547(b) of this title; and
 - (2) was made for the benefit of a creditor that at the time of such transfer was an insider;
 the trustee may not recover under subsection (a) from a transferee that is not an insider.ⁿ¹⁴

The legislative history of that provision indicated that the amendment to section 550 was intended to "overrule [] the *Deprizio* line of cases and clarif [y] that non-insider transferees should not be subject to the preference provisions of the Bankruptcy Code beyond the 90-day statutory period."^{n14a} The legislative solution--amending *section 550 of the Code*--appeared to resolve the standard *Deprizio* scenario of a transfer to a lender of property made more than 90 days before the petition date in respect of indebtedness guaranteed by an insider. Nevertheless, despite this congressional intent to remove non-insiders from the effect of preference provisions generally, the drafting solution by its terms only curtailed the trustee's ability to recover property from the non-insider under section 550 and does not affect the ability of a trustee to avoid a transfer under section 547 to the extent the transfer was for the benefit of an insider.

One example that suggested the continued relevance of *Deprizio* is the case of a lien granted to a non-insider beyond the 90-day period to secure an antecedent debt that is guarantied by an insider. Because the grant of a lien constitutes "a transfer of an interest of the debtor in property" which, under the *Deprizio* analysis, is "for the benefit of" the insider guarantor, the lien granted by the noninsider is avoidable by the trustee under section 547. In turn, the effect of such avoidance (or, put another way, the remedy of the trustee for such avoidance) is covered by section 551, which states, in relevant part that "[a]ny transfer avoided under section ... 547 of this title ... is preserved for the benefit of the estate."^{n14b} Thus, this legislative solution to *Deprizio*--amending section 550--did not by its terms affect the ability of a trustee to avoid for the benefit of the estate pursuant to section 551 a lender's lien under the scenario just described. In addition to this example, it is possible that future court decisions and fact patterns will reveal other scenarios in which a non-insider is adversely affected by the avoidance of a transfer under section 547 notwithstanding the curtailment of the trustee's remedy under section 550.^{n14c}

In the scenario described above, it is questionable whether a court would override the implications of section 551 in light of the legislative history, which appears to evidence a congressional intent to protect non-insiders from all adverse affects of the *Deprizio* line of cases. On the other hand, the United States Supreme Court has stated that when interpreting the Bankruptcy Code, courts should follow the unambiguous language of the statute and not resort to legislative history "except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters."^{n14d} It is arguable that using the *Deprizio* analysis under any

scenario to penalize non-insider creditors, even when such analysis is compelled by the language of the statute, causes such a result. Therefore, a court might seek to further the legislative intent by holding that transfers outside the 90-day period cannot be avoided with respect to non-insiders. In fact, one bankruptcy court case has specifically held that the amendment to 550(c) did not override the trustee's right to avoid under the preference statute a lien granted to a noninsider outside the 90 day period which benefited an insider guarantor.^{n14e} In any case, it is clear that notwithstanding the Bankruptcy Reform Act of 1994, *Deprizio* may continue to raise concerns, particularly in the context of liens to secure antecedent debt granted during the insider preference period because of the trustee's ability to use the provisions of section 547 or 548 and 551, rather than the remedy in *section 550 of the Bankruptcy Code*.

Because of the uncertainty of the effect of the amendments to section 550 in 1994 on the *Deprizio* issues, Congress intended to address the problem more directly in the 2005 Act by amending the preference avoidance provision itself, section 547, by adding a new subsection (i), which provides:

(i) If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.^{n14f}

There is no ambiguity that the legislative intent of this provision was to fully protect noninsiders from possible adverse effects of a preferential transfer to an insider and that Congress recognized in 2005 the deficiency of its attempted remediation in 1994. As noted in the House Report accompanying the 2005 Act:

Section 547 of the Bankruptcy Code authorizes a trustee to avoid a preferential payment made to a creditor by a debtor within 90 days of filing, whether the creditor is an insider or an outsider. To address the concern that a corporate insider (such as an officer or director who is a creditor of his or her own corporation) has an unfair advantage over outside creditors, section 547 also authorizes a trustee to avoid a preferential payment made to an insider creditor between 90 days and one year before filing. Several recent cases, including *DePrizio*, allowed the trustee to "reach-back" and avoid a transfer to a noninsider creditor made within the 90-day to one-year time frame if an insider benefited from the transfer in some way. This had the effect of discouraging lenders from obtaining loan guarantees, lest transfers to the lender be vulnerable to recapture by reason of the debtor's insider relationship with the loan guarantor. Section 202 of the Bankruptcy Reform Act of 1994 addressed the *DePrizio* problem by inserting a new section 550(c) into the Bankruptcy Code to prevent avoidance or recovery from a noninsider creditor during the 90-day to one-year period even though the transfer to the noninsider benefited an insider creditor. The 1994 amendments, however, failed to make a corresponding amendment to section 547, which deals with the avoidance of preferential transfers. As a result, a trustee could still utilize section 547 to avoid a preferential lien given to a noninsider bank, more than 90 days but less than one year before bankruptcy, if the transfer benefited an insider guarantor of the debtor's debt. Accordingly, section 1213 of the Act makes a perfecting amendment to section 547 to provide that if the trustee avoids a transfer given by the debtor to a noninsider for the benefit of an insider creditor between 90 days and one year before filing, that avoidance is valid only with respect to the insider creditor. Thus both the previous amendment to section 550 and the perfecting amendment to section 547 protect the noninsider from the avoiding powers of the trustee exercised with respect to transfers made during the 90-day to one year pre-filing period. This provision is intended to apply to any case, including any adversary proceeding, that is pending or commenced on or after the date of enactment of this Act.^{n14g}

The authors of this volume believe that the combination of the amendments to section 550 pursuant to the Bankruptcy Reform Act of 1994 and the new subsection 547(i) pursuant to the 2005 Act should eliminate most, if not virtually all, potential issues facing noninsider creditors with respect to the potential avoidance, as against such noninsider, of greater

than 90-day transfers. Nonetheless, the complexity of the *Deprizio* analysis lends itself to possible unintended consequences and it remains to be seen, at the time of the latest update to this volume, if these legislative solutions will be completely effective or whether new fact patterns will develop that warrant further attention and concern.

One important issue left unclear by *Deprizio*, and still important notwithstanding the Bankruptcy Reform Act of 1994 and the 2005 Act, is whether a lender may raise its own defenses under section 547(b) and (c) to defeat a trustee's attempt to recover payments made to the lender during the expanded preference period. In *dictum*, the court noted:

- (1) Payments made during the expanded preference period to a fully secured creditor on account of insider-guaranteed indebtedness would not be avoidable by the trustee since "under § 547(b)(5) a transfer is avoidable only to the extent the creditor received more than it would have in a Chapter 7 liquidation";ⁿ¹⁵ and
- (2) Lenders could raise the "payment in the ordinary course of business" defense under section 547(c)(2) in opposition to the trustee's efforts to recover loan repayments.ⁿ¹⁶

However, since the court in *Deprizio* concluded that the "creditor" referred to in section 547(b)(1) was the insider, it would seem that the provisions of section 547 setting forth defenses of the "creditor" or "such creditor" are referring to defenses applicable to the insider, not the lender. It should also be noted that *Deprizio* expressly held that the lender's most apparent section 547 defense (i.e., that the lender was not an insider and that, therefore, the 90-day preference period, and not the one-year period, applies) was unavailable to the lender. Given the inconsistency between the court's *dictum* and its holding, in situations where the case is still of concern, notwithstanding the Bankruptcy Reform Act of 1994, it is uncertain whether a lender may raise its own section 547 defenses in circumstances such as those in *Deprizio*. It would appear, at the very least, that *Deprizio* entitles the lender to raise any section 547 defenses that are applicable to the insider (for example, if the insider gave contemporaneous "new value" to the debtor company in exchange for the debtor company's grant of a lien in respect of the guaranteed debt).

Although, as noted, the adverse affect has been substantially diminished, if eliminated, by the amendments to section 550 by the Bankruptcy Reform Act of 1994 and the amendments to section 547 by the 2005 Act, the holding in *Deprizio* continues to raise a number of concerns about its applicability to other types of financing transactions.

Deprizio's express rejection of the "two transfer" analysis raises the concern that collateral granted by a debtor/account party to a bank issuing a letter of credit in favor of a creditor of the debtor may be recoverable from the issuer bank if the letter of credit is deemed to be a preference in favor of the creditor/beneficiary. In *In re Compton Corp.*,ⁿ¹⁷ the court adopted the "two transfer" approach and held that the grant of collateral to the issuing bank was a preferential transfer to the letter of credit beneficiary and recoverable only from such beneficiary, but not from the bank. However, the analysis in *Deprizio* at least suggests the possibility of initial transferee exposure for the letter of credit issuer if the letter of credit is preferential as between the debtor/account party and the creditor/beneficiary. To the extent that the transfer took place within the 90 day noninsider window, the amendment to section 550 by the Bankruptcy Reform Act of 1994 and the amendments to section 547 by the 2005 Act do not, of course, mitigate this risk.

The *Deprizio* holding also raises a question about the avoidability of payments or transfers made by a general partnership to a lender on account of recourse indebtedness within the one year insider preference period. Since general partners, who are "insiders" under the Code, are jointly and severally liable for partnership obligations and thereby benefit from the partnership's payments or other transfers in respect of recourse partnership obligations, *Deprizio* suggests that such payments or transfers made within the one-year period may be subject to avoidance by the trustee. This same concern would also apply to loans involving a co-maker, co-signer or other accommodation party who is an insider.

Deprizio also suggests another context in which a trustee may argue that the expanded preference period is applicable: payments made by a debtor to a fully secured creditor when the collateral is also subject to the lien of a junior creditor whose debt is guaranteed by an insider. This structure is common in real estate transactions in which a seller provides purchase money financing secured by a subordinate mortgage on the transferred property. In *Deprizio*, the trustee argued that payments made to a noninsider senior creditor within the expanded one-year period should be recoverable from the senior creditor since such payments increased the collateral available to the junior creditor and thereby benefited the insider/guarantor. The court expressed doubt that, on remand, the trustee could recover from the senior creditor, since as a fully secured creditor it would have been paid in full in a chapter 7 liquidation, thereby disqualifying the payment as a preference pursuant to section 547(b)(5)(A).¹⁸ However, as discussed above, this *dictum* is inconsistent with other aspects of the court's analysis. *Deprizio* would appear to support an argument by a trustee that payments made within the one year preference period that benefit an insider/guarantor, however indirectly, are recoverable from the senior lender, as the "initial transferee."

In light of *Deprizio*, and the possibility of its continued viability in certain situations, the following measures may help lenders reduce exposure to the one year preference period in cases in which insider guarantees are obtained.

[1] Waiver of Claims by the Guarantor Against the Debtor Company

Section 547 requires that, for the expanded preference period to apply with respect to a transfer, the transfer must be for the benefit of a "creditor" who is an insider. *Deprizio* holds that an insider guarantor has a "claim" against the debtor, and is therefore a "creditor" of the debtor with respect to the guaranteed obligations, due to the guarantor's contingent right of subrogation against the debtor in the event that the guarantor is required to perform under his guaranty. In *Deprizio*, the absence of any subrogation or reimbursement right of the insider against the debtor for federal withholding taxes for which the insider could be liable led the court to conclude that the insider was not a "creditor" with respect to withholding tax payments made by the debtor to the United States. Therefore, an express waiver by the guarantor of his rights against the debtor of reimbursement, contribution, indemnification and all other claims arising from the guaranteed indebtedness would appear to remove the guarantor from the "creditor" category and defeat the trustee's claim for an expanded preference period with respect to payments of the guaranteed debt.

It has been suggested that a waiver of claims may be of questionable effectiveness for the following reasons:

- (1) Courts may conclude that the waiver is not motivated by any business purpose other than avoidance of *Deprizio* and may, therefore, disregard it;¹⁹
- (2) The insider may remain a "creditor" due to other claims that the insider has against the debtor;²⁰
- (3) The courts may be concerned that the waiver, from a policy standpoint, actually increases the insider's motivation to cause the debtor to repay the guaranteed creditor, since the insider has no recourse against the debtor if the guaranty is called;²¹
- (4) The waiver enables the lender to require the guarantor to make effectively a capital contribution to the debtor, and this increased influence over the insider could result in courts attributing "insider" status to the lender itself;²²
- (5) Elimination of the right of subrogation and other claims may create an increased duty of the lender to the guarantor;²³ and
- (6) The waiver could result in repayments made by the debtor to the lender being classified as a fraudulent conveyance.

The fraudulent conveyance risk created by the waiver has been expressed as follows:²⁴

- (1) The insider-guaranteed loan (without a waiver of claims) can be recharacterized as a loan from the lender to the insider, who has re-loaned the proceeds to the debtor company and has pledged the corporate note to the lender to secure the lender's loan to the insider;
- (2) The substance of the guaranteed loan structure (without a waiver of claims) and the sequential loan structure described above are the same: the lender has recourse against both the debtor company and the insider, the insider is liable to the lender but has recourse against the debtor company and the debtor company is ultimately liable for the obligation to the lender;
- (3) If a waiver of claims is added as an element to the recharacterized transaction, the insider is agreeing to remain primarily liable to the lender but is releasing the debtor company from any obligation to repay the loan proceeds advanced by the insider to the debtor company, and the proceeds, in effect, become a capital contribution from the insider to the debtor company; and
- (4) If, notwithstanding the waiver/release granted to the debtor by the insider, the debtor elects to repay the lender, this repayment should be recharacterized as a dividend or stock redemption by the debtor to the insider without fair consideration (and, therefore, subject to a fraudulent conveyance attack), followed by a repayment by the insider to the lender.

However, in response to the foregoing concerns about the effectiveness of the waiver of claims, the lender could argue as follows:

- (1) The parties are free to contract as they wish, and guarantees customarily contain a number of waivers that are generally believed to be enforceable;
- (2) The holding in *Deprizio* strongly implies that the expanded preference period only applies to payments if the insider is a "creditor" with respect to such specific payments;
- (3) Policy considerations, although discussed in *dictum* in *Deprizio*, were secondary to the court's literal approach to statutory interpretation;
- (4) Attributing "insider" status to a lender due to the existence of a waiver of claims is not supported by the Code and is no more compelling than designating a lender as an "insider" due to the existence of financial covenants in a loan agreement; and
- (5) The lender should have no increased duty to the guarantor arising from the waiver since various waivers are customary in guarantees and are supported by fair consideration (i.e., the lender's agreement to make the loan to the debtor company).

With respect to the argument that the waiver of claims gives rise to a fraudulent conveyance risk, it should be noted:

- (1) No court has yet endorsed this view, although *Deprizio* and its progeny are evidence of the dangers of proceeding without a waiver of claims;
- (2) The fraudulent conveyance analysis rests on the questionable proposition that payment by the debtor to the lender is a transfer to the insider *without consideration* if the insider has waived its claims, but such payment is supported by fair consideration if the insider retains its claims; and

(3) If recharacterization of the guaranteed loan as two sequential loans is necessary to the fraudulent conveyance analysis, any payment by the debtor company to the bank should similarly be recharacterized as dividend or stock redemption proceeds paid by the debtor to the insider, which proceeds are then deemed to be paid by the insider to the lender; the lender thereby becomes a "subsequent transferee" who is eligible to claim section 550(a)(2) and (b) defenses, an improvement from the situation in *Deprizio* in which the lender was held to be the "initial transferee."

Although requiring a waiver of subrogation clearly involves some risk and is not an absolute panacea, *Deprizio* appears to mandate a one-year preference period with respect to payments and other transfers on the guaranteed debt if the waiver is not obtained. Subject to further developments in the case law, it appears that requiring the waiver of subrogation is the better approach.

[2] Sequential Loans

In an effort to obtain protection as a subsequent transferee under section 550(a)(2) and (b), the transaction could be expressly structured as a loan to the insider, who would then re-loan the proceeds to the debtor. Repayments would be made by the debtor to the insider and then by the insider to the lender. The lender could argue that, notwithstanding the preferential nature of the repayments from the debtor to the insider, the lender is a subsequent transferee under section 550(a)(2) and is thereby insulated from preference attack. The principal problem with this structure is that section 550(b) protects only subsequent transferees who take for value in good faith. The fact that the lender may appear to have created the sequential loan structure expressly to avoid the *Deprizio* result could undermine its status as a "good faith" subsequent transferee.

[3] Cost-Benefit Analysis

The lender should seriously weigh the economic benefits of the guaranty and the financial strength of the guarantor against the increased preference risk that the guaranty may create, and should not simply require an insider guaranty as a matter of course. If a guaranty is taken but later diminishes in value due to an adverse change in the guarantor's financial circumstances, the lender should consider releasing the guarantor in order to protect subsequent transfers from preference attack.

[4] Terms of Insider Guaranty

If an insider guaranty is obtained, it should:

- (1) contain an indemnity by the guarantor in favor of the lender for any amounts paid by the debtor that are recovered from the lender as a preference (confirming a general rule of surety law); and
- (2) provide that the guaranty and any lien securing the guaranty will not be released until one year has passed after the debtor's final payment without a bankruptcy filing by the debtor having occurred.

[5] Guard Against Outside Guarantor Becoming Insider

The lender should be alert for any change in circumstances which would result in an outside guarantor becoming an insider.

[6] Partial Guaranty

The lender should consider limiting any insider guaranty to a portion of the principal debt, so that repayments by the debtor of amounts not covered by the guaranty would not create a "benefit" to the insider and thus may be exempt from the expanded preference period.

[7] Maintain Fully Secured Position

The court's *dictum* in *Deprizio* suggests that a lender that maintains a fully secured position would not be subject to the expanded preference period on the grounds that repayments by the debtor would not enable the lender to receive more than it would receive in a chapter 7 proceeding. However, lenders should be wary of this analysis because:

- (1) It appears to be at odds with the court's conclusion that the insider is the "creditor" referred to in section 547(b)(1); and
- (2) The existence of subordinate financing backed by an insider guaranty may place even a fully secured lender at risk during the insider preference period.ⁿ²⁵

The lender should carefully monitor the value of the collateral during the term of the loan to determine whether its fully secured status has changed.

[8] Limitations on Subordinate Financing

A senior, fully secured lender should be wary of consenting to subordinate financing which provides for an insider guaranty, since a trustee could argue (as it did in *Deprizio*) that the one-year preference period applies because payments or other transfers, such as a grant of a lien, made to the senior lender expand the collateral available to the junior lender and thereby benefit the insider/guarantor. If subordinate financing is permitted, the senior lender should:

- (1) provide in the senior loan documents that the collateral secures any claim of the senior lender resulting from a recovery of payments made to such lender due to a successful preference attack;
- (2) provide in the senior loan documents that its lien is effective until the one-year period after final payment has passed without a bankruptcy filing by the debtor; and
- (3) require an indemnity from the subordinate lender and the insider guarantor for any losses incurred by the senior lender due to a successful preference attack by the trustee.

FOOTNOTES:

(n1)Footnote 1. 874 F.2d 1186, 22 C.B.C.2d 36 (7th Cir. 1989) .

(n2)Footnote 2. See, e.g., *Rubin Bros. Footwear, Inc. v. Chemical Bank*, 119 B.R. 416, 425 (S.D.N.Y. 1990) .

(n3)Footnote 3. See, e.g., Alces, *The Law of Fraudulent Transactions*, § 16.02(2)(a) (1989 & Supp. 1990); Blumberg, *The Law of Corporate Groups: Bankruptcy Law*, § 9.03 (1985 & Supp. 1989); Boshkoff, *Insider Guarantees and Preference Liability*, Norton Bankr. L. Adv. 1 (No. 3, 1985); Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1) and 546(a)(1)*, 41 Bus. Law. 175, 186-99 (1985); Pitts, *Insider Guarantees and the Law of Preferences*, 55 Am. Bankr. L.J. 343 (1981).

(n4)Footnote 4. See, e.g., *In re Wesley Indus.*, 30 F.3d 1438, 31 C.B.C.2d 1160 (11th Cir. 1994) ; *Official Unsecured Creditors Comm. v. United States Nat'l Bank (In re Suffola, Inc.)*, 2 F.3d 977 (9th Cir. 1993) ; *In re T.B. Westex Foods, Inc.*, 950 F.2d 1187, 26 C.B.C.2d 682 (5th Cir. 1992) ; *In re Robinson Bros. Drilling*, 892 F.2d 850 (10th Cir. 1989) , *aff'g In re Robinson Bros. Drilling, Inc.*, 97 B.R. 77 (W.D. Okla. 1988) ; *In re C-L Cartage Co.*, 899 F.2d 1490 (6th Cir. 1990) , *rev'g* No. 1-87-190 (E.D. Tenn., March 25, 1988), *aff'g* 16 C.B.C.2d 766, 70 B.R. 928 (Bankr. E.D. Tenn. 1987) .

(n5)Footnote 5. *Levit v. Melrose Park Nat'l Bank (In re V.N. Deprizio Constr. Co.)*, 58 B.R. 478 (Bankr. N.D. Ill. 1986) .

(n6)Footnote 6. *Levit v. Ingersoll Rand Fin. Corp.*, 86 B.R. 545 (N.D. Ill. 1988) .

(n7)Footnote 7. 11 U.S.C. § 547(b).

(n8)Footnote 8. 11 U.S.C. § 101(31).

(n9)Footnote 9. 11 U.S.C. § 101(9)(A).

(n10)Footnote 10. 11 U.S.C. § 101(5)(A).

(n11)Footnote 11. It is well established that the trustee may recover from the *insider guarantor* preferential payments made during the expanded preference period by the debtor to noninsider lenders on account of the guaranteed debt. *See, e.g., In re R.A. Beck Builder*, 34 B.R. 888, 892 (Bankr. W.D. Pa. 1983) .

(n12)Footnote 12. *See, e.g., Goldberger v. Davis Jay Corrugated Box Corp. (In re Mercon Indus. Inc.)*, 37 B.R. 549 (Bankr. E.D. Pa. 1984) .

(n13)Footnote 13. *See, e.g., Hertzberg, Insider Guarantees and Preference Liability--A Response to Professor Boshkoff*, Norton Bankr. L. Advisor 7, 8-9 (No. 3, 1986); Note, *The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code* , 89 Colum. L. Rev. 530, 541-49 (1989).

(n14)Footnote 14. 11 U.S.C. § 550(c), added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n15)Footnote 14a. H.R. Rep. No. 103-835, 103rd Cong., 2nd Sess. 44-45 (1994), *reprinted in* App. Vol. 4 Collier on Bankruptcy, Part XLI (Matthew Bender 15th ed.).

(n16)Footnote 14b. 11 U.S.C. § 551.

(n17)Footnote 14c. *See Glanz v. RJF Int'l Corp. (In re Glanz)*, 205 B.R. 750 (Bankr. D. Md. 1997) , holding that avoidance under section 544(a) of a subordinate interest in real property provides complete relief without reference to section 550 of the Code. *But see Weaver v. Aquila Energy Mktg. Corp.*, 196 B.R. 945, 954-55 (S.D. Tex. 1996) (benefit to estate under section 550(a) is a required element in all avoidance actions).

(n18)Footnote 14d. *United States v. Ron Pair Enters.*, 489 U.S. 235, 242, 109 S. Ct. 1026, 1031, 103 L. Ed. 2d 290, 299, 20 C.B.C.2d 267, 272 (1989) .

(n19)Footnote 14e. *In re Williams*, 234 B.R. 201 (Bankr. D. Or 1999) .

(n20)Footnote 14f. 11 U.S.C. § 547(i), added by Pub. L. No. 109-8, § 1213 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n21)Footnote 14g. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), at 10-422 (Matthew Bender 15th Ed. Revised).

(n22)Footnote 15. *Levit v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio)*, 874 F.2d 1186, 1199-1200 .

(n23)Footnote 16. 874 F.2d 1186, 1200 .

(n24)Footnote 17. *In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987) , *modified on other grounds*, 835 F.2d 584, 18 C.B.C.2d 273 (1988) ; *see also In re Air Conditioning, Inc.*, 845 F.2d 293 (11th Cir.) , *cert. denied*, 488 U.S. 993, 109 S. Ct. 557, 102 L. Ed. 2d 584 (1988) (endorsing the *Compton* holding).

(n25)Footnote 18. *Levit v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio)*, 874 F.2d 1186, 1200 (7th Cir. 1989) .

(n26)Footnote 19. Katzen, *Deprizio and The Bankruptcy Code Section 550: Extended Preference Exposure via Insider Guarantees and Other Perils of Transferee Liability*, 45 *Bus. Law.* 511, 530-31 (1990).

(n27)Footnote 20. Baker, *Repayments of Loans Guaranteed by Insiders as Avoidable Preferences in Bankruptcy: Deprizio and its Aftermath*, 23 *U.C.C.L.J.* 115, 145-46 (1990).

(n28)Footnote 21. Borowitz, *Waiving Subrogation Rights and Conjuring Demons in Response to Deprizio*, 45 *Bus. Law.* 2151, 2156 (1990).

(n29)Footnote 22. Katzen, *Deprizio and The Bankruptcy Code Section 550: Extended Preference Exposure via Insider Guarantees and Other Perils of Transferee Liability*, 45 *Bus. Law.* 511 (1990).

(n30)Footnote 23. Preble, *Insider Guarantees and Real Estate Loans: Implications of Deprizio*, *Real Estate Financing Newsletter*, ABA Section of Real Property, Probate and Trust Law (Group I--Commercial Financing) (November 1, 1990).

(n31)Footnote 24. Borowitz, *Waiving Subrogation Rights and Conjuring Demons in Response to Deprizio*, 45 *Bus. Law.* 2151, 2158-65 (1990).

(n32)Footnote 25. See P 2.08[8] *supra*.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code §§ 2.09 through 2.50

[Reserved]



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.51

P 2.51 Form--Proof of Claim of Creditor Bank Company

Form--Proof of Claim of Creditor Bank Company.

Editors' Note:

This should be an annex to Official Form 10.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	)	
<i>In re</i>	)	In a Proceeding for Reorganization Under Chapter 11
DOE OPERATIONS, INC.,	)	Case No.:
<i>Debtor.</i>	)	
	)	

Annex to Proof of Claim of Creditor Bank Company

1. Creditor Bank Company, as Mortgagee under that certain indenture of mortgage dated as of November 4, 1999, executed by Doe Realty Corp. ("Doe Realty") (such indenture being hereinafter referred to as the "Mortgage") is the claimant herein and is hereinafter referred to as "Claimant." Claimant is a banking corporation having its principal place of business at Ralph Smith resides at He is Vice President of Claimant and is duly authorized to make this Proof of Claim on its behalf.

2. Doe Operations, Inc., the above-named debtor (hereinafter called "Debtor"), is liable to Claimant in the amount of \$7,772,126.51.

3. This claim arises from the considerations set forth in:

- a) a certain lease agreement dated as of November 4, 1999 (the "Lease"), pursuant to which Doe Realty leased to the Debtor certain real property known as 3000 East 81st Street, in the City and State of New York (the "Premises");
- b) a certain Assignment of Lease dated as of November 4, 1999 from Doe Realty to Claimant (the "Assignment");
- c) a certain security agreement dated as of November 4, 1999 between Doe Realty and Claimant (the "Security Agreement"); and
- d) the Mortgage.

True and correct copies of each of the Lease, the Assignment, the Security Agreement and the Mortgage are annexed hereto as Exhibits "A," "B," "C" and "D," respectively.

4. The claim arises from:

- a) the Debtor's failure to pay and perform its obligations under the Lease prior to November 10, 2002, the date on which the Debtor commenced a case under chapter 11 of the Bankruptcy Code;
- b) the Debtor's failure, as debtor in possession, to pay and perform its obligations under the Lease from November 10, 2002 through December 31, 2002; and
- c) the rejection of the Lease by the Debtor on December 31, 2002.

An itemization of the elements of the Debtor's liability to the Claimant is attached hereto as Exhibit "E." The portion of the Debtor's unpaid obligations arising under the Lease from and including November 10, 2002 through December 31, 2002, the date of the rejection of the Lease, is entitled to priority pursuant to *Section 365(d)(3) of the Bankruptcy Code*.

5. No judgment has been rendered on this claim.

6. The amount of all payments on this claim has been credited and deducted for the purpose of making this Proof of Claim.

7. This claim is not subject to any setoff or counterclaim.

8. Claimant does not hold as security for said debts an interest in property of the Debtor's estate.

9. Claimant reserves the right to amend or supplement this Proof of Claim from time to time hereafter as it may deem necessary or proper.

10. This proof of claim is filed under compulsion of the bar date set in this case and is filed to protect Claimant from forfeiture of its claims by reason of said bar date. Filing of this proof of claim is not and should not be construed to be: (a) a waiver or release of Claimant's rights against any other entity or person, including, without limitation, Doe Realty, liable for all or part of any claim described herein; (b) a waiver of the right to withdraw the reference with respect to the subject matter of these claims, any objection or other proceedings commenced with respect thereto or any other proceedings commenced in this case against or otherwise involving Claimant; (c) a waiver of any right to the subordination, in favor of Claimant, of indebtedness or liens held by creditors of the Debtor or affiliated debtors; or (d) an election of remedy which waives or otherwise affects any other remedy of Claimant.

Dated:, 20

CREDITOR BANK COMPANY

By.....
 Ralph Smith
 Vice President

EXHIBIT A

[Attach Copy of Lease]

EXHIBIT B

[Attach Copy of Assignment]

EXHIBIT C

[Attach Copy of Security Agreement]

EXHIBIT D

[Attach Copy of Mortgage]

EXHIBIT E--Itemization of Claim

1. Liability arising from Debtor's failure to perform its obligations under the Lease prior to November 10, 2002, consisting of:

a) basic rent, due on January 31, 2002 and on the last day of each month thereafter to and including October 31, 2002	\$ 759,461.42
b) interest on basic rent	\$ 11,628.42
c) basic rent liability incurred from November 1, 2002 to November 10, 2002	\$ 25,315.38
d) additional rent, consisting of unpaid real estate taxes and assessments, exclusive of interest and penalties thereon	\$1,181,195.61
e) expenses of Claimant	\$ 1,000.00
TOTAL PREPETITION CLAIM	\$1,978,600.83

2. Liability entitled to priority under *section 365(d)(3) of the Bankruptcy Code*, by reason of the use and occupation of the Premises by Debtor from November 10, 2002 through December 31, 2002, at \$256,350.68 for one month and twenty days (based on basic rent of \$911,353 per annum, together with additional rent of \$934,372, consisting of unpaid real estate taxes and assessments, exclusive of interest and penalties thereon).

TOTAL PRIORITY CLAIM \$256,350.68

3. Damages arising out of the rejection of the Lease on December 31, 2002, in the amount of \$5,537,175.00, representing Claimant's damages as limited by *11 U.S.C. § 502(b)(6)*, which is the rent and additional rent reserved in the Lease for the next three years following November 10, 2002, the date on which Debtor filed its petition herein.

TOTAL PREPETITION CLAIM	\$1,978,600.83
TOTAL PRIORITY CLAIM	\$ 256,350.68
TOTAL REJECTION DAMAGE CLAIM	\$5,537,175.00
TOTAL CLAIM	\$7,772,126.51

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.52

P 2.52 Form--Notice of Motion and Application for Termination of Automatic Stay and Other Relief (S.D.N.Y.)

Form--Notice of Motion and Application for Termination of Automatic Stay and Other Relief (S.D.N.Y.).

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

_____	)	
<i>In re</i>	)	
DOE REALTY CORP., <i>et al.</i>	)	Case Nos. 02-(.....)
<i>Debtors.</i>	)	(Jointly Administered)
	)	

**HEARING ON MOTION FOR RELIEF FROM
THE AUTOMATIC STAY AND RELATED RELIEFⁿ¹**

please take notice, that upon the annexed motion ("Motion") of Creditor Bank Company ("Creditor"), the undersigned will move this Court before the Honorable, United States Bankruptcy Judge, in Room of the United States Bankruptcy Court for the Southern District of New York, Alexander Hamilton Custom House, One Bowling Green, New York, New York, on, 20 ..., at 10:00 a.m. prevailing Eastern Time, or as soon thereafter as counsel can be heard, for an order, pursuant to *Rule 9014* of the Bankruptcy Rules and *Bankruptcy Code* § 362(d), (1) terminating and annulling the automatic stay in effect in the within proceeding under *Bankruptcy Code* § 362(a), to the extent required to permit Creditor to proceed with an action against Doe Realty Corp. to foreclose a mortgage on certain real property located in the City and State of New York (the "Mortgaged Premises"); (2) permanently enjoining Doe Realty Corp., as Debtor and debtor in possession (collectively: "Debtor") from interfering with Creditor's exercise of its rights and remedies under such mortgage; (3) permanently enjoining Debtor from using any earnings, revenues, rents, issues, profits and income heretofore or hereafter received by it in respect of the Mortgaged Premises, requiring Debtor to segregate and account for such funds and further requiring Debtor to provide Creditor with adequate protection to the extent that any previous unauthorized use of such funds has resulted in a decrease of the value of Creditor's interest therein; and (4) granting to Creditor such other and further relief as the Court

deems just and proper.

PLEASE TAKE FURTHER NOTICE that any responses or objections to the Motion must be in writing, shall conform to the Federal Rules of Bankruptcy Procedure and the Local Rules of the Bankruptcy Court, and shall be filed with the Bankruptcy Court electronically in accordance with General Order M-182 (General Order M-182 and the User's Manual for the Electronic Case Filing System can be found at <http://www.nysb.uscourts.gov>, the official website for the Bankruptcy Court), by registered users of the Bankruptcy Court's case filing system and, by all other parties in interest, on a 3.5 inch disk, preferably in Portable Document Format (PDF), Wordperfect or any other Windows-based word processing format (with a hard-copy delivered directly to Chambers), and shall be served in accordance with the General Order M-182, upon (i) the Office of the United States Trustee for the Southern District of New York, 33 Whitehall Street, 21st Floor, New York, New York 10004 (Attention: Jane Smith); (ii) [attorneys for Creditor]; (iii) [attorneys for Debtor] and (iv) those parties entitled to notice pursuant to this Court's order dated, establishing notice procedures in the above-captioned case, so as to be actually received no later than, 20... at 4:00 p.m. prevailing Eastern Time.

Dated: New York, New York

....., 20....

[Attorneys for Creditor Bank Company]

By.....

A Member of the Firm

Office & Post Office Address:

Telephone Number:

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re

DOE REALTY CORP., *et al.*

Debtors.

)
)
)
)
)

Case Nos.(.....)
(Jointly Administered)

**MOTION FOR RELIEF FROM THE
AUTOMATIC STAY AND RELATED RELIEF**

to the honorable, Bankruptcy Judge.

The motion of Creditor Bank Company ("Creditor") respectfully represents:

1. This is a contested matter brought pursuant to Bankruptcy Rule 9014, and §§ 362 and 363 of the *Bankruptcy Code* for an order, *inter alia*:

a) terminating and annulling the stay imposed by *Bankruptcy Code* § 362, insofar as such stay operates to prevent Creditor from proceeding with an action against Doe Realty Corp. to foreclose a mortgage on certain real property located in the City and State of New York (the "Mortgaged Premises") and to obtain certain other relief related thereto;

b) permanently enjoining Doe Realty Corp., as Debtor and debtor in possession (collectively: "Debtor") from interfering with Creditor's enforcement of any such rights and remedies; and

c) permanently enjoining Debtor from using all earnings, revenues, rents, issues, profits and income heretofore or hereafter received by it in respect of the Mortgaged Premises (hereinafter referred to as the "Cash Collateral") and requiring it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and, further, requiring Debtor to provide Creditor with adequate protection to the extent that any previous unauthorized use by Debtor of Cash Collateral has resulted in a decrease of the value of Creditor's interest in such Cash Collateral.

Jurisdiction and Parties

2. Creditor is a banking corporation organized under the laws of the State of.....
....., having its principal place of business at

3. Debtor purports to be a corporation organized and existing under the laws of the State of New York.

4. This contested matter arises in the case of *In re Doe Realty Corp., 02 B*, a chapter 11 case pending in the United States Bankruptcy Court for the Southern District of New York.

5. Debtor is a wholly owned subsidiary of Doe Operations, Inc. ("Doe Operations"), the debtor in the case of *In re Doe Operations, Inc., 02 B*, a chapter 11 case pending in the Southern District of New York. The cases of Debtor and Doe Operations are being jointly administered by order of the Court dated, 20....

6. Jurisdiction is conferred on this Court by the provisions of 28 U.S.C. § 1334. This is a proceeding to terminate and annul the automatic stay and is a "core proceeding" within the meaning of 28 U.S.C. § 157(b)(2)(G).

7. On November 10, 2002, Debtor filed a petition (the "Petition") seeking relief under chapter 11 of the Bankruptcy Code. Pursuant to § 1108 of the Bankruptcy Code, Debtor is continuing to operate its business as debtor in possession. No examiner or trustee has been appointed in this case.

8. By virtue of the automatic stay provisions of Bankruptcy Code § 362, the filing of the Petition by Debtor operated, *inter alia*, as a stay of the continuation of any court proceeding to enforce any lien against the property of Debtor. Upon information and belief, Debtor has only three creditors all of which either hold secured claims or are entitled to the benefit of statutory liens.

9. By virtue of the automatic stay provisions of Bankruptcy Code § 362, Creditor was heretofore enjoined from proceeding with an action of foreclosure (the "Foreclosure Action") instituted in the Supreme Court of New York, New York County and entitled *Creditor Bank Company v. Doe Realty Corp., et al.*, Index No. (A Copy of the complaint initiating the Foreclosure Action is annexed hereto as Exhibit "A".) By virtue of the automatic stay and at the request of the State Court Judge, Debtor and Creditor entered into a stipulation of dismissal without prejudice of the Foreclosure Action.

Request for Relief From the Automatic Stay

10. On or about November 4, 1999, Debtor executed a "Secured Note" (the "Note") in favor of Creditor in the original principal amount of \$12,000,000 and with interest thereon at the rate of fifteen percent (15%) per annum, payable as follows: interest accrued from the date of the Note to February 1, 2000, payable on February 1, 2000, and principal and interest thereafter payable in 88 equal quarter-annual installments in the aggregate amount of \$468,349.17 each on the first day of each May, August, November, and February commencing with May 1, 2000, and continuing to and

including February 1, 2022. The Note provides that any overdue principal and, to the extent permitted by law, any overdue interest and premium, shall bear interest at the rate of sixteen percent (16%) per annum.

11. To secure payment of the Note, Debtor executed the Mortgage and thereby granted to Creditor a first and prior lien on all of its right, title, interest, and estate in and to the Mortgaged Premises and the buildings, structures, improvements, fixtures, and appurtenances then standing or thereafter to be constructed thereon, on the express condition that such Mortgage would be void if payment was made according to the terms of the Note and the Mortgage. On November 4, 1990, the Mortgage was duly recorded in the Office of the City Register of New York County. (A copy of the Mortgage is annexed hereto as Exhibit "B".)

12. The Mortgage further provides that, in case of an event of default (as defined therein) all earnings, revenues, rents, issues, profits and income from the Mortgaged Premises are thereby assigned to Creditor and that during the continuance of any such default, Creditor may enter upon and take possession of the Mortgaged Premises and collect all earnings, revenues, rents, issues, profits and income therefrom. Additionally, the Mortgage provides for the appointment of a receiver as a matter of right.

13. As additional security for the Note, Debtor assigned to Creditor its entire interest as lessor under a certain lease agreement (the "Lease") affecting the Mortgaged Premises between Debtor, as lessor, and Doe Operations, as lessee, dated as of November 4, 1999. Doe Operations is a subsidiary of Debtor. On November 4, 1999, this assignment (the "Lease Assignment") was duly recorded in the Office of the City Register of New York County. (A copy of the Lease Assignment is annexed hereto as Exhibit "C".)

14. In furtherance of the foregoing grant of security, Debtor, as debtor, and Creditor, as secured party, executed a UCC-1 Financing Statement which was duly recorded in the Office of the City Register of New York County on November 4, 1999. The Financing Statement covers: (a) all buildings, structures, improvements, fixtures, and appurtenances now standing or at any time hereafter constructed or placed upon the Mortgaged Premises; (b) Debtor's interest under the Lease; and (c) all proceeds of the conversion, voluntary or involuntary, of any of the foregoing into cash or other liquidated claims including, without limitation, proceeds of insurance and condemnation awards.

15. The Mortgaged Premises constitutes a sewing machine manufacturing facility of Doe Operations and is comprised of approximately 10 acres of land together with various improvements including a three story building. The facility has not been used in the operations of Doe Operations since the filing of the chapter 11 petition of Doe Operations.

Indebtedness; Default

16. The Mortgage provides that Creditor may declare the principal of the Note then outstanding to be immediately due and payable, with accrued interest and advances thereon, in the event, *inter alia*, the mortgagor fails to pay any installment of principal or interest and such failure continues for a period of ten days or if the mortgagor fails to observe or perform any covenant, condition, or agreement contained in the Note or the Mortgage, including nonpayment of taxes, and such failure continues for thirty days after notice thereof.

17. On May 1, 2002, August 1, 2002 and November 1, 2002, quarter-annual installment payments of principal and interest on the Note fell due and in each instance were not paid. As of the date hereof, no part of any of such installments has been paid. By virtue of the failures to make payments on each of such dates and pursuant to a notice from Creditor to Debtor, dated October 15, 2002, Creditor has declared the principal balance of \$11,863,637, together with interest and any advances thereon, to be due and payable. (A copy of the notice is annexed hereto as Exhibit "D".)

18. Debtor has further defaulted in its obligation to Creditor under the Mortgage by its repeated failure to pay real estate taxes and assessments to the City of New York, together with penalties and interest which have accrued thereon. The aggregate amount of said taxes due and owing as of the date hereof exceeds \$800,000, exclusive of accrued interest and

penalties thereon.

19. On November 2, 2002, as a result of the continuing defaults of Debtor, Creditor filed the Foreclosure Action. As heretofore set forth, after the filing of the Petition, such action was voluntarily dismissed without prejudice.

Grounds for Vacating the Stay

20. Upon information and belief, the operation of the Mortgaged Premises as a manufacturing facility was terminated on November 10, 2002 and, upon information and belief, the Mortgaged Premises--which was especially constructed for use as a sewing machine manufacturing facility by Debtor's parent-lessee Doe Operations--presently has little value as a manufacturing facility.

21. The outstanding indebtedness owing on the Note, including principal, accrued interest, reasonable collection costs, late charges and attorneys' fees is approximately \$13,000,000. Upon information and belief, outstanding tax arrearages on the Mortgaged Premises aggregate at least \$800,000, plus penalties and interest thereon. Upon information and belief, both the liquidation and fair market value of the Mortgaged Premises are substantially less than the aggregate charges against the Mortgaged Premises. Debtor therefore has no equity in the Mortgaged Premises.

22. Upon information and belief, additional claims which may be charges against the Mortgaged Premises, and which would further negate any equity in favor of Debtor (which will soon fall due or which are presently accruing), include: (i) interest that continues to accrue on unpaid taxes; (ii) interest that continues to accrue on the Note; and (iii) interest that continues to accrue on Creditor's secured claim and any other claims secured by the Mortgaged Premises pursuant to § 506 of the Bankruptcy Code. These substantial forthcoming and presently accruing charges, in addition to negating any equity in favor of Debtor, have dissipated and threaten to further dissipate Creditor's interest in the Mortgaged Premises and deprive Creditor of the benefit of its bargain with Debtor. There are also substantial other charges being accrued by Debtor which include charges relating to the ordinary operating expenses of the Mortgaged Premises, including charges for heat, maintenance, utilities and insurance. Upon information and belief, the Mortgaged Premises is presently not being used for any significant business purpose and is not generating any income. Additionally, upon information and belief, Debtor does not have sufficient financial resources to otherwise continue to meet such additional charges and Creditor will bear the risk of the overall depreciation of the Mortgaged Premises if not properly maintained. From the foregoing it is apparent that Creditor's ability to recover in full on its mortgage lien is seriously threatened while at the same time Debtor's ability to realize any equity from the Mortgaged Premises or otherwise use the Mortgaged Premises for purposes of reorganization is realistically non-existent.

23. Upon information and belief, real estate taxes and assessments in excess of \$700,000 have accrued since the filing of the Petition and, upon information and belief, in excess of \$100,000 of additional such taxes and assessments will accrue by the end of 2002. At the present rate of accrual of such taxes and assessments Creditor's interest in the Mortgaged Premises may be eliminated in the foreseeable future because the value of the property may be insufficient to satisfy the senior liens of unpaid taxes.

24. Upon information and belief, on numerous occasions Debtor has sought unsuccessfully to transfer its interest in the Mortgaged Premises on terms which would satisfy the indebtedness on the Note. Upon information and belief, there is no reason to believe that a disposition of Debtor's interest at favorable terms can now be obtained.

25. Upon information and belief, Debtor filed the Petition in an effort to avert an adverse determination in the Foreclosure Action.

26. Upon information and belief, Debtor has not filed a plan of reorganization nor is it likely to be in a position to file such a plan within the 120-day period during which it has the exclusive right to do so.

27. Debtor has continued to be in default on its indebtedness by failing to remit to Creditor the entire amount of installments of principal and interest pursuant to the terms of the Note and the Mortgage and to pay real estate taxes affecting the Mortgaged Premises.

28. Upon information and belief, the marketing and disposition of the Mortgaged Premises on reasonable terms will require a substantial period of time because, among other reasons, it is probable that the use of the Mortgaged Premises as a manufacturing facility no longer represents its most valuable economic use. As a result, even if the stay were lifted immediately, significant charges would continue to accrue against the Mortgaged Premises because of the unavoidable delay which would occur in consummating a sale thereof. Any further delay in lifting the stay will only extend the period prior to sale during which such charges will continue to accrue.

29. Creditor is being further damaged because it is not being compensated in the form of interest or otherwise for the loss of the use of its money while the automatic stay remains in effect.

30. *Section 362(d)(1) of the Bankruptcy Code* provides in pertinent part that the Court shall grant relief from the stay imposed by § 362 "for cause, including lack of adequate protection of an interest in property. ..." As set forth above, Debtor has failed to provide and, upon information and belief, is unable to provide adequate protection to Creditor of its interest in the Mortgaged Premises inasmuch as (i) Debtor lacks equity in the property, (ii) the value of the Mortgaged Premises and Creditor's interest therein is dissipating and, upon information and belief, will continue to dissipate, and (iii) past experience and present information clearly indicate that Debtor is unable and unlikely to obtain a purchaser for the Mortgaged Premises on terms sufficient to pay the indebtedness burdening such premises.

31. *Section 362(d)(2) of the Bankruptcy Code* provides as a further ground for relief from the stay that the Court shall grant relief if "(A) the debtor does not have an equity in the property; and (B) such property is not necessary to an effective reorganization." This basis for relief is also met inasmuch as (i) as hereinabove set forth, Debtor lacks equity in the Mortgaged Premises, and (ii) the Mortgaged Premises is not necessary to an effective reorganization because there is no reasonable likelihood of an effective reorganization in view of the lack of any equity in the Mortgaged Premises, the shutdown of the Mortgaged Premises as a manufacturing facility, Debtor's failure to promulgate a plan of reorganization thus far and the likelihood that it will be unable to do so at any time in the foreseeable future, and the repeated inability of the Debtor to procure a purchaser of the Mortgaged Premises.

Diversion of the Cash Collateral

32. The rents and other monies assigned to Creditor under the Mortgage and the Lease Assignment constitute "cash collateral" (the "Cash Collateral"), as such term is defined in § 363(a) of the *Bankruptcy Code*.

33. Upon information and belief, subsequent to the filing of the Petition, Debtor has received and used Cash Collateral in the operation and management of Debtor's business.

34. *Section 363(c)(2) of the Bankruptcy Code* provides in pertinent part that a debtor-in-possession "may not use, sell, or lease cash collateral ... unless--(A) each entity that has an interest in such collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale or lease. ..." Creditor has not given any such consent, and Debtor has failed to give notice or to seek the hearing referred to in such section. Accordingly, the use by Debtor of the Cash Collateral has been and is in violation of the express provisions of the *Bankruptcy Code*.

35. The unlawful and unauthorized use by Debtor of the Cash Collateral as aforesaid has caused Creditor to sustain significant and irreparable damages, in that Debtor has failed to provide Creditor with substitute collateral having an equivalent value and, upon information and belief, is unable to provide such substitute collateral.

36. Under the provisions of the *Bankruptcy Code*, Debtor is not permitted to use the Cash Collateral unless and until

Creditor has been provided adequate protection in accordance with the provisions of §§ 361 and 363 of the *Bankruptcy Code*. Debtor has not provided and, upon information and belief, is not able to provide Creditor with adequate protection against the decrease in value of Creditor's interest in the Cash Collateral that has resulted from Debtor's use thereof. Creditor has suffered and will continue to suffer significant, irreparable and immediate harm and damages unless it is immediately permitted to commence direct collection of all rentals and other monies assigned to it under the Mortgage and the Lease Assignment.

37. Section 363(c)(4) of the *Bankruptcy Code* requires that Debtor segregate and account for any Cash Collateral in its possession, custody or control. Upon information and belief, Debtor has failed to segregate or account for the Cash Collateral.

38. No previous application for the relief sought herein has been made to this or any other Court, except as set forth above.

wherefore, Creditor prays that this Court enter an order:

I. Terminating and annulling all stays and injunctions which prevent Creditor from proceeding with the Foreclosure Action;

II. Permanently enjoining and restraining Debtor and its officers, agents, servants, employees and attorneys and all persons in active concert and participation with them, from interfering with Creditor's enforcement of its rights and remedies with respect to Debtor and the Mortgaged Premises;

III. Permanently enjoining Debtor from using the Cash Collateral and requiring it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and, further, requiring Debtor to provide Creditor with adequate protection to the extent that any previous unauthorized use by Debtor of Cash Collateral has resulted in a decrease of the value of Creditor's interest in such Cash Collateral;

IV. For costs of suit and disbursements of this contested matter, including reasonable attorneys' fees; and

V. For such other and further relief as the Court may deem just and proper.

Dated: New York, New York

....., 20....

[Attorneys for Creditor Bank Company]

By

A Member of the Firm

Office & Post Office Address:

Telephone Number:

FOOTNOTES:

(n1)Footnote 1. This form of motion is of a type generally employed in the Southern District of New York. This form does not comply with Official Form 20A. See P 2.53 *infra*, for a form of a type generally employed in other jurisdictions.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.53

P 2.53 Form--Motion of Creditor Bank Company for Termination of Automatic Stay and Other Relief

2:3 Form--Motion of Creditor Bank Company for Termination of Automatic Stay and Other Relief.

UNITED STATES BANKRUPTCY COURT
 FOR THE EASTERN DISTRICT OF MICHIGAN
 SOUTHERN DIVISION--DETROIT

In re

XYZ CO., INC.,

Debtor.

)
)
)
)
)

In Proceedings for Reorganization under Chapter 11
 Case No.:

Motion of Creditor Bank Company for Termination of Automatic Stay and Other Relief

to the honorable, Bankruptcy Judge.

Creditor Bank Company ("Creditor"), hereby moves for an order, pursuant to *Rule 9014* of the Bankruptcy Rules and *Bankruptcy Code* §§ 362(d) and 363(e), (1) terminating and annulling the automatic stay in effect in the within proceeding under *Bankruptcy Code* § 362(a) insofar as such stay operates to prevent Creditor from selling, pursuant to a final judgment of foreclosure, certain real property located in Scarsdale, New York (the "Mortgaged Premises") and insofar as it prevents Creditor from collecting rent receipts heretofore assigned to it; (2) permanently enjoining XYZ Co., Inc. as Debtor and debtor in possession (collectively: "Debtor") from interfering with Creditor's enforcement of its rights and remedies in respect of the Mortgaged Premises; (3) permanently enjoining Debtor from using any rent receipts heretofore or hereafter received by it from the Mortgaged Premises, requiring Debtor to segregate and account for such receipts and further requiring Debtor to provide Creditor with adequate protection to the extent that any previously unauthorized use of such receipts has resulted in a decrease of the value of Creditor's interest therein; and (4) preliminarily enjoining Debtor from using such receipts and directing it to segregate and account to Creditor for such

receipts in its possession, custody or control and to place all such receipts heretofore or hereafter received by Debtor in a separate escrow account for distribution to Creditor.

The grounds for this motion are that (a) the value of Creditor's interest in the Mortgaged Premises is being eroded through the imposition of additional charges against the Mortgaged Premises, (b) Debtor lacks equity in the Mortgaged Premises, and such premises are not necessary to an effective reorganization because there is no reasonable likelihood of an effective reorganization; and (c) as a matter of contract and law, Creditor is entitled to the rent receipts arising from the Mortgaged Premises from and after the date it commenced an action for foreclosure against XYZ Co., Inc.

This motion is based upon the affidavit of John Doe, sworn to , 2002, the exhibits thereto, Creditor's Memorandum of Law dated , 2002, and all papers and proceedings heretofore had herein.

Dated: Detroit, Michigan

....., 20....

.....

By

(Name)

Detroit, Michigan

Telephone Number

Attorneys for

Creditor Bank Company

Notice of Motion

TO:

.....

Attorneys for Debtor

Please take notice that the undersigned will bring the above motion on for hearing before this Court at Room , United States Courthouse, ... , Detroit, Michigan, on the day and time fixed by the Court in the order to show cause served upon you herewith.

.....

By

(Name)

.....

Detroit, Michigan

Telephone Number

Attorneys for

Creditor Bank Company

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 2 Mortgages *

*-2 Collier Real Estate Trans & Bankruptcy Code P 2.53A***P 2.53A Form--Motion for Relief from Automatic Stay by First Mortgagee Where Debtor Is Second Mortgagee**

2.53A Form--Motion for Relief from Automatic Stay by First Mortgagee where Debtor is Second Mortgagee

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

_____	)	
In re	)	Chapter 11
SECOND MORTGAGE CORPORATION	)	Case No.:
Debtor.	)	
	)	

**MOTION FOR RELIEF FROM AUTOMATIC STAY
UNDER SECTION 362 OF THE BANKRUPTCY CODE WITH
RESPECT TO REAL PROPERTY LOCATED AT
100 MAIN STREET, PHOENIX, AZ 85006**

Creditor First Mortgage Holder Bank, National Association (hereinafter "Movant"), by its undersigned counsel, respectfully moves this Honorable Court to terminate the Automatic Stay to allow Movant to exercise its rights against a parcel of real property located at 100 Main Street, Phoenix, AZ 85006 (the "Property") and, as grounds therefore, states as follows:

1. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). Venue is proper pursuant to 28 U.S.C. § 1409(a). The statutory basis for the relief requested in this motion is 11 U.S.C. §§ 362 and 105.
2. On July 13, 2007 (the "Petition Date"), Second Mortgage Corporation (hereinafter "Debtor") filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code. Since the Petition Date, the Debtor has managed its affairs as a debtor in possession pursuant to 11 U.S.C. §§ 1107 and 1108.

3. Prior to the Petition Date, Debtor was in the business of originating second mortgage loans to "sub-prime" borrowers. Within a few months of such origination (typically 180 days), the Debtor would typically transfer the second mortgage loans to an investment bank or securitization entity in exchange for cash that was used to finance its business and originate further mortgage loans. At the Petition Date, the Debtor had failed to securitize a number of its second mortgage loans including the Second Mortgage Note described below.

4. Shortly after the Petition Date, the Debtor announced that it was exiting the mortgage origination business and would seek to liquidate its remaining assets for the benefit of its creditors.

5. On or about July 21, 2005, John Doe ("Obligor") executed and delivered to Movant a promissory note (the "First Mortgage Note"), a copy of which is attached hereto as an Exhibit, in the amount of Two Hundred Eighty Five Thousand, Two Hundred and Fifty Dollars (\$285,250.00), plus interest at the rate of 8.125% per annum, attorneys' fees, costs and late charges to be paid over thirty (30) years.

6. To secure the repayment of the sums due under the First Mortgage Note, Obligors executed and delivered to Movant a mortgage on the Property dated July 21, 2005 (hereinafter "First Mortgage"), encumbering the real property and improvements thereon known as 100 Main Street, Phoenix, AZ 85006. A copy of the First Mortgage is attached hereto and incorporated herein an Exhibit.

7. On or about April 21, 2007, Obligor executed and delivered to Debtor a promissory note (the "Second Mortgage Note"), a copy of which is attached hereto as an Exhibit, in the amount of One Hundred Thousand, Five Hundred Dollars (\$100,500.00), plus interest at the rate of 14.125% per annum, attorneys' fees, costs and late charges to be paid over thirty (30) years.

8. To secure the repayment of the sums due under the Second Mortgage Note, Obligors executed and delivered to Debtor a second mortgage on the Property dated April 21, 2007 (hereinafter "Second Mortgage"), encumbering the real property and improvements thereon known as 100 Main Street, Phoenix, AZ 85006. A copy of the Second Mortgage is attached hereto and incorporated herein an Exhibit.

9. The lien on the Property in favor of the Debtor pursuant to the Second Mortgage is junior to the lien on the Property in favor of the Movant pursuant to the First Mortgage.

10. The Obligor is now in default under the First Mortgage Note, having failed to make payments under the First Mortgage Note since August 2007, and Movant seeks to exercise its non-bankruptcy rights and remedies with respect to the First Mortgage Note, including but not limited to enforcement of its rights under the First Mortgage, including foreclosure of such First Mortgage in the appropriate state court. The current pay-off amount for the First Mortgage Note is \$312,360.61.

11. On information and belief, the Obligor has not been making any payments to Debtor on the Second Mortgage Note since at least the time of the default on the First Mortgage Note.

12. According to the opinion of a broker qualified to sell real property in the region in which the Property is located, a copy of which is attached as an Exhibit hereto, the Property is currently worth approximately \$240,000, before deducting costs of sale, broker's fees, and other fees that might be incurred in the liquidation of the Property.

13. Because its Second Mortgage described in paragraph 8 above is subordinate to the First Mortgage, and the value of the Property is significantly below the payoff amount on the First Mortgage Note, the Debtor has no equity in the underlying Property pursuant to such Second Mortgage.

14. Because the Debtor has announced that it has exited the mortgage origination business and is in the process of liquidating its assets, and because the Debtor's junior mortgage under the Second Mortgage adds little or no value to the bankruptcy estate, the Property and the Second Mortgage are not necessary for any reorganization of Debtor.

15. Because the Debtor has no equity in the Property and the Property is not necessary for an effective reorganization, relief from the automatic stay is appropriate under § 362(d)(2) of the *Bankruptcy Code* to permit Movant to exercise its non-bankruptcy rights and remedies with respect to the First Mortgage.

16. Moreover, upon information and belief, the value of the Property is decreasing, or not increasing at the same rate as the Obligor's indebtedness under the First Mortgage Note is increasing. Also, Movant does not know whether the Property is properly insured, and, based on a recent observation of the Property by an agent of Movant, it does not appear that the Obligor is properly maintaining the physical premises of the Property. Therefore, Movant's interest in the First Mortgage is not adequately protected.

17. A continued stay of Movant's action against the Obligor and the Property will cause Movant significant prejudice.

18. Therefore, cause exists to terminate the automatic stay to permit Movant to exercise its non-bankruptcy rights and remedies with respect to the First Mortgage pursuant to § 362(d)(1) of the *Bankruptcy Code*.

19. Movant believes that this motion will be unopposed or entered upon consensual terms. A stay of any order granting this motion would, in such instance, be inappropriate. Therefore, Movant is seeking relief from the stay provisions of *Fed. R. Bankr. P. 4001(a)(3)*.

20. Copies of this motion and notice hereof have been served upon the Debtor, counsel for the Debtor, counsel for the Committee, and counsel for the United States Trustee. In light of the extremely high volume of similar motions being filed in this case and the fact that the parties most likely to seek a position with respect to this motion are receiving notice, Movant believes that limiting notice to these parties is appropriate and requests that the Court consider the merits of this motion accordingly.

WHEREFORE, for the foregoing reasons, Movant respectfully requests that this Court enter an Order in the form attached hereto as Exhibit A terminating the automatic stay and allowing Movant to exercise its non-bankruptcy rights and remedies as to the Property, including but not limited to foreclosure of the First Mortgage, and granting such other and further relief as this court deems just and proper.

Respectfully submitted,

ATTORNEYS & COUNSEL LLP

..... /s/

Attorneys for First Mortgage Holder Bank N.A.

Dated:

EXHIBIT A (Form of Order)

UNITED STATES BANKRUPTCY COURT

DISTRICT OF DELAWARE

In re

SECOND MORTGAGE CORPORATION

)

)

)

Chapter 11

Case No.:

Debtor.)
)

**ORDER TERMINATING AUTOMATIC STAY UNDER
 SECTION 362 OF THE BANKRUPTCY CODE AS IT APPLIES TO
 100 MAIN STREET, PHOENIX, AZ 85006
 (Relates to Docket**

UPON CONSIDERATION of the Motion for Relief from Automatic Stay (the "Motion") filed by First Mortgage Holder Bank, National Association (the "Movant"), and the Court having determined that (A) the Court has jurisdiction over the Motion pursuant to 28 U.S.C. §§ 157 and 1334; (B) that this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); (C) venue is proper pursuant to 28 U.S.C. § 1409(a); and (D) service to the limited parties stated on the Certificate of Service is adequate under the circumstances; and in consideration of any response filed thereto, it is hereby **ORDERED** as follows:

1. To the extent that the automatic stay of 11 U.S.C. § 362(a) is applicable, such stay is hereby terminated to allow the Movant and its successors and/or assignors to pursue any state court remedies to which Movant may be entitled under applicable law with respect to the following property: 100 MAIN STREET, PHOENIX, AZ 85006.
2. This Order is immediately effective and is not stayed by operation of law, notwithstanding the stay provisions of *Fed. R. Bankr. P. 4001(a)(3)*.

Dated:

.....

The Honorable Brendan L. Shannon

United States Bankruptcy Judge

FOOTNOTES:

(n1)Footnote 1. Attention should be paid to the local rules and local practice concerning the evidentiary requirements for submitting an appraisal or other evidence of value.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.54

P 2.54 Form--Affidavit

2:4 Form--Affidavit.

UNITED STATES BANKRUPTCY COURT
 FOR THE EASTERN DISTRICT OF MICHIGAN
 SOUTHERN DIVISION--DETROIT

	)	
<i>In re</i>	)	In a Proceeding for Reorganization Under Chapter 11
XYZ CO., INC.,	)	No.
<i>Debtor.</i>	)	
	)	

Affidavit

	)	
STATE OF NEW YORK	)	ss.
COUNTY OF NEW YORK	)	

John Doe, being duly sworn, deposes and says:

1. I am a Vice President of Creditor Bank Company ("Creditor"), the moving party herein, and am fully familiar with the facts set forth herein. I make this affidavit in support of Creditor's motion made pursuant to Bankruptcy Rule 9014, and §§ 362 and 363 of the *Bankruptcy Code* for an order, *inter alia*:

a) terminating and annulling the stay imposed by *Bankruptcy Code* § 362, insofar as such stay operates to prevent Creditor from selling, pursuant to a final judgment of foreclosure, certain real property located in Scarsdale, New York (the "Mortgaged Premises") and insofar as it prevents Creditor from collecting rent receipts heretofore assigned to it;

b) permanently enjoining XYZ Co., Inc., as Debtor and debtor in possession (collectively: "Debtor") from interfering with Creditor's enforcement of any such rights and remedies;

c) permanently enjoining Debtor from using all rent receipts heretofore or hereafter received by it from the Mortgaged Premises (hereinafter referred to as the "Cash Collateral") and requiring it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and, further, requiring Debtor to provide Creditor with adequate protection to the extent that any previous unauthorized use by Debtor of Cash Collateral has resulted in a decrease of the value of Creditor's interest in such Cash Collateral; and

d) preliminarily enjoining Debtor from using the Cash Collateral and directing it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and to place all Cash Collateral heretofore or hereafter received by Debtor in a special escrow account for distribution to Creditor.

2. Creditor is a banking association organized under the laws of the, having its principal place of business at

3. XYZ Co., Inc. ("XYZ") purports to be a corporation organized and existing under the laws of the State of New York.

4. This contested matter arises in the case of *In re XYZ Co., Inc.*, 02 B, a chapter 11 case pending in the Eastern District of Michigan, Southern Division--Detroit.

5. Jurisdiction is conferred on this Court by the provisions of 28 U.S.C. § 1334. This is a proceeding to terminate and annul the automatic stay and is a "core proceeding" within the meaning of 28 U.S.C. § 157(b)(2)(G).

6. On November 30, 2002, XYZ filed a petition (the "Petition") seeking relief under chapter 11 of the Bankruptcy Code. Pursuant to § 1108 of the Bankruptcy Code, XYZ is continuing to operate its business as debtor in possession. By virtue of the automatic stay provisions of Bankruptcy Code § 362, the filing of the Petition operated, *inter alia*, as a stay of the enforcement of any judgment against XYZ or the continuation of any court proceeding to enforce any lien against its property.

7. Specifically, by virtue of the automatic stay provisions of Bankruptcy Code § 362, Creditor has been enjoined from enforcing a final judgment of foreclosure (the "Foreclosure Judgment") previously entered in favor of Creditor and against XYZ, dated January 23, 2002 and entered in the Supreme Court of the State of New York, County of Westchester, in an action entitled *Creditor Bank Company v. XYZ Co., Inc., et al.*, Index No. (the "Foreclosure Action") and from enforcing its right to directly collect rentals with respect to the Mortgaged Premises pursuant to an assignment of rentals between XYZ and Creditor.

8. On May 3, 1991, XYZ executed and delivered a mortgage (the "Mortgage") on the Mortgaged Premises in favor of Creditor as mortgagee to secure an indebtedness of \$1,800,000. In connection therewith, XYZ made, executed and delivered a mortgage note to Creditor in the principal amount of \$1,800,000 (the "Note"). The Note and Mortgage provided for payment of equal consecutive installments of principal and interest (at the rate of 9 1/2% per annum) on the first day of each month commencing on June 1, 1991, until and including May 1, 2011, when the balance of any unpaid principal would be due and payable. On May 3, 1991, the Mortgage was duly recorded in the Westchester County Clerk's Office. A copy of the Note and of the Mortgage is annexed hereto respectively as Exhibit "A" and "B."

9. On May 3, 1991, an agreement (the "Assignment Agreement") was entered into between XYZ and Creditor whereby XYZ assigned to Creditor, as additional security for the payment of the indebtedness due under the Mortgage, all of the rents payable under and all of its right, title and interest in and to the leases made with the lessees of the Mortgaged Premises. The agreement permitted XYZ to collect the rentals payable under the leases but expressly provided that if XYZ defaulted in the payment of its mortgage indebtedness, Creditor would have the right to collect such rentals and apply them toward the payment of the mortgage indebtedness. On May 3, 1981, the Assignment Agreement was duly recorded in the Westchester County Clerk's Office. A copy of the Assignment Agreement is annexed hereto as Exhibit

"C."

10. On June 1, 2001, Creditor failed to receive the monthly installment of principal and interest payable under the Note and has not received any payments under the Note thereafter. By notice dated August 15, 2001, Creditor in accordance with the provisions of the Note and Mortgage, declared by written notice to XYZ that the entire principal balance of the Note together with interest and late charges were due and payable. Creditor commenced the Foreclosure Action on September 19, 2001.

11. As hereinabove set forth (paragraph 7), a judgment of foreclosure was entered in the Foreclosure Action on January 23, 2002. On several occasions, XYZ attempted to stay the foreclosure sale by alleging that it was seeking refinancing. Creditor thereupon obtained a court order appointing a receiver of rents. A stay of the foreclosure sale was entered on March 11, 2002, but said stay was vacated in an order entered on November 29, 2002. Thereafter a sale was scheduled to commence but was automatically stayed upon the filing of the Petition on November 30, 2002.

12. On or about January 24, 2002, pursuant to the terms of the Assignment Agreement Creditor notified the tenants on the Mortgaged Premises that XYZ was in default under its mortgage. Creditor further advised the tenants that inasmuch as the terms of the Mortgage provided for the assignment of rents to Creditor, all further remittances of rent should be made to it.

13. Debtor has continued to be in default of its indebtedness by failing to remit to Creditor the entire amount of monthly installments of principal and interest pursuant to the terms of the Mortgage and to pay real estate taxes affecting the Mortgaged Premises. Furthermore, memoranda (copies of which are annexed hereto as Exhibit "D") submitted by XYZ to Creditor concerning the forwarding of rent receipts under the terms of the Assignment Agreement clearly indicate that XYZ has defaulted under the terms of the Assignment Agreement by not remitting to Creditor the entire amount of all rent receipts from the Mortgaged Premises and, upon information and belief, diverting and using portions of the receipts for its own purposes.

14. In the Petition, XYZ valued its assets, which consist of the Mortgaged Premises, at \$2,214,994.

15. The outstanding amount of principal and accrued interest owing on the Mortgage is at least \$1,764,694.45. In addition, Creditor is entitled to its reasonable collection costs, late charges and attorneys' fees. Upon information and belief, the outstanding principal on a second mortgage of the Mortgaged Premises in favor of Second National Bank, as mortgagee, is approximately \$100,000.00. Upon information and belief, outstanding tax arrearages on the Mortgaged Premises aggregate at least \$320,000.00. Upon information and belief, outstanding mechanics' liens on the Mortgaged Premises aggregate at least \$450,745.94. The aggregate charges against the Mortgaged Premises thus appear to be at least \$2,634,694.45 or at least \$419,700.45 more than the value which Debtor has itself attributed to the Mortgaged Premises. Debtor therefore has no equity in the Mortgaged Premises.

16. Upon information and belief, additional claims which may be charges against the Mortgaged Premises, and which would further negate any equity in favor of Debtor (which will soon fall due or which are presently accruing), include: (i) a school tax payment which will likely approximate \$60,000 which is due and payable on January 1, 2003, (ii) further mechanics' liens which may arise in connection with construction on the Mortgaged Premises, (iii) interest which continues to accrue on unpaid taxes, (iv) interest which continues to accrue on the unpaid indebtedness owing on the Mortgage and any such interest which may be accruing on subordinate mortgage liens on the Mortgaged Premises, and (v) interest which continues to accrue on Creditor's secured claim and any other claims secured by the Mortgaged Premises pursuant to § 506 of the *Bankruptcy Code*. These substantial forthcoming and presently accruing charges, in addition to negating any equity in favor of Debtor, have dissipated and threaten to further dissipate Creditor's interest in the Mortgaged Premises and deprive Creditor of the benefit of its bargain with XYZ. There are also substantial other charges being accrued by Debtor which include amounts owing to trade creditors and charges relating to the ordinary operating expenses of the Mortgaged Premises, including charges for heat, maintenance, utilities and insurance. There is

no apparent source of payment for such costs. Furthermore, Creditor bears the risk of the overall depreciation of the Mortgaged Premises if not properly maintained. From the foregoing it is apparent that Creditor's ability to recover in full on its mortgage lien is seriously threatened while at the same time Debtor's ability to realize any equity from the Mortgaged Premises or otherwise use the Mortgaged Premises for purposes of reorganization is realistically non-existent.

17. Upon information and belief, on numerous occasions XYZ has sought to refinance the indebtedness on the Mortgaged Premises. In fact, a letter to XYZ from its mortgage broker, dated March 4, 2003 (a copy of which is annexed hereto as Exhibit "E") lists twenty-one lenders which rejected a mortgage loan to XYZ. Upon information and belief, there is no reason to believe that financing can now be obtained.

18. Upon information and belief, the present precarious financial situation of Debtor was caused, in large part, by the diversion of income from the Mortgaged Premises by XYZ.

19. *Section 362(d)(1) of the Bankruptcy Code* provides in pertinent part that the Court shall grant relief from the stay imposed by § 362 "for cause, including lack of adequate protection of an interest in property... ." As set forth above, Debtor has failed to provide and, upon information and belief, is unable to provide adequate protection to Creditor of its interest in the Mortgaged Premises inasmuch as (i) the Debtor lacks equity in the Mortgaged Premises, (ii) the value of the Mortgaged Premises and Creditor's interest therein is dissipating and, upon information and belief, will continue to dissipate; and (iii) past experience and present information clearly indicate that Debtor is unable and unlikely to obtain refinancing for the Mortgaged Premises and will be unable to pay the indebtedness burdening such premises.

20. *§ 362(d)(2) of the Bankruptcy Code* provides as a further ground for relief from the stay that the Court shall grant relief if "(A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization." This basis for relief is also met inasmuch as (i) as hereinabove set forth, the Debtor lacks equity in the Mortgaged Premises, and (ii) Mortgaged Premises is not necessary to an effective reorganization because there is no reasonable likelihood of an effective reorganization in view of the lack of any equity in the Mortgaged Premises, the repeated inability of XYZ to procure refinancing of the Mortgaged Premises, and XYZ's history of diverting funds necessary to the proper operation of the Mortgaged Premises or properly due Creditor, for unrelated purposes.

Second Claim

21. The rents assigned to Creditor under the Assignment Agreement constitute "cash collateral" (the "Cash Collateral"), as such term is defined in *§ 363(a) of the Bankruptcy Code*.

22. Upon information and belief, subsequent to the filing of the Petition, Debtor has used Cash Collateral in the operation and management of Debtor's business and has diverted Cash Collateral to unrelated purposes.

23. *§ 363(c)(2) of the Bankruptcy Code* provides in pertinent part that a debtor in possession "may not use, sell, or lease cash collateral ... unless--(A) each entity that has an interest in such collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale or lease... ." Creditor has not given any such consent, and Debtor has failed to give notice of or to seek the hearing referred to in such section. Accordingly, the use by Debtor of the Cash Collateral has been and is in violation of and with total disregard for the express provisions of the Bankruptcy Code.

24. The unlawful and unauthorized use by Debtor of the Cash Collateral has caused Creditor to sustain substantial and irreparable damages, in that Debtor has failed to provide Creditor with substitute collateral having an equivalent value and, upon information and belief, is unable to provide such substitute collateral.

25. Under the provisions of the Bankruptcy Code, Debtor is not permitted to use the Cash Collateral unless and until

Creditor has been provided adequate protection in accordance with the provisions of §§ 361 and 363 of the *Bankruptcy Code*. Debtor has not provided and, upon information and belief, is not able to provide Creditor, with adequate protection against the decrease in value of Creditor's interest in the Cash Collateral that has resulted from Debtor's use thereof. Creditor has suffered and will continue to suffer substantial, irreparable and immediate harm and damages unless it is immediately permitted to commence direct collection of all rentals.

26. § 363(c)(4) of the *Bankruptcy Code* requires that Debtor segregate and account for any Cash Collateral in its possession, custody or control. Upon information and belief, Debtor has failed to segregate or account for the Cash Collateral.

27. The default of Debtor under the Assignment Agreement, by failing to remit all rent receipts to Creditor and, upon information and belief, by diverting such funds to its own use, has already injured and will immediately and irreparably injure Creditor if the January rent receipts, due January 1, 2003, and any outstanding December, 2002 rent receipts, are similarly diverted from Creditor, which has the right to such payments as assignee of rents under the Assignment Agreement.

28. At the very least, the funds which constitute the January, 2003 rent should be immediately segregated and accounted for in order to prevent the improper dissipation of such funds. If such funds are not so segregated and accounted for, no means will be available to prevent the dissipation of such rent rightfully due Creditor.

29. Creditor will suffer substantial, irreparable and immediate harm and damages unless such funds are immediately segregated and a proper distribution thereof provided for to prevent the dissipation of Creditor's interest therein.

30. Creditor is requesting in the present motion that this Court enter an order:

I. Terminating and annulling all stays and injunctions which prevent Creditor from proceeding with the sale of the Mortgaged Premises pursuant to the Foreclosure Judgment and from collecting the Cash Collateral;

II. Permanently enjoining and restraining Debtor and its officers, agents, servants, employees and attorneys and all persons in active concert and participation with them, from interfering with Creditor's enforcement of its rights and remedies with respect to XYZ and the Mortgaged Premises and the Cash Collateral;

III. Permanently enjoining Debtor from using the Cash Collateral and requiring it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and, further, requiring Debtor to provide Creditor with adequate protection to the extent that any previous unauthorized use by Debtor of Cash Collateral has resulted in a decrease of the value of Creditor's interest in such Cash Collateral;

IV. Preliminarily enjoining Debtor from using the Cash Collateral and directing it to segregate and account to Creditor for Cash Collateral in its possession, custody or control and to place all Cash Collateral heretofore or hereafter received by Debtor in a special escrow account to be distributed in accordance with the Assignment Agreement;

V. For costs of suit and disbursements of this contested matter, including reasonable attorneys' fees; and

VI. For such other and further relief as the Court may deem just and proper.

.....

JOHN DOE

Sworn to before me this

..... day of, 20....

.....

Notary Public

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.55

P 2.55 Form--Chapter 11 Plan

Form--Chapter 11 Plan.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

_____	)	
<i>In re</i>	)	Case No.:
DEBTOR ASSOCIATES,	)	
<i>Debtor.</i>	)	
_____	)	

Chapter 11 Plan

Debtor Associates, the above-named debtor, proposes the following plan pursuant to chapter 11 of the Bankruptcy Code.

Article I Definitions

Certain Defined Terms. For purposes of the Plan, the following terms shall have the respective meanings hereinafter set forth (such meanings to be equally applicable to both the singular and plural forms of the terms defined):

"Allowed Claim" shall mean a Claim (a) in respect of which a proof of claim has been filed with the Bankruptcy Court within the applicable period of limitation fixed by Bankruptcy *Rule 3003* or (b) scheduled in the list of creditors prepared and filed with the Bankruptcy Court pursuant to *Rule 1007(b)* and not listed as disputed, contingent or unliquidated as to amount, in either case as to which no objection to the allowance thereof has been interposed within any applicable period of limitation fixed by *Rule 3007* or an order of the Bankruptcy Court, or as to which any such objection has been determined by an order or judgment which is no longer subject to appeal or certiorari proceeding and as to which no appeal or certiorari proceeding is pending.

"Allowed Interests" shall mean the limited partnership interests of Joe Smith and Ralph Jones and the general partnership interest of Debtor Corp., a New York corporation, in the Debtor provided for in the Partnership Agreement dated among Joe Smith, Ralph Jones and Debtor Corp.

"Bankruptcy Court" shall mean the United States Bankruptcy Court for the Southern District of New York having jurisdiction over this case.

"Claim" shall mean any right to payment, or right to an equitable remedy for breach of performance, if such breach gives rise to a right to payment, against Debtor in existence on or as of the Petition Date, whether or not such right to payment or right to an equitable remedy is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured or unsecured.

"Code" shall mean the Bankruptcy Code, *11 U.S.C. § 101 et seq.* , and any amendments thereof.

"Consummation Date" shall mean a business day on or prior to following the Date of Confirmation.

"Creditor Bank" shall mean Creditor Bank, N.A., the mortgagee under the Mortgage.

"Date of Confirmation" shall mean the date of the entry of an order of the Bankruptcy Court confirming the Plan in accordance with the provisions of chapter *11 of the Code*.

"Debtor" shall mean Debtor Associates, a limited partnership formed under the laws of the State of New York, the debtor in this chapter 11 case, and any successor thereto.

"Event of Default" shall mean any event specified in Article XI of the Plan.

"Foreclosure Action" shall mean the foreclosure action against the Property commenced by Creditor Bank in the Supreme Court of the State of New York, New York County (Index No.).

"Indebtedness" shall mean as applied to a Person (a) all items, except items of capital stock, surplus, partners' equity or of general contingency reserves or reserves for deferred income taxes which in accordance with sound accounting principles and practices would be included in determining total liabilities as shown on the liability side of a balance sheet of such Person as at the date of which Indebtedness is to be determined; (b) all indebtedness secured by any mortgage, pledge, lien or conditional sale of other title retention agreement existing on any property or asset owned or held by such Person subject thereto, whether or not such indebtedness shall have been assumed; and (c) all indebtedness of others which such Person has directly or indirectly guaranteed, endorsed (otherwise than for collection or deposit in the ordinary course of business), discounted or agreed (contingently or otherwise) to purchase or repurchase or otherwise acquire, or in respect of which such Person has agreed to supply or advance funds (whether by way of loan, stock purchase, capital contribution or otherwise) or otherwise to become liable directly or indirectly with respect thereto.

"Investment" in any Person shall mean an acquisition of all or substantially all of the assets of such Person or any investment by stock purchase, capital contribution, loan, advance or other extension of credit, guaranty of any Indebtedness or creation or assumption of any other liability in respect of any Indebtedness of such Person, or the transfer or sale of property or assets to such Person.

"Mortgage" shall mean a certain mortgage dated between Debtor as Mortgagor and Creditor Bank as Mortgagee, creating a first lien on the Property for the benefit of Creditor Bank, as amended by the Amendment to Mortgage annexed hereto as Exhibit A as of the effective date thereof and all other amendments, modifications and supplements thereto.

"Person" shall mean an individual, corporation, partnership, limited liability company, joint venture, trust, estate, unincorporated organization, or a governmental agency or political subdivision thereof.

"Petition Date" shall mean [insert date of filing of chapter 11 petition], the date on which Debtor filed its chapter 11 petition with the Court.

"Plan" shall mean this chapter 11 plan and any duly authorized amendments hereto, supplements hereto or modifications hereof.

"Property" shall mean the real property and improvements thereon located at, in New York City, State of New York, more fully described in Schedule I hereto.

"Receiver Account" shall mean all monies held by the Receiver on the Petition Date and thereafter deposited by Debtor into a segregated account in the Substantial Savings Bank pursuant to § 543 of the Code and an order of the Bankruptcy Court dated, after deduction of the costs, expenses and compensation of the Receiver allowed by the Bankruptcy Court under § 543(c)(2) of the Code.

"Receiver" shall mean in his capacity as Receiver of the rents, issues and profits of the Property pursuant to order of the Supreme Court of the State of New York, County of New York in the Foreclosure Action.

"Settlement Agreement" shall mean a certain Settlement Agreement dated as of between Debtor and Creditor Bank in the form annexed hereto as Exhibit "B."

Article II Classification of Claims and Interests

The Claims and Interests are classified as follows:

1. Class I. Allowed Claims, if any, entitled to priority pursuant to *section 507(a)(3), (4) or (8) of the Code*.
2. Class II. Allowed Claims which are unsecured, except those included in Class I herein.
3. Class III. The Allowed Claim of Creditor Bank.
4. Class IV. The Allowed Interests.

Article III Treatment of Claims and Interests

1. *Administration and Certain Priority Claims.* The administrative expenses of the Debtor's chapter 11 case allowed pursuant to *section 503(b) of the Code* and each allowed claim entitled to priority pursuant to *section 507(a)(8) of the Code* shall be paid in full upon the Consummation Date unless otherwise ordered by the Bankruptcy Court, in cash, or upon such other terms as may be agreed upon by the holder of any such claim and Debtor.

2. *Class I Claims.* The holder of each Class I claim shall be paid in full on the Consummation Date, in cash, or upon such other terms as may be agreed upon by any such creditor and Debtor. Since the Claims of all such creditors shall be paid in full, such Claims are not impaired by the Plan.

3. *Class II Claims.* The holder of each Class II claim shall be paid in full on the Consummation Date, in cash, or upon such other terms as may be agreed upon by any such creditor and Debtor. Since the Claims of all such creditors shall be paid in full, such Claims are not impaired by the Plan.

4. *Class III Claim.* The Class III Claim shall be deemed to include indebtedness under the Mortgage in the amount of \$7,500,000; interest due and owing thereon as of June 1, 2002, in the amount of \$1,340,000; accrued interest on such principal in the amount of \$38,770 per month for the period subsequent to June 1, 2002, to the Consummation Date; the sum of \$459,811.34 representing funds advanced by Creditor Bank to the Receiver for real estate taxes imposed against the Property and interest thereon, but not reimbursed to Creditor Bank; and expenses incurred by Creditor Bank in connection with the enforcement of its rights and remedies under the Mortgage in the amount of \$195,000. Under the Plan, such Class III Claim shall be modified and provided for as follows:

(a) *Allowance of Claim.* The Class III claim shall be allowed in the aggregate sum of (i) \$9,494,811.34, representing indebtedness in the amount of \$7,500,000 (the "Principal Obligation"); interest due and owing under the Mortgage to June 1, 2002, in the amount of \$1,340,000 (the "Interest Obligation"); expenses incurred by Creditor Bank under the Mortgage in the amount of \$195,000 (the "Allowed Expense Claim"); \$459,811.34 for reimbursement for the payment of real estate taxes, interest thereon and ground rent previously advanced by Creditor Bank with respect to the Property; and (ii) interest on the Principal Obligation from June 1, 2002, to the Consummation Date.

(b) *Continuation of Mortgage; Amendments to Mortgage; Waiver of Prior Defaults.* The Mortgage shall continue in full force and effect in accordance with the terms thereof and shall provide for the payment of the aggregate of the Principal Obligation and \$1,000,000 of the Interest Obligation or, if such \$1,000,000 balance has been reduced pursuant to the provisions of clause (d)(iii) of this Section 4 of this Article III, such lesser balance of the Interest Obligation, provided that on the Consummation Date the Mortgage shall be amended by the execution and delivery by Debtor to Creditor Bank of an amendment thereto in the form annexed hereto as Exhibit "A."

All defaults under the Mortgage existing as of the date of acceptance by Creditor Bank of the Plan of which Creditor Bank has actual notice shall be deemed to have been cured or waived on the Consummation Date. Any notice of default or of acceleration declaring the indebtedness under the Mortgage shall, effective as of the Consummation Date, be deemed cancelled, rescinded and of no further force or effect. Commencing with the Consummation Date, all payments provided for in the Mortgage shall be made in accordance with the terms thereof.

(c) *Payments on Consummation Date.* On the Consummation Date, Debtor shall pay or, with respect to clauses (i) and (iii) hereof shall cause to be paid from the Receiver Account, to Creditor Bank (i) the sum of \$459,811.34 in full reimbursement for the payment of real estate taxes, interest thereon and ground rent previously advanced by Creditor Bank with respect to the Property; (ii) \$340,000 of the Interest Obligation, (iii) interest on the Principal Obligation from June 1, 2002, to the Consummation Date at the rate of \$38,770 per month; (iv) interest on the Principal Obligation and on \$1,000,000 of the Interest Obligation at the interest rate called for in the Mortgage as amended, for the period commencing upon the Consummation Date through and including December 31, 2003; and (v) the Allowed Expense Claim.

(d) *Disposition of Receiver Account.* After payment or provision for the fees, expenses and compensation of the Receiver, the Receiver Account shall be disposed of as follows: (i) first to the payment to Creditor Bank of the \$459,811.34 called for by clause (c)(i) of this Section 4 of this Article III, (ii) next, to the payment to Creditor Bank of the \$38,770 per month interest payment called for by clause (c)(iii) of this Section 4 of this Article III; and (iii) the balance, if any, to Creditor Bank to be applied as a partial prepayment of the Interest Obligation. The payments called for by clauses (d)(i) and (d)(ii) hereof shall be made by the Debtor on the Consummation Date.

(e) *Termination of Foreclosure Action.* Promptly subsequent to the Consummation Date, Creditor Bank and Debtor shall cause to be discontinued without prejudice the Foreclosure Action and shall cause the judgment of foreclosure and order of sale issued in connection therewith to be vacated and set aside.

5. *Class IV Interests.* The Allowed Interests shall remain in full force and effect in accordance with their terms and the

legal, equitable and contractual rights to which such Allowed Interests are entitled shall remain unaltered. The Class IV interests are therefore not impaired by the Plan.

6. *Disputed Claims.* In the event that there is pending on the Date of Confirmation either an objection to all or any portion of any Claim, or an appeal from an order determining the amount in which any such Claim should be allowed, Debtor or any disbursing agent appointed herein shall be authorized to pay that portion of each such Claim as to which no objection is interposed or no appeal is pending. Debtor or any disbursing agent appointed herein shall also withhold and retain the balance of the payment on such Claim to the extent that the Claim is in dispute, pending appeal or a final order of the Bankruptcy Court determining such dispute or agreement among the parties to such dispute or appeal. Any amounts in respect of disputed Claims shall be returned to or retained by Debtor in the event and to the extent such Claims are determined not to be Allowed Claims.

Article IV Means for Execution of Plan

The Bankruptcy Court shall on or before the Date of Confirmation enter an order authorizing and approving (i) the execution and delivery by Debtor of the Settlement Agreement, and (ii) the consummation of the transactions contemplated thereby. On the Date of Confirmation and the Consummation Date and at all other times Debtor shall execute and deliver such other instruments and documents and perform such other acts and provide such other information and assistance as may reasonably be required to effect consummation of the Plan and the Settlement Agreement. Debtor shall not do or perform any act, or omit to perform any acts that shall delay, prevent or hinder consummation of the Settlement Agreement.

Article V Provisions Applicable to All Classes

The payments, distributions and other treatments provided in respect of each Allowed Claim and the Allowed Interests in Article III shall be in complete satisfaction, discharge and release of each Allowed Claim and the Allowed Interests except as otherwise provided in respect of any Class of Allowed Claims or Allowed Interests which are unimpaired under the Plan.

Article VI Property Dealt With by the Plan

The Plan shall deal with all of Debtor's property, including, without limitation, the Property and all of Debtor's other tangible real or personal or intangible property of whatsoever character.

Article VII Executory Contracts

Debtor hereby assumes pursuant to *section 1123(b)(2) of the Code* the executory contracts set forth on Exhibit "C" hereto, and rejects the executory contracts set forth on Exhibit "D" hereto. Debtor reserves the right to assume or reject pursuant to *section 365 of the Code* prior to the Date of Confirmation any executory contract not assumed or rejected pursuant to the preceding sentence.

Article VIII No Waiver of Rights

Except as expressly provided for herein and in the Mortgage and the Settlement Agreement, acceptance of the Plan by Creditor Bank shall not affect or impair in any respect the rights and remedies of Creditor Bank under the Mortgage or any other agreement, document or instrument executed and delivered in connection therewith. Acceptance of the Plan by the holder of an Allowed Claim shall not, except as otherwise expressly provided for herein, constitute a waiver of any rights or claims such holder may have against any party other than Debtor, all such rights and claims against any such other party being hereby expressly reserved.

Article IX Valid Obligations of Debtor

Debtor hereby represents and warrants that it is a limited partnership formed under the laws of the State of New York; that as of the date hereof the partners of Debtor are those persons listed in the Schedule annexed hereto as Exhibit "E"; that there have been no other partners of Debtor from the date of formation thereof to the date hereof other than those persons listed on Exhibit "E" hereto; and that on the Consummation Date the obligations of Debtor hereunder and under the agreements, documents and instruments executed and delivered by Debtor in connection herewith shall be valid and enforceable against it in accordance with the terms hereof and thereof.

Article X Negative Covenants

Until such time as the indebtedness to Creditor Bank secured by the Mortgage shall have been fully satisfied, Debtor covenants for the benefit of Creditor Bank that it shall not:

(a) Sell, assign, lease, transfer or otherwise dispose of any of the Property; provided, however, that nothing contained in this clause (a) shall prohibit or limit the leasing of space in the Property in the ordinary course of Debtor's business or the sale or other disposition of obsolete or unnecessary equipment or furniture consisting of personal property and constituting part of the Property;

(b) Make or agree to make, any loan to, or other Investment in, any Person, in excess of an aggregate amount with respect to all such loans and Investments by Debtor of \$....., other than:

(1) readily marketable direct obligations of the United States of America;

(2) certificates of time deposit issued by a member of the Federal Reserve System having a net worth of at least \$50,000,000 which mature not later than one year following their date of purchase; or

(3) shares of interest in a money market fund having assets of at least \$250,000,000.

(c) Directly or indirectly create, incur, assume, guarantee, agree to purchase or repurchase, pay or provide funds in respect of any Indebtedness, or otherwise secure, or be or remain liable for, contingently, directly or indirectly, any Indebtedness, except the foregoing restrictions shall not apply to:

(1) Indebtedness created by or unimpaired under the Plan;

(2) liabilities for taxes, fees, purchases of supplies, maintenance equipment, services and other obligations incurred in the ordinary course of business of the Debtor; and

(3) purchase money obligations incurred in the ordinary course of business of the Debtor, provided that the aggregate outstanding balance of all such obligations at any one time shall not exceed \$; or

(d) Create, incur, assume or suffer to exist, directly or indirectly, any mortgage, deed of trust, pledge, lien, security interest or other charge or encumbrance with respect to the Property, or be bound by or subject to any agreement to do so, or assign or otherwise convey any right to receive income, except that the foregoing restrictions shall not apply to:

(1) the Mortgage;

(2) liens, security interests or other encumbrances for taxes, assessments or governmental levies on the Property the payment of which is not at the time required by law;

(3) liens imposed by law, such as carriers' and warehousemen's liens and other similar liens arising in the ordinary

course of Debtor's business and securing amounts not at the time due and payable; and

(4) liens and security interests securing any Indebtedness permitted under clause (c)(3) of this Article X.

Article XI Events of Default and Declaration of Acceleration

A. *Events of Default.* The occurrence of any of the following shall constitute an "Event of Default" under the Plan.

1. If Debtor shall fail to make any payment when due under the Plan or under the Mortgage.
2. If Debtor shall fail to observe or perform any other covenant set forth in the Mortgage, which failure remains uncured for a period equal to the applicable notice and grace periods, if any, provided for by the Mortgage.
3. If Debtor shall fail to observe or perform any other covenant set forth in the Plan.
4. If any material representation or warranty made by Debtor hereunder or otherwise in writing in connection with the transactions contemplated hereby shall prove to have been false or incorrect in any material respect on the date as of which it is made.
5. Debtor shall generally not pay its debts as they become due or shall admit in writing its inability to pay its debts, or shall make a general assignment for the benefit of creditors; or Debtor shall commence any case, proceeding or other action seeking to have an order for relief entered on its behalf as debtor or to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, liquidation, dissolution or composition of it or its debts under the Code or any other law relating to bankruptcy, insolvency, reorganization or relief of debtors or seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its property; or Debtor shall take any action to authorize or in contemplation of any of the actions set forth above in this paragraph 5.
6. Any case, proceeding or other action against Debtor shall be commenced seeking to have an order for relief entered against it as debtor or to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, liquidation, dissolution or composition of it or its debts under the Code or any other law relating to bankruptcy, insolvency, reorganization or relief of debtors, or seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its property, and such case, proceeding or other action (a) results in such an adjudication, the entry of such an order for relief or such an appointment, which is not fully stayed, (b) shall not be contested by Debtor through appropriate proceedings or procedures within 10 days of commencement thereof or shall be acquiesced in by Debtor, or (c) shall remain undismissed for a period of 30 days.

B. *Remedies After Default.* Upon the occurrence of an Event of Default, Creditor Bank may, in addition to its rights and remedies hereunder or under the Mortgage, by written notice to Debtor declare the indebtedness and obligations under the Mortgage to be due and payable, whereupon the same shall forthwith mature and become due and payable together with interest accrued thereon, without any further demand, which is hereby waived.

Article XII Retention of Jurisdiction

The Bankruptcy Court shall retain jurisdiction until the Consummation Date to do all things necessary and appropriate to aid in the consummation of the Plan and shall retain jurisdiction after such date pursuant to the provisions of *section 1127(b) of the Code* for the purposes set forth therein and for the following purposes: (1) to determine any disputes as to the classification or allowance of Claims; (2) to determine any and all pending applications for the rejection or disaffirmance of executory contracts and the allowance of any Claims arising therefrom; (3) to fix and determine all fees and other expenses of administration; and (4) to direct Debtor, on application of Creditor Bank, to perform and otherwise observe its obligations hereunder.

Article XIII Acceptance of Plan by Creditor Bank

Upon the due filing by Creditor Bank with the Bankruptcy Court of an acceptance of the Plan, Creditor Bank shall be deemed to have agreed on the Consummation Date to execute and deliver the Settlement Agreement and the instruments and documents contemplated thereby, provided that all of the following conditions shall have been satisfied:

1. Debtor shall have executed and delivered to Creditor Bank the Settlement Agreement and otherwise performed in accordance with the terms thereof;
2. Debtor shall have executed and delivered to Creditor Bank the amendment to the Mortgage in the form annexed hereto as Exhibit "A";
3. Debtor shall have paid to Creditor Bank the sum of \$459,811.34 contemplated by clause (c)(i) of Section 4 of Article III hereof;
4. Debtor shall have paid to Creditor Bank the sum of \$340,000 contemplated by clause (c)(ii) of Section 4 of Article III hereof;
5. Debtor shall have paid to Creditor Bank the payments of \$38,770 per month contemplated by clause (c)(iii) of Section 4 of Article III hereof to the extent that such payments have not been paid out of the Receiver Account;
6. Debtor shall have paid to Creditor Bank the amount of the Allowed Expense Claim;
7. A New York Board of Title Underwriters title insurance policy covering the Property issued by [name of title company] in form and substance satisfactory to Creditor Bank shall have been issued to Creditor Bank in the face amount of \$8,500,000;
8. Debtor shall have performed and complied with all agreements provided for herein required to be performed or complied with by Debtor prior to or on the Consummation Date; and
9. There shall not exist on the Consummation Date any condition or event which would constitute an Event of Default or which, after notice or lapse of time or both, would constitute an Event of Default.

Article XIV Date of Consummation

In the event that the Consummation Date does not occur on or before, this Plan and any acceptance of this Plan by Creditor Bank shall be withdrawn and revoked and of no further force or effect without any action required by Creditor Bank. In such event, Debtor shall take all steps necessary to have the Bankruptcy Court vacate any order confirming this Plan.

Article XV Miscellaneous

A. Exemption from Transfer Taxes. Pursuant to 1146(c) of the Code, the issuance, transfer or exchange of securities under the Plan, the creation of any mortgage or other security interest, the making or assignment of any lease or sublease, or the making or delivery of any deed or other instrument of transfer under, in furtherance of, or in connection with the Plan, shall not be subject to any stamp, real estate transfer, mortgage recording or similar tax.

B. Severability. If, prior to the entry of the Confirmation Order, any term or provision of the plan is held by the Bankruptcy Court to be invalid, void, or unenforceable, the Bankruptcy Court, at the request of the Debtor, shall have

the power to alter and interpret such term or provision to make it valid or enforceable to the maximum extent practicable, consistent with the original purpose of the term or provisions held to be invalid, void or unenforceable, and such term or provision shall then be applicable as altered or interpreted. Notwithstanding any such holding, alteration, or interpretation, the remainder of the terms and provisions of the Plan will remain in full force and effect and will in no way be effected, impaired, or invalidated by such holding, alteration or interpretation. The Confirmation Order shall constitute a judicial determination and shall provide that each term and provision of the Plan, as it may have been altered or interpreted in accordance with the foregoing, is valid and enforceable pursuant to its terms.

C. *Notices.* All notices provided for herein shall be in writing and shall be deemed to have been given at the time when (i) personally delivered by hand, or (ii) mailed in any general or branch office of the United States Postal Service, enclosed in a certified or registered postpaid envelope, such notice to be addressed, sent or delivered as follows:

1. If to Debtor, at.....

..... ,

or such other address as may have been furnished in writing by Debtor to Creditor Bank; and

2. If to Creditor Bank, at.....

..... ,

or such other address as may have been furnished in writing by Creditor Bank to Debtor.

D. *Headings.* The headings used herein are inserted for convenience only and neither constitute a portion hereof nor in any manner affect the provisions hereof.

E. *Choice of Law.* Except to the extent that the Code is applicable and except as may be otherwise provided in the Mortgage, the rights and obligations arising hereunder shall be governed by, and construed and enforced in accordance with, the internal laws of the State of New York without giving effect to principles of conflicts of laws.

F. *Effective Date.* For purposes of all determinations to be made pursuant to the Code in respect of the Plan or any Claims, the "effective date" of the Plan shall be

G. *Reservation of Rights.* Neither the filing of this Plan, nor any statement or provision contained herein, nor the taking by any creditor of any action with respect to this Plan shall (a) be or be deemed to be an admission against interest and (b) until the Consummation Date, be or be deemed to be a waiver of any rights which any creditor might have against Debtor or any of its properties or any other creditor of Debtor, and until the Consummation Date all such rights are specifically reserved. In the event that the Consummation Date does not occur, neither this Plan nor any statement contained herein, may be used or relied upon in any manner in any suit, action, proceeding or controversy within or outside of the reorganization case involving Debtor.

H. *Amendments and Waivers.* Creditor Bank, as holder of the Class III Allowed Claim, may amend, with the concurrence of Debtor, or waive compliance with any term or condition of the Plan relating to or for the benefit of Creditor Bank. No amendment or waiver shall be effective unless in writing and signed by Creditor Bank and, in the case of an amendment, Debtor.

Dated: New York, New York

....., 20....

Debtor Associates

By

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.55A

P 2.55A Form--Alternative Chapter 11 Plan

Form--Alternative Chapter 11 Plan.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	)	
<i>In re</i>	)	Case No. 02-B
DEBTOR ASSOCIATES LIMITED PARTNER-	)	Chapter 11
SHIP,	)	
<i>Debtor.</i>	)	

Chapter 11 Plan

Debtor Associates Limited Partnership, a New York limited partnership (the "Debtor"), proposes the following plan pursuant to the provisions of Chapter 11 of Title 11, United States Code, to resolve the outstanding creditor claims and partnership interests of the Debtor.

Article I Definitions

As used in this Plan, the following terms shall have the respective meanings specified below and shall be equally applicable to the singular and plural of the terms defined:

1.1. *Action*: Any cause of action or claim belonging to the Debtor or to its estate arising under the Bankruptcy Code including, without limitation, Sections 542, 544, 545, 547, 549, 550, and 553 thereof, and other applicable state and federal law.

1.2. *Administration Expense*: Any Claim constituting a cost or expense of administration of the Chapter 11 Case allowed by Final Order under *Section 503(b) of the Bankruptcy Code*, including, without limitation, any actual and necessary expenses of preserving the estate of the Debtor, any actual and necessary expenses of operating the business

of the Debtor, any indebtedness or obligations incurred or assumed by the Debtor in Possession in connection with the conduct of its business in the ordinary course, any costs and expenses of the management, maintenance, preservation, sale, or other disposition of any of the Debtor's Assets, the administration and implementation of the Plan, the prosecution of Actions, any allowances of compensation and reimbursement of expenses under *Section 330 of the Bankruptcy Code* to the extent allowed by Final Order, whether arising before or after the Effective Date, and any fees or charges assessed against the Debtor under Chapter 123, Title 28, United States Code.

1.3. *Affiliate*: Shall mean with respect to any party hereto, a person or entity which is owned by, owns, or is in common ownership with such party; provided that "owned by" shall include a situation where a majority of the voting stock of the entity is owned, or a controlling interest is held by such party, either directly or indirectly; and further provided that "common ownership" shall include persons related by blood or marriage and/or trusts for the benefit of such related persons and/or entities owned or controlled by such related parties; and further provided that a general or limited partnership shall be deemed an Affiliate if any one of its general partners would be deemed an Affiliate.

1.4. *Allowed*: The term Allowed when used with respect to a Claim or Class of Claims or Partnership Interest or Class of Partnership Interests, as the case may be, means any Claim against or Partnership Interest in the Debtor, proof of which was filed on or before the date designated by the Bankruptcy Court as the last date for filing proofs of claims against or Partnership Interests in the Debtor or, if no proof of claim or Partnership Interest is filed, which has been or hereafter is listed by the Debtor in its Schedules as liquidated in amount and not disputed or contingent and, in either case, a Claim or Partnership Interest as to which no objection to the allowance thereof has been interposed within the applicable period of limitation fixed by the Plan, the Bankruptcy Code, the Bankruptcy Rules or a Final Order of the Bankruptcy Court, or as to which an objection has been interposed and such Claim or Partnership Interest has been allowed in whole or in part by a Final Order. For purposes of determining the amount of an "Allowed Claim," there shall be deducted therefrom an amount equal to the amount of any claim which the Debtors may have against the holder thereof, to the extent such claim may be set off pursuant to *Section 553 of the Bankruptcy Code*.

1.5. *ASP Claim*: The secured claim of American Secured Partners arising under its mortgages encumbering the Debtor's interest as tenant under the Ground Lease.

1.6. *Asset Purchase Agreement*: The Agreement of Purchase and Sale of Leasehold, Improvements and Personal Property between Debtor, as Seller, and, as Purchaser, substantially in the form of Exhibit "A" hereto.

1.7. *Bankruptcy Code*: The Bankruptcy Reform Act of 1978, as amended, and as codified in Title 11, United States Code, as applicable to the Chapter 11 Case.

1.8. *Bankruptcy Court*: The unit of the United States District Court for the Southern District of New York having jurisdiction over the Chapter 11 Case, or in the event such court ceases to exercise jurisdiction over the Chapter 11 Case, such court or adjunct thereof that exercises jurisdiction over the Chapter 11 Case in lieu of the United States Bankruptcy Court for the Southern District of New York.

1.9. *Bankruptcy Rules*: The Rules of Bankruptcy Procedure, as amended, as applicable to the Chapter 11 Case.

1.10. *Business Day*: Any day except Saturday, Sunday, or legal holidays as such term is defined in Bankruptcy Rule 9006(a).

1.11. *Cash*: Lawful currency of the United States of America.

1.12. *Center Partners Partnership Interest*: The limited partnership interest in the Debtor held by Center Partners Limited Partnership.

1.13. *Chapter 11 Case*: The case under Chapter 11 of the Bankruptcy Code in which the Debtor is a debtor and debtor in possession.

1.14. *Claim*: Any right to payment from the Debtor, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured, known or unknown, or any right to an equitable remedy for breach of performance if such breach gives rise to a right of payment from the Debtor, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, disputed, undisputed, secured, or unsecured.

1.15. *Confirmation Date*: The date upon which the Confirmation Order is entered by the Clerk of the Bankruptcy Court.

1.16. *Confirmation Order*: An order of the Bankruptcy Court confirming the Plan in accordance with the provisions of Chapter 11 of the Bankruptcy Code.

1.17. *Consummation Date*: The date on which all of the Debtor's Assets have been liquidated to Cash and distributed in accordance with the Plan.

1.18. *Contract Rate*: The regular interest rate provided for in a contract, note or other agreement between a Creditor and the Debtor; provided, however, the term "Contract Rate" shall not mean or include the interest rate imposed in the event of default by the Debtor.

1.19. *Creditor*: Any person that has a Claim against the Debtor that arose or is deemed to have arisen on or before the Petition Date, including a Claim against the Debtor's estates of a kind specified in *Sections 502(g) or 502(i) of the Bankruptcy Code*.

1.20. *Creditors Committee*: The committee of unsecured creditors appointed in the Chapter 11 Case by the United States Trustee for the Southern District of New York pursuant to *Section 1102 of the Bankruptcy Code*.

1.21. *Debtor*: Debtor Associates Limited Partnership, a New York limited partnership.

1.22. *Debtor's Assets*: All tangible and intangible assets and properties of the debtor in existence immediately prior to the Effective Date, including, without limitation, the Debtor's interest under any lease of real or personal property, Cash, Actions, whether or not the subject of pending litigation, and all proceeds thereof.

1.23. *Debtor in Possession*: The Debtor as debtor in possession pursuant to *Sections 1107 and 1108 of the Bankruptcy Code*.

1.24. *Disbursement Account(s)*: The account(s) to be established by the Plan Administrator on the Effective Date in accordance with Article VIII of the Plan, together with any interest earned thereon.

1.25. *Disputed Claim*: A Claim against the Debtor the allowance of which, in whole or in part, is the subject of a timely objection to the Allowance thereof, whether by motion or adversary proceeding, interposed by the Debtor, the Creditors Committee or the Plan Administrator; provided, however, that for purposes of determining the aggregate amount of Disputed Claims against the Debtor, "Disputed Claims" shall mean the lesser of (a) Disputed Claims as filed with the Bankruptcy Court or (b) Disputed Claims as estimated by the Bankruptcy Court pursuant to *Section 502(c) of the Bankruptcy Code*; and further, provided, that in the event that the Bankruptcy Court shall estimate a Disputed Claim for purposes of allowance pursuant to *Section 502(c) of the Bankruptcy Code*, such estimation shall constitute and represent the maximum amount in which such Claim may ultimately become an Allowed Claim.

1.26. *Effective Date*: The date on which the Confirmation Order becomes a Final Order.

1.27. *Enterprising Bank Claim*: The Allowed Claim of Enterprising Bank, N.A. arising under its mortgages encumbering the Debtor's interest as tenant under the Ground Lease.

1.28. *Final Order*: An order of the Bankruptcy Court (a) as to which the time to appeal, petition for certiorari, or seek reargument or rehearing has expired and as to which no appeal, reargument, certiorari petition, or rehearing is pending, or (b) if an appeal, reargument, certiorari, or rehearing thereof has been sought, the order of the Bankruptcy Court has been affirmed by the highest court to which the order was appealed or from which the reargument or rehearing was sought, or certiorari has been denied, or the appeal is dismissed or rendered moot, and the time to take any further appeal or to seek certiorari or further reargument or rehearing has expired.

1.29. *Ground Lease*: That certain lease dated August 10, 1991 between Ground Lessor and Debtor, a memorandum of which was recorded on August, 1991, in the office of the City Register of the County of New York in Reel, at Page

1.30. *Holder*: A person who owns or holds a Claim against, or Partnership Interest in, the Debtor.

1.31. *Interest*: Simple interest at the rate of nine percent (9%) per annum.

1.32. *Lien*: A valid, perfected, and enforceable charge against or interest in property of the Debtor, to secure payment of a debt or performance of an obligation.

1.33. *Partnership Agreement*: The limited partnership agreement of the Debtor, as amended.

1.34. *Partnership Interest*: Any general or limited partnership interest in the Debtor.

1.35. *Person*: An individual, a corporation, a partnership, an association, a joint stock company, a joint venture, an estate, a trust, an unincorporated organization, or a government or any subdivision thereof or any other entity.

1.36. *Petition Date*: February 3, 2002, the date the Debtor filed a voluntary Chapter 11 petition with the Bankruptcy Court.

1.37. *Plan*: This Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, either in its present form or as it may be altered, amended, or modified from time to time.

1.38. *Plan Administrator*: A Person designated by the Creditors Committee who shall fulfill the responsibilities and duties of the Plan Administrator set forth in Article VII of the Plan.

1.39. *Priority Claim*: Any Claim, other than an Administration Expense and a Priority Tax Claim, entitled to priority in payment pursuant to *Section 507(a) of the Bankruptcy Code*, but only to the extent entitled to such priority.

1.40. *Priority Tax Claim*: Any Claim entitled to priority in payment pursuant to *Section 507(a)(8) of the Bankruptcy Code*, but only to the extent entitled to such priority.

1.41. *Pro Rata*: With respect to Allowed Claims within the same class, the proportion that an Allowed Claim bears to all Allowed Claims within such class; with respect to all Allowed Claims within different classes, the proportion that an Allowed Claim bears to all Allowed Claims within such classes.

1.42. *Schedules*: The schedules of liabilities filed by the Debtor with the Bankruptcy Court, as amended on or before the Effective Date, listing the assets and liabilities of the Debtor.

1.43. *Secured Claim*: Any Allowed Claim, other than the ASP Claim and the Enterprising Bank Claim, in respect of which a Lien or Security Interest is held in any of the Debtor's Assets, to the extent that the amount of any such Allowed Claim is not greater than the net proceeds of the appropriate asset(s) of the Debtor found by the Bankruptcy Court to be valid security therefor, and reduced by such further amount or amounts, if any, as may be determined by the Bankruptcy Court after notice and a hearing to be the reasonable and necessary costs and expenses of preserving and disposing of such asset(s) pursuant to *Section 506(c) of the Bankruptcy Code*.

1.44. *Security Interest*: A Lien created by an agreement.

1.45. *Unsecured Claim*: Any claim, other than an Administration Expense, a Priority Claim, a Priority Tax Claim, a Secured Claim, the ASP Claim, the Enterprising Bank Claim and Claims of Affiliates.

1.46. *Other Definitions*: Unless the context otherwise requires, any capitalized term used and not defined herein or elsewhere in the Plan but that is defined in the Bankruptcy Code shall have the meaning set forth therein. The words "herein," "hereof," "hereto," "hereunder," and others of similar inference refer to the Plan as a whole and not to any particular section, subsection, or clause contained in the Plan.

Article II Means for Executing the Plan

2.1. *Liquidating Plan*: This Plan is a liquidating plan pursuant to which all of the Debtor's Assets including its principal asset, the Debtor's interest in the Ground Lease for the property known as the Secured Apartments together with all furniture and fixtures owned by the Debtor and certain executory contracts, excluding contracts with the Debtor's Affiliates, will be sold (or assumed and assigned as the case may be) for the highest and best price pursuant to the Asset Purchase Agreement. It is anticipated that the sale of substantially all of the Debtor's Assets pursuant to the Asset Purchase Agreement will be consummated prior to the Effective Date. The proceeds from the Asset Purchase Agreement and other Debtor's Assets will be distributed to Creditors and Holders of Partnership Interests (to the extent funds are available) in accordance with the provisions of this Plan.

Article III Provisions for Payment of Administration Expenses

3.1. *Administration Expenses*: Each Holder of an Administration Expense shall be paid the full amount of such Administration Expense, in Cash on the Effective Date or as soon thereafter as practicable, or upon such other terms as may be agreed upon between the Holder of such Administration Expense and the Plan Administrator.

Article IV Provisions for Treatment of Priority Tax Claims

4.1. *Priority Tax Claims*: Each Holder of an Allowed Priority Tax Claim shall be paid the full amount of such Allowed Priority Tax Claim, in Cash on the Effective Date or as soon thereafter as practicable, or upon such other terms as may be agreed upon between the Holder of such Allowed Priority Tax Claim and the Plan Administrator.

Article V Classification of Claims and Partnership Interests

For the purposes of this Plan, Claims and Partnership Interests are classified as follows:

5.1. *Class 1--Priority Claims*.

5.2. *Class 2--Secured Claims*.

5.3. *Class 3--ASP Claim*.

5.4. *Class 4--Enterprising Bank Claim.*

5.5. *Class 5--Unsecured Claims.*

5.6. *Class 6--Center Partners Partnership Interest.*

5.7. *Class 7--Claims of Affiliates.*

5.8. *Class 8--General and Limited Partnership Interests of Affiliates.*

Article VI Treatment of Classes of Claims and Partnership Interests

6.1. *Class 1 Claims (Priority Claims):* Each Holder of an Allowed Class 1 Claim shall be paid the full amount of such Allowed Class 1 Claim, in Cash, on the Effective Date or as soon thereafter as practicable, or upon such other terms as may be agreed upon between the Holder of such Allowed Class 1 Claim and the Plan Administrator.

6.2. *Class 2 Claims (Secured Claims):* Each Holder of an Allowed Class 2 Claim shall be paid the full amount of such Allowed Class 2 Claim, in Cash, on the Effective Date or as soon thereafter as practicable.

6.3. *Class 3 Claim (ASP):* The Allowed Class 3 Claim shall be paid in full, in Cash, on the Effective Date, or as soon thereafter as practicable; provided, however, that interest on the principal amount of the Allowed Class 3 Claim shall be limited in all respects to the Contract Rate.

6.4. *Class 4 Claim (Enterprising Bank, N.A.):* The Allowed Class 4 Claim shall be paid in full, in Cash, on the Effective Date, or as soon thereafter as practicable; provided, however, that interest on the principal amount of the Allowed Class 4 Claim shall be limited in all respects to the Contract Rate.

6.5. *Class 5 Claims (Unsecured Claims):* After payment of all Administration Expenses, Priority Tax Claims and Allowed Claims in Classes 1 through 4, inclusive, each Holder of an Allowed Class 5 Claim shall, commencing not later than sixty (60) days after the Effective Date, receive payment, in Cash, of such Holder's Pro Rata share of the Debtor's Assets then remaining until paid in full, including Interest from the Petition Date to the date of payment of each such Allowed Class 5 Claim.

6.6. *Class 6 Partnership Interest (Partnership Interest of Center Partners Limited Partnership):* After the payment in full of all Class 5 Claims (including reserve for Disputed Claims in Class 5) Center Partners Limited Partnership shall receive from the Debtor's Assets then remaining payment, in Cash, in respect of its Partnership Interest in the Debtor in accordance with the provisions of the Partnership Agreement until paid in full.

6.7. *Class 7 Claims (Affiliate Claims):* After the payment in full of all Class 5 Claims (including reserve for Disputed Class 5 Claims) and after prior payment in full of the Allowed Class 6 Partnership Interest of Center Partners Limited Partnership in accordance with the provisions of the Partnership Agreement, each Holder of an Allowed Class 6 Claim shall receive payment, in Cash, of such Holder's Pro Rata share of the Debtor's Assets then remaining until paid in full.

6.8. *Class 8 Interests (General and Limited Partnership Interests of Affiliates):* After the payment in full of all Class 7 Claims of Affiliates, the Holders of Class 8 Partnership Interests shall receive the remainder, if any, of the Debtor's Assets.

Article VII The Plan Administrator

7.1. *Designation of Plan Administrator:* Not later than ten (10) days after the Confirmation Date, the Debtor shall

designate a person or entity to act as the Plan Administrator under the Plan, which person shall be reasonably acceptable to the Creditors' Committee. In the event of a dispute relating to the identity of the Plan Administrator, the Debtors shall move for approval of the identity of the Plan Administrator by the Bankruptcy Court.

7.2. Duties and Responsibilities of the Plan Administrator: On the Effective Date, the Plan Administrator shall assume his/her duties and responsibilities which shall consist of:

- (a) To act as disbursing agent under the Plan;
- (b) To act as the representative of the Debtor in the prosecution of all Actions;
- (c) To act as the representative of the Debtor in connection with filing objections to Disputed Claims and resolving disputes with respect to the Allowance of Claims; and
- (d) To perform all other duties and responsibilities specifically assigned to the Plan Administrator under the terms of the Plan.

Article VIII Provisions for the Establishment and Maintenance of Disbursement Accounts

8.1. Establishment of Disbursement Accounts by the Plan Administrator: On the Effective Date, the Plan Administrator shall establish one or more segregated bank accounts, as disbursing agent under the Plan, which accounts shall be held in trust for the benefit of Creditors pursuant to the Plan and utilized solely for the investment of Cash and the distribution of Cash consistent with the terms and provisions of the Plan. On or before the Effective Date, the proceeds from the sale or other disposition of the Debtor's Assets shall be deposited into such Disbursement Account(s) less the sum of Five Hundred Thousand Dollars (\$500,000) which sum shall be retained by the Plan Administrator in a segregated account for reasonably anticipated post-Effective Date Administration Expenses in connection with the administration and implementation of the Plan, including, without limitation, the prosecution of Actions by the Plan Administrator, the prosecution of objections to Disputed Claims, the payment of compensation and reimbursement of expenses to the Plan Administrator and its counsel to the extent allowed by the Bankruptcy Court upon application therefor. From and after the Effective Date, the Debtor shall deposit into the Disbursement Account(s) all proceeds of the Debtor's Assets.

8.2. Maintenance of Disbursement Account(s): Disbursement Account(s) shall be maintained by the Plan Administrator at one or more domestic banks or financial institutions of the Plan Administrator's choice having a shareholders' equity or equivalent capital of not less than Five Hundred Million Dollars (\$500,000,000). The Plan Administrator may invest Cash in Disbursement Account(s) in obligations of, or obligations guaranteed by, the United States of America, commercial paper of domestic corporations carrying a Moody's Rating of "A" or better, or equivalent rating of any other nationally recognized rating service, or interest-bearing certificates of deposit or other similar obligations of domestic banks or other financial institutions having a shareholder's equity or equivalent capital of not less than Five Hundred Million Dollars (\$500,000,000), having maturities of not more than six (6) months, at the then best generally available rates of interest for like amounts and like periods; provided, however, that sufficient liquidity shall be maintained in such account or accounts to (a) make promptly when due all payments upon Disputed Claims if, as, and when they may become Allowed Claims, and (b) make promptly when due the other payments provided for in the Plan.

Article IX Provisions for Treatment of Disputed Claims

9.1. Objections to Claims; Prosecution of Disputed Claims: The Plan Administrator shall object to the allowance of Claims filed with the Bankruptcy Court with respect to which the Debtor or the Creditors Committee disputes liability in whole or in part. All objections shall be prosecuted by the Plan Administrator. The Plan Administrator may compromise and settle any objections to Claims, subject to the approval of the Bankruptcy Court. The Plan

Administrator shall serve and file all objections to Claims as soon as practicable, but in no event later than sixty (60) days after the Effective Date or such later date as approved by the Bankruptcy Court.

9.2. Payments and Distributions on Disputed Claims:

(a) From and after the Effective Date, the Plan Administrator shall reserve and hold for the benefit of each Holder of a Disputed Claim, Cash in an amount equal to the Pro Rata payment which would have been made to the Holder of such Disputed Claim if it were an Allowed Claim in an amount equal to the lesser of (i) the amount of the Disputed Claim or (ii) the amount in which the Disputed Claim shall be estimated by the Bankruptcy Court for purposes of allowance, which amount shall constitute and represent the maximum amount in which such Claim may ultimately become an Allowed Claim. Such Cash shall be either (i) held by the Plan Administrator in an interest-bearing account or (ii) invested in interest-bearing obligations issued by the United States Government, or by an agency of the United States Government and guaranteed by the United States Government, and having (in either case) a maturity of not more than thirty (30) days, for the benefit of such Holder pending determination of their entitlement thereto under the terms of the Plan. No payments or distributions shall be made with respect to all or any portion of any Disputed Claim pending the entire resolution thereof by Final Order.

(b) At such time as a Disputed Claim becomes, in whole or in part, an Allowed Claim, the Holder of such Allowed Claim shall receive the payments to which such Holder is then entitled under the Plan. Such payments shall be made as soon as practicable after the date that the order of the Bankruptcy Court allowing such Claim becomes a Final Order but in no event later than thirty (30) days after the date such order becomes a Final Order.

Article X Prosecution of Actions

10.1. *Prosecution of Actions:* From and after the Effective Date, the Plan Administrator shall prosecute all Actions that may be pending on the Effective Date, or instituted by the Plan Administrator after the Effective Date.

Article XI Acceptance or Rejection of Plan: Effect of Rejection by One or More Classes

11.1. *Impaired Classes to Vote:* Each impaired Class of Creditors with Claims against or Partnership Interests in the Debtor's estate shall be entitled to vote to accept or reject the Plan.

11.2. *Acceptance by Class of Creditors:* A Class of Creditors or Partnership Interests shall have accepted the Plan if the Plan is accepted by at least two-thirds (2/3) in amount and more than one-half (1/2) in number of the Allowed Claims or Allowed Partnership Interests of such Class that have accepted or rejected the Plan.

11.3. *Cramdown:* In the event that any impaired Class of Creditors with Claims against, or Class of Partnership Interests in, the Debtor shall fail to accept the Plan in accordance with *Section 1129(a) of the Bankruptcy Code*, the Debtor reserves the right to request that the Bankruptcy Court confirm the Plan in accordance with *Section 1129(b) of the Bankruptcy Code* or amend the Plan pursuant to the Plan.

Article XII Identification of Claims Not Impaired by the Plan

12.1. *Unimpaired Classes:* The Claims included in Classes 1, 2, 3, and 4 are not impaired under this Plan.

12.2. *Impaired Classes to Vote on Plan:* The Claims and Partnership Interests included in Classes 5, 6, 7, and 8 of the Plan are impaired and are therefore entitled to vote to accept or reject the Plan.

12.3. *Controversy Concerning Impairment:* In the event of a controversy as to whether any Creditor or Holder of a Partnership Interest or Class of Creditors or Class of Partnership Interests is impaired under the Plan, the Bankruptcy

Court shall, after notice and a hearing, determine such controversy.

Article XIII Executory Contracts and Unexpired Leases

13.1. *Rejection of Executory Contracts:* Any executory contracts or unexpired leases not assumed pursuant to the Asset Purchase Agreement or by the Debtor prior to the Effective Date, or which are not the subject of a motion by the Debtor or the Creditors Committee to assume the same pending as of the Effective Date, shall be deemed to have been rejected by the Debtor upon the Effective Date, in accordance with *Section 365 of the Bankruptcy Code*.

Article XIV Creditors' Committee

14.1. *Composition and Term:* From and after the Effective Date and until all payments and distributions to Holders of Allowed Unsecured Claims shall have been made under the Plan, the members of the Creditors' Committee appointed pursuant to *Section 1102 of the Bankruptcy Code*, and their duly appointed successors shall continue to serve. Upon the disallowance by Final Order or satisfaction in full of the Claim held by a Creditor having designated a member of the Creditors' Committee, such membership shall terminate and no replacement shall be appointed. Upon the resignation or disability of a member of the Creditors' Committee, the Creditor having appointed such member shall have the right to designate a replacement. In the event such Creditor shall fail to designate a replacement, the Creditors' Committee may designate a replacement. Members of the Creditors' Committee shall serve without compensation but shall be entitled to reimbursement of only their reasonable out-of-pocket expenses which are attributable to their attendance at Creditors' Committee meetings and other Creditors' Committee business. The Creditors' Committee shall be entitled to continue to retain legal counsel and such other professionals as previously authorized by the Bankruptcy Court prior to the Effective Date, the fees and expenses of which shall be entitled to payment to the extent allowed by the Bankruptcy Court upon application therefor.

Article XV Provisions for Execution and Supervision of the Plan

15.1. *Retention of Jurisdiction:* The Bankruptcy Court shall retain and have exclusive jurisdiction over the Chapter 11 Case for the following purposes:

- (a) To determine any and all objections to the allowance of Disputed Claims or Partnership Interests;
- (b) To determine any and all pending applications for the rejection or assumption of executory contracts or unexpired leases to which the Debtor is a party or with respect to which it may be liable, and to hear and determine, and if need be to liquidate, any and all Claims arising therefrom;
- (c) To determine any and all applications, adversary proceedings and contested or litigated matters that may be pending on the Effective Date, or instituted by the Plan Administrator after the Effective Date, including, without limitation, any Actions;
- (d) To consider any modifications of the Plan, any defect or omission or reconcile any inconsistency in any order of the Bankruptcy Court, including the Confirmation Order, to the extent authorized by the Bankruptcy Court;
- (e) To determine all controversies, suits and disputes that may arise in connection with the interpretation, enforcement or consummation of the Plan;
- (f) To consider and act on the compromise and settlement of any Action;
- (g) To issue such orders in aid of execution of the Plan to the extent authorized by *Section 1142 of the Bankruptcy Code*;

(h) To enforce the provisions of the Asset Purchase Agreement; and

(i) To determine such other matters which may be set forth in the Confirmation Order or which may arise in connection with the Plan or the Confirmation Order.

15.2. *Amendment of Plan:* The Plan may be amended by the Debtor before or after the Effective Date as provided in *Section 1127 of the Bankruptcy Code*.

Article XVI Miscellaneous Provisions

16.1. *Severability.* If, prior to the entry of the Confirmation Order, any term or provision of the plan is held by the Bankruptcy Court to be invalid, void, or unenforceable, the Bankruptcy Court, at the request of the Debtor, shall have the power to alter and interpret such term or provision to make it valid or enforceable to the maximum extent practicable, consistent with the original purpose of the term or provisions held to be invalid, void or unenforceable, and such term or provision shall then be applicable as altered or interpreted. Notwithstanding any such holding, alteration, or interpretation, the remainder of the terms and provisions of the Plan will remain in full force and effect and will in no way be effected, impaired, or invalidated by such holding, alteration or interpretation. The Confirmation Order shall constitute a judicial determination and shall provide that each term and provision of the Plan, as it may have been altered or interpreted in accordance with the foregoing, is valid and enforceable pursuant to its terms.

16.2. *Governing Law.* Except to the extent that the Bankruptcy Code or other federal law is applicable, or to the extent an exhibit or schedule hereto provides otherwise, the rights, duties, and obligations arising under the Plan shall be governed by, and construed and enforced in accordance with, the laws, of the State of New York, without giving effect to the principles of conflicts of law thereof.

16.3. *Filing of Additional Documents:* On or before the Effective Date, the Creditors Committee shall file with the Bankruptcy Court such agreements and other documents as may be necessary or appropriate to effectuate and further evidence the terms and conditions of the Plan.

16.4. *Section Headings:* The section headings contained in the Plan are for reference purposes only and shall not affect in any way the meaning or interpretation of the Plan.

Dated: New York, New York

....., 20....

DEBTOR ASSOCIATES LIMITED

PARTNERSHIP

By

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 2 Mortgages *

*1-2 Collier Real Estate Trans & Bankruptcy Code P 2.56***P 2.56 Form--Disclosure Statement**

Form--Disclosure Statement.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

_____	)	
<i>In re</i>	)	Case No.:
BUILDING ASSOCIATES,	)	Disclosure Statement
<i>Debtor.</i>	)	
	)	

On January 5, 2002 (the "Petition Date"), Building Associates (the "Debtor") filed a voluntary petition for reorganization (the "Petition") pursuant to chapter 11 of the Bankruptcy Code (the "Code") in the United States Bankruptcy Court for the Southern District of New York (the "Court"). The proceedings are pending before the Honorable, Bankruptcy Judge.

After the filing of the Petition, the Debtor was authorized to remain in possession of its property and to operate its business as debtor-in-possession. The Debtor has continued the operation of its business as debtor in possession.

On October 20, 2002, the Debtor filed its proposed Plan of Reorganization (the "Plan").

Pursuant to *section 1125 of the Code*, the Debtor has prepared and filed this Disclosure Statement, which has been approved by the Court, for submission to the holders of claims against, and interests in, the Debtor. The purpose of this Disclosure Statement is to provide such holders of claims and interests with adequate information about the Debtor and the Plan so that they may be in a position to make an informed judgment about the merits of the Plan. A copy of the Plan, together with this Disclosure Statement, is being forwarded to each holder of a claim or interest, along with a ballot for the purpose of having the holder of a claim or interest accept or reject the Plan.

The Court has set a hearing on confirmation of the Plan for the 12th day of January, 2003, at 10:00 A.M. Ballots are to

be returned to [Attorney for Creditors' Committee] [address], on or before the 8th day of January, 2003, or the holder of a claim or interest may attend the confirmation hearing on the aforesaid date and present its ballot at that time.

In order for the Plan to be accepted, creditors that hold at least two-thirds (2/3) in amount and more than one-half (1/2) in number of the allowed claims of the class designated in the Plan as Class 2 Claims which actually vote, and the holder of the Class 4 Claim, must vote in favor of the Plan. The holders of other claims and interests are unimpaired under the Plan and therefore under *Section 1126(f) of the Code* are deemed to have accepted the Plan.

The following is a list containing the names, addresses and telephone numbers of the members of the Creditors' Committee, its counsel and accountant, and the Debtor's counsel and accountant:

CREDITORS' COMMITTEE

[names, addresses and telephone numbers]

COMMITTEE COUNSEL

[name, address and
telephone number]

DEBTOR'S COUNSEL

[name, address and
telephone number]

COMMITTEE ACCOUNTANT

[name, address and
telephone number]

DEBTOR'S ACCOUNTANT

[name, address and
telephone number]

IF YOU WISH ANY INFORMATION IN CONNECTION WITH THE DISCLOSURE STATEMENT OR THE PLAN, PLEASE COMMUNICATE WITH ANY OF THE AFOREMENTIONED PERSONS.

I. The Debtor and the Property

The Debtor is a limited partnership organized and existing under the laws of the State of New York with a place of business at 900 East 42nd Street, New York, New York. It commenced business in May of 1985 as the owner in fee of the twelve story office building located at 900 East 42nd Street, New York, New York (the "Property"). On May 10, 1995 the Debtor acquired the Property for the price of \$10,500,000, by taking title subject to an existing first mortgage in the amount of \$5,000,000 (the "Mortgage") held by Creditor Bank, N.A. ("Creditor Bank"), by giving to John Doe ("Doe"), the seller of the Property, a second purchase money mortgage in the amount of \$5,000,000 (the "Purchase Money Mortgage") and by payment of \$500,000 in cash. The outstanding principal balance of the Mortgage as of the Petition Date was \$4,000,000 payable together with interest thereon at the rate of 10% per annum in equal monthly installments of interest and principal of \$50,000.00 each until January 1, 2010, when the remaining principal balance together with accrued and unpaid interest is due and payable. The outstanding principal balance of the Purchase Money Mortgage as of the Petition Date was \$3,000,000 payable together with interest thereon at the rate of 10% per annum in equal quarterly installments of interest and principal of \$150,000.00 each until January 1, 2006, when the remaining principal balance together with accrued and unpaid interest is due and payable.

As of the Petition Date, the Debtor was in default under the Mortgage by reason of non-payment of the installments of principal and interest due on each of October 1, November 1, and December 1, 2001, and January 1, 2002, and was in default under the Purchase Money Mortgage by reason of non-payment of the installments of principal and interest due on each of October 1, 2001, and January 1, 2002. In addition, as of the Petition Date, Debtor was in arrears in the payment of wages to employees in the amount of \$1,000, contributions to employee benefit plans in the amount of \$1,000, charges for electrical service for the Property in the amount of \$15,000 and amounts due under the maintenance

contract for the Property with XYZ Maintenance Co. of \$3,000. A description of the claims filed and allowed in the chapter 11 case is set forth in II. below.

During the one year period prior to the Petition Date, Debtor operated the Property at a loss for the following reasons:

- a) Approximately 10,000 square feet of space in the Property was vacant and not under lease;
- b) On June 1, 2001, a tenant of approximately 5,000 square feet of space in the Property failed to pay the monthly installment of rent and thereafter filed a chapter 11 petition under the Code. Debtor has not been successful in its efforts to receive payments from such tenant on account of use and occupation charges since the filing of the chapter 11 petition and on December 1, 2002, the tenant, as debtor in possession, rejected its lease; and
- c) the costs of electricity and fuel have increased substantially during each year of Debtor's ownership of the Property.

Subsequent to the filing of the petition, Debtor entered into a lease of the approximately 10,000 feet of space which had been vacant and into a separate lease of the approximately 5,000 feet of space in respect of which the prior lease had been rejected.

II. Financial Information

A. Creditors' Claims

1. *Administration Claims.* The estimated amounts of administration claims (which are subject to court approval) are:

a) Fees of attorneys for debtor and Creditors' Committee (aggregate):	\$100,000.00
(1), Attorney for Debtor (Bal. of Fee): \$30,000.00 (in addition to a retainer fee of \$20,000.00)	
(2), Attorneys for Creditors' Committee: \$50,000.00	
b) Fees of accountants for debtor and Creditors' Committee (aggregate):	\$ 50,000.00
(1), Accountant for Debtor: \$25,000	
(2), Accountants for Creditors' Committee: \$25,000	
c) Reimbursable expenses of members of Creditors' Committee:	500.00
TOTAL	\$150,500.00

2. *Priority Claims.* The estimated amount of the priority claims are:

Wages and Salaries	\$1,000.00
Contributions to Employee Benefit Plans	1,000.00

TOTAL	\$2,000.00

3. *Class 2 Claims.* The estimated amount of the general unsecured creditors' claims (defined in the Plan as "Class 2 Claims") to be paid on confirmation is \$19,000.00.

The schedules filed by the Debtor list total claims of approximately \$39,000.00 consisting of:

a) Undisputed claims:	\$19,000.00
b) Disputed claims:	\$20,000.00
TOTAL	\$39,000.00

Among the disputed claims are a claim in the amount of \$15,000 filed by the XYZ Brokerage Company for leasing brokerage commissions in respect of certain leases in effect at the Property. If all disputed claims are allowed in full, the allowed Class 2 Claims will be \$39,000.00 in the aggregate. If the disputed portion of the Class 2 Claims is disallowed in full, the allowed Class 2 Claims will be \$19,000.00 in the aggregate. Based upon these figures, the Debtor estimates that holders of Class 2 Claims should receive between 32% to 65.8% of their claims, exclusive of any distributions which may be made in respect of prepetition litigated claims and preferences which are recovered by the Debtor. (For further information on such distributions, see IV. A.3. below.)

4. *Class 3 Claim.* The claim of Creditor Bank under the Mortgage, without giving effect to acceleration, is

a) Unpaid principal and interest	\$650,000.00
b) Late charges on unpaid principal	10,000.00
c) Costs of collection including attorneys' fees and expenses	10,000.00
TOTAL	\$670,000.00

5. *Class 4 Claim.* The claim of Doe under the Purchase Money Mortgage, without giving effect to acceleration, is

a) Unpaid principal and interest	\$750,000.00
b) Late charges on unpaid principal	15,000.00
c) Costs of collection including attorneys' fees and expenses	12,000.00
TOTAL	\$777,000.00

B. Assets of the Debtor

The assets of the Debtor consist of the Property, cash on hand, a litigated claim and claims for the recovery of preferences.

1. *Cash on hand.* There is available for distribution to unsecured creditors on confirmation the sum of \$165,000.00, together with interest, from which the administration expenses and priority claims set forth above (see II. A.1. and 2. above) will be deducted. These expenses and priority claims are estimated to aggregate approximately \$152,500.00 thereby leaving a net amount for distribution in the approximate sum of \$12,500.00, which is to be paid to holders of Class 2 Claims on a pro rata basis.
2. *Litigated claim.* The litigated claim consists of a claim in the amount of \$50,500.00 for rental arrearages, use and occupation charges, and damages arising out of the rejection of the lease referred to in I.(b) above. The face value of the claim is \$50,500.00, and the assumed value under the Plan is \$15,000.00.
3. *Preferences.* In addition to the aforesaid assets of the Debtor, the Debtor is investigating possible recoveries of preferential transfers. It is estimated that the amount of recovery on these claims will be \$13,000.00 subject to the payment of the legal fees and expenses to be fixed by the Court. A proportionate share of 50% of the net proceeds of the prepetition litigation claims, and of recoveries of preferential transfers after giving effect to certain deductions will be distributed to holders of Class 2 Claims. (See IV. A.3. below.)

C. Financial Statements

The debtor in possession has been operating its business since the Petition Date and has continued the operation of its business to date. The operating statements which are appended hereto as Exhibit A summarize the business operations of the debtor in possession commencing with the Petition Date and continuing for each month thereafter until September 30, 2002.

The accountant for the debtor in possession has prepared a balance sheet containing the assets and liabilities of the debtor in possession as at September 30, 2002. This is appended hereto as Exhibit B.

The debtor in possession, with the assistance of its accountant, has prepared a projected operating statement, dated August 5, 2002, for the one calendar year subsequent to the confirmation of the Plan. This is appended hereto as Exhibit C.

Appended hereto as Exhibit D is a rent roll for the Property, summarizing the principal terms of each of the space leases at the Property including the new leases referred to in I. above.

Appended hereto as Exhibit E is an appraisal of the Property prepared by and setting forth a maximum sale price of the Property of \$6,500,000 and a minimum sale price of the Property of \$5,000,000.n1

III. The Plan Is in the Best Interests of Creditors

Under the terms of the Plan, holders of Class 2 Claims and the holder of the Class 4 Claim will receive on account of their respective indebtedness an amount that is not less than the amount which such holders would receive if the Debtor were liquidated under chapter 7 of the Code.

As indicated above (see II. A.3.) the maximum amount of allowed Class 2 Claims should not exceed \$39,000.00. However, as a result of proceedings filed by the Debtor in connection with disputed claims, the Debtor believes that the claims will be reduced so that the maximum amount thereof will be approximately \$19,000.00. Based upon the latter figure, holders of Class 2 Claims would receive 65.8% of their claims on confirmation. If the former figure results, such holders would receive 32% of their claims on confirmation.

Under the Plan, in addition to the amounts paid on confirmation, holders of Class 2 Claims will participate in the proceeds of the recovery of the claim asserted by the Debtor having an assumed value of \$15,000.00 and preferential

transfers in the sum of \$13,000.00. The Debtor estimates these recoverable amounts to be in excess of the amounts that could be recovered in the event of a liquidation under chapter 7.

It is the Debtor's belief that liquidation under chapter 7 would result in holders of Class 2 Claims receiving an amount that is less than the amount which they will receive if the Plan is accepted and confirmed. The bases for that belief are:

- a) A liquidation under chapter 7 would entail additional costs such as trustee's compensation and reimbursement for the professional services of the trustee's attorneys and accountants.
- b) Distribution to creditors could be unduly delayed pending the liquidation of assets and the complete administration of the proceeding.
- c) The Plan provides for an aggregate capital contribution of \$920,000.00 by Joe Smith and Ralph Jones, the limited partners of the Debtor, prior to confirmation of the Plan (see IV. B.1.).

With respect to the Class 4 Claim, the appraisal appended hereto as Exhibit E states that on a bankruptcy sale basis the Property may be expected to sell for not more than \$5,000,000. At this figure, there would be only \$800,000 available for distribution to the holder of the Class 4 Claim, as compared to payment in full of the indebtedness secured by the Purchase Money Mortgage over the extended payment schedule set forth in the Plan.

IV. Summary of the Plan

The following summary is intended to provide holders of claims and interests with a description of the basic payment and other provisions of the Plan. However, the Plan itself should be reviewed in its entirety.

A. Summary of Payment Provisions

The Plan provides for the treatment of administrative expenses, priority claims ("Class 1 Claims"), nonpriority claims ("Class 2 Claims"), the claim under the Mortgage (the "Class 3 Claim"), the claim under the Purchase Money Mortgage (the "Class 4 Claim") and equity interests in the Debtor ("Class 5 Interests") in the following manner:

1. Administrative Expenses

Allowed expenses of administration shall be paid in full upon confirmation of the Plan or as soon thereafter as is practicable or upon such other terms as may be agreed upon by the holder of an administrative expense and the Debtor. The expenses of administration include (a) compensation and reimbursement of disbursements for the attorneys for the Debtor, the attorneys for the Creditors' Committee, the accountant for the Debtor, and the accountant for the Creditors' Committee, and (b) reimbursement of disbursements for the members of the Creditors' Committee. The amount of all such administrative expenses is subject to the approval of the Bankruptcy Court.

Administrative expenses are estimated at approximately \$150,500.00. (See II. A. above.)

2. Class 1 Claims

All allowed claims entitled to priority under the Code shall be paid in full upon confirmation of the Plan or as soon thereafter as is practicable unless otherwise ordered by the Court, in cash, or upon such other terms as may be agreed upon by the holder of such priority claim and the Debtor.

Priority claims are estimated at \$2,000. (See II. A. above.)

3. Class 2 Claims

The holder of each Class 2 Claim shall receive distributions under the Plan as follows:

a. *On Confirmation:* Upon confirmation of the Plan, or as soon thereafter as is practicable, each holder of a Class 2 Claim shall receive its pro rata share of an amount (defined in the Plan as the "Confirmation Cash Amount") equal to \$165,000.00, plus interest after January 30, 2003, reduced by the allowed amounts to be distributed to holders of allowed administrative expenses and Class 1 Claims (see "1." and "2." above). In addition, any recoveries made by the Debtor on or before confirmation of the prepetition litigation claim and of preferential payments will be paid to holders of Class 2 Claims. The Debtor estimates that recoveries in respect of such amounts will be minimal as of the date of confirmation.

Without giving effect to interest which shall accrue after January 1, 2003, or to possible recoveries in respect of the prepetition litigation claim or preferences, the Debtor estimates that each holder of a Class 2 Claim shall receive a pro rata distribution of approximately \$12,500.00 on the confirmation date or as soon thereafter as is practicable. That amount is arrived at as follows:

Amount Available for Distribution		\$165,000.00
Administrative Expenses	(\$150,500.00)	
Priority Claims	(2,000.00)	152,500.00
Total Available for Distribution		\$ 12,500.00

b. *Post-Confirmation:* In quarterly distributions commencing January 1, 2004, each holder of a Class 2 Claim shall receive the following distributions:

(1) its pro rata share of 50% of the net proceeds, if any, received by or on behalf of the Debtor in respect of the prepetition litigation claims:

(2) its pro rata share of an amount equal to a proportionate share of the net proceeds, if any, received by the Debtor in respect of preferences. That proportionate share to be distributed to holders of Class 2 Claims will be calculated by deducting from such net proceeds (i) an amount to be paid to the entities from which the preferences were recovered (which, as a result of such recoveries will become holders of Class 2 Claims, such claims being defined in the Plan as "Preference Claims") proportionately equal to prior distributions made to holders of Class 2 Claims, and (ii) an amount (defined in the Plan as the "Preference Recovery Incentive Amount") to be distributed to the Debtor. The formula is designed to provide holders of Class 2 Claims and the Debtor with approximately equal shares of such net proceeds, after giving effect to amounts to be paid to holders of Preference Claims in order to "catch-up" with prior distributions to holders of Class 2 Claims; and

(3) its pro rata share of (i) amounts, if any, reserved from distribution in respect of disputed or unliquidated administrative expenses or priority claims in the event and to the extent such expenses or priority claims are determined by the Court not to be allowable and (ii) amounts reserved from distribution in respect to disputed or contingent claims, other than priority claims, in the event and to the extent that such claims are determined by the Court not to be allowable. The Debtor shall maintain a special bank account from which these payments are to be made and the funds shall be held by the Debtor as trustee for holders of Class 2 Claims.

4. The Class 3 Claim

The Class 3 Claim shall not be impaired by the Plan. The Plan will not alter any legal, equitable or contractual rights of Creditor Bank, as holder of the Class 3 Claim, except that the maturity of the Class 3 Claim will be reinstated upon the confirmation of the Plan to the maturity existing immediately before any default under the Mortgage. Creditor Bank, as holder of the Class 3 Claim, will receive on confirmation or as soon thereafter as is practicable, the sum of \$670,000.00, representing the aggregate amount of the arrearages and other sums claimed by Creditor Bank as set forth in I. A.4. above.

5. The Class 4 Claim

The Class 4 Claim shall receive upon confirmation, or as soon thereafter as is practicable, the sum of \$100,000.00 on account of and in full discharge of the Class 4 Claim as set forth in I. A.5. above. In addition, the Purchase Money Mortgage shall be amended to provide for the payment by Debtor of the outstanding principal balance of \$3,000,000.00 together with interest thereon at the rate of 5% per annum in equal quarterly installments of \$25,000.00 each commencing on January 1, 2006, and continuing to and including October 1, 2016, when the remaining principal and accrued and unpaid interest shall be due and payable.

6. Class 5 Interests

Class 5 Interests consist of the limited partnership interests in the Debtor of Joe Smith and Ralph Jones and the general partnership interest in the Debtor of Building Corp., a New York corporation. Class 5 Interests shall not be impaired by the Plan.

B. Miscellaneous Provisions

1. Capital Contribution

As a condition precedent to the confirmation of the Plan, the principals of the Debtor, Joe Smith and Ralph Jones, will deposit the sum of \$920,000.00 as a capital contribution to the Debtor prior to confirmation of the Plan and such amount shall be included in the capital of the Debtor as of the confirmation date.

2. Ownership and Management

The ownership interests in the Debtor will continue to be held by Joe Smith, Ralph Jones and Building Corp. and the management of the Debtor will continue under the direction of Building Corp.

3. Default

Defaults under the Plan include the filing by the Debtor of a voluntary bankruptcy proceeding or the commencement of an involuntary bankruptcy proceeding resulting in an adjudication or order for relief or which is not dismissed after 30 days; the entry of a judgment in a specified amount against the Debtor which remains outstanding; a default in payment of any indebtedness; a default in performing any of the provisions of the Plan; and a default in the payment or performance of any obligation under the Mortgage or the Purchase Money Mortgage.

4. Retention of Jurisdiction

Jurisdiction is to be retained by the court in order to determine the allowance of claims and interests, actions brought to recover preferences and adversary proceedings; to fix allowances; and for such other matters as are provided for in the order of confirmation.

V. Position of the Creditors' Committee

The Creditors' Committee appointed by the United States Trustee has participated in the extensive negotiations which have resulted in the formulation and filing of the Plan.

The members of the Committee have unanimously indicated that they intend to vote in favor of the Plan.

BUILDING ASSOCIATES, Debtor

By:

Dated: New York, New York

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FOOTNOTES:

(n1)Footnote 1. Under *section 1125(b) of the Code*, the court may approve a disclosure statement without a valuation or appraisal of the debtor's assets. An appraisal is called for in the above sample to justify the treatment accorded to the holder of the Mortgage and the Purchase Money Mortgage.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 2 Mortgages *

1-2 Collier Real Estate Trans & Bankruptcy Code P 2.57

P 2.57 Form--Notice of Appearance and Request for Service of Notices and Other Documents

Form--Notice of Appearance and Request for Service of Notices and Other Documents.
UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

_____	)	
<i>In re</i>	)	Case No. 03-
XYZ OWNER, INC.,	)	
<i>Debtor.</i>	)	
_____	)	

**NOTICE OF APPEARANCE AND REQUEST FOR
SERVICE OF NOTICES AND OTHER DOCUMENTS**

PLEASE TAKE NOTICE that the undersigned attorney of the law firm of ABC Lawyers L.L.P. hereby appears for **Leasehold Mortgage Lender N.A.**, a party in interest in the above referenced case, and hereby submits this Notice of Appearance in the above-captioned case and requests notice of all hearings and conferences herein and makes demand for service of all papers and notices pursuant to *Rules 2002, 3017, 9007, and 9010* of the Bankruptcy Rules and *Sections 342 and 1009(b)* of the Bankruptcy Code and requests that all notices given or required to be given in this case be given to and served upon:

ABC Lawyers LLP
666 Fifth Avenue, 27th Floor
New York, New York 10103
Telephone: (917) 555-8137
Facsimile: (917) 555-8100

Attn: John Q. Lawyer

and

Leasehold Mortgage Lender N.A.
555 Fifth Avenue
New York, New York 10103
Telephone: (212) 556-1234
Facsimile: (212) 556-4320
Attn: Frederick L. Officer

PLEASE TAKE FURTHER NOTICE that the foregoing demand is not only for the notices and papers referred to in the Bankruptcy Rules and sections of the Bankruptcy Code specified above, but also includes, without limitation, the schedules, statement of financial affairs, operating reports, any plan of reorganization, or disclosure statement and any letter, application, motion, complaint, objection, claim, demand, hearing, petition, pleadings, or request, whether formal or informal, whether written or oral, and whether transmitted or conveyed by mail, delivery, telephone, telegraph, telex, or otherwise filed with or delivered to the Bankruptcy Clerk, Clerk, Court, or Judge (as those terms are defined in Bankruptcy *Rule 9001*) in connection with and with regard to the above-referenced bankruptcy cases and any proceedings related thereto, including, without limitation, any proceeding involving the premises located at 225 East 84th Street, New York, New York 10128, which are owned by the Debtor.

PLEASE TAKE FURTHER NOTICE that this Notice of Appearance and Demand for Service of Papers shall not be deemed or construed to be a waiver of the rights of Leasehold Mortgage Lender NA (i) to have final orders in non-core matters entered only after de novo review by a District Judge, (ii) to trial by jury in any proceeding so triable in these cases or any case, controversy, or proceeding related to these cases, (iii) to have the District Court withdraw the reference in any matter subject to mandatory or discretionary withdrawal, or (iv) to any other rights, claims, actions, setoffs, or recoupments to which Leasehold Mortgage Lender NA is or may be entitled, either in law or in equity, all of which rights, claims, actions, defenses, setoffs, and recoupments are expressly reserved.

ABC LAWYERS L.L.P.

By:

John Q. Lawyer

A member of the firm

666 Fifth Avenue

New York, New York 10103

Telephone: (917) 555-8137

Facsimile: (197) 555-8100

Dated: New York, New York

....., 20....

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of the chapter.



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code 3.syn

§ 3.syn Synopsis to Chapter 3: Leases *

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P 3.51 Form--Notice of Motion and Application for Order Directing Assumption or Rejection of Lease, Payment of Rents and Charges, and Relief From Stay (S.D.N.Y.)

P 3.52 Form--Order Approving Agreement with Real Estate Consultant, Finder and Broker; Application for Order

P 3.53 Form--Order Approving Solicitation of Bids on Certain Leases; Application for Order

P 3.54 Form--Order Approving Assumption of Lease and Assignment; Application

P 3.55 Form--Assignment and Assumption Agreement

P 3.56 Form--Order Approving Termination of Lease; Application

P 3.57 Form--Notice of Motion Authorizing Rejection of Lease; Application

P 3.58 Form--Notice of Motion for Order Extending Time for Assumption or Rejection of Leases

P 3.59 Form--Motion for Order Extending Time for Assumption or Rejection of Leases

P 3.60 Form--Notice of Election of Lessee to Retain Rights Under Rejected Lease (S.D.N.Y.)



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.01

P 3.01 The Tenant as Debtor

[1] Introduction

The provisions of the Bankruptcy Code relating to unexpired real property leases have substantially enhanced the ability of the trustee of a tenant to (1) avoid the loss of a leasehold interest constituting property of the estate as a consequence of the filing of a petition under the Code; (2) avoid loss of the leasehold as a consequence of a nonbankruptcy default under the lease; (3) transform a lease which may have been regarded as a mere operating lease into a capital asset that may be transferred to a third party for consideration; and (4) eliminate or limit the burdens and obligations arising from the breach of the lease agreement.ⁿ¹ These powers and benefits have engendered countervailing efforts by landlords to recapture properties leased to debtor-tenants in order to (1) avoid the uncertainties of dealing with a debtor under the Bankruptcy Code or the trustee of such debtor; (2) reduce the flexibility and negotiating leverage that could be asserted by a trustee; (3) eliminate the possibility that the leasehold may be assigned to a third party which has not been approved by the landlord; and (4) obtain control over the leased property in the hope of obtaining a rental superior to that provided for in the debtor's lease. As set forth in greater detail in this chapter, these efforts have resulted in important amendments to the Bankruptcy Code that have had the effect of imposing certain limitations on the rights of the trustee as tenant with respect to the real property leases.

Under Section 70b of the former Bankruptcy Act, bankruptcy default or so-called *ipso facto* termination clauses were enforceable. Although the courts engrafted numerous exceptions onto the rule of enforceability,ⁿ² a landlord seeking to recapture leased premises from a debtor-tenant would ordinarily assert in the bankruptcy court that the lease had been terminated by reason of the commencement of the bankruptcy case and that this alone warranted a determination that the lease had been terminated. Of course, if the tenant was in breach of other provisions of the lease, these breaches would also be asserted as grounds for termination.ⁿ³ In any event, the principal issue to be dealt with by a landlord in seeking to recapture leased premises was whether the lease had been terminated. If a landlord could demonstrate that a lease had been terminated, there would be no need to litigate issues relating to the trustee's right to assume the lease, to assign the lease to a third party, or to enjoin the landlord from recapturing the property in order to gain time within which to decide whether the lease should be assumed or rejected.

Under the Bankruptcy Code, landlord-tenant litigation appears to encompass a broader range of issues, including (1) whether a lease has been terminated under state law prior to the filing of the petition;ⁿ⁴ (2) whether the landlord is entitled to relief from the automatic stay in order to enforce its rights in respect of nonbankruptcy defaults under the

lease;ⁿ⁵ (3) whether the trustee or debtor in possession can delay its decision on whether it intends to assume or reject the lease;^{n5a} (4) whether the trustee of the debtor-tenant has satisfied its obligations under the lease prior to making a decision on whether to reject or assume the lease; (5) whether the trustee of the debtor-tenant has satisfied the standards under which a lease may be assumed, particularly the requirement, in the case of a defaulted lease, of providing adequate assurance of cure and of future performance;ⁿ⁶ and (6) whether the trustee of the debtor-tenant has satisfied the standards under which a lease may be assumed and then assigned to a third party.ⁿ⁷ Thus, if a landlord has been unable to recapture the subject property by demonstrating that the lease has been or should be terminated, it may nevertheless effect recapture by actively monitoring the case and forcing the debtor-tenant to comply with its obligations pending the decision to reject or assume and by successfully opposing an assumption of the lease by the trustee or an assumption and assignment, thereby leaving the trustee no practical recourse but to reject the lease and surrender possession of the premises to the landlord.

As a result of what Congress perceived to be inappropriate burdens and risks to landlords and enhanced powers of the trustee or debtor in possession under the Code as originally enacted in 1978, there have been periodic amendments to the original statute to reduce the powers of a trustee and enhance the rights of landlords in respect of nonresidential real property leases. First, the Bankruptcy Amendments and Federal Judgeship Act of 1984ⁿ⁸ (the "1984 Amendments") included provisions that create certain financial and legal obstacles to the assumption and assignment of nonresidential real estate leases by the trustee of a debtor-tenant.ⁿ⁹ The 1984 Amendments have particular relevance in the case of "shopping center" leases. These provisions were further strengthened in favor of landlords pursuant to the Bankruptcy Reform Act of 1994 and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), including amendments that were directed at removing some of the ambiguities and perceived deficiencies in the 1984 Amendments and accelerating the timing of a debtor's decision on whether to assume or reject a lease.^{n9a} Nevertheless, these obstacles are potentially surmountable, and thus many of the issues which have arisen under the Bankruptcy Code prior to enactment of the 1984 Amendments and subsequent revisions still require consideration.

[2] The Effect of the Automatic Stay

[a] Scope of the Stay

The automatic stay set forth in *section 362(a) of the Code* creates the procedural framework within which the landlord will ordinarily be compelled to operate in order to enforce its rights in respect of nonbankruptcy defaults under a lease.ⁿ¹⁰ The stay takes effect concurrently with the commencement of a case under the Code.

Section 362(a)(1) creates a stay against:

the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.ⁿ¹¹

This means that a landlord may not commence or continue a state court proceeding for past due rent, for accelerated rent, for damages or for a summary dispossess order with respect to a default under the lease that occurred prior to the filing of the tenant's petition.ⁿ¹²

Section 362(a)(2) provides for a stay against "the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title."ⁿ¹³ Under section 362(b)(10), as added by the 1984 Amendments, the automatic stay is made inapplicable to an action by a landlord under a nonresidential real estate lease to recover possession of the leased premises if the lease has terminated at its stated expiration date before or during the pendency of the tenant's Bankruptcy Code case.ⁿ¹⁴ As a corollary, *section 541(b)(2) of the Code* excludes from property of the estate any interest of the debtor as a lessee under a lease of nonresidential real property that has

terminated at the expiration of the stated term of such lease before or during the pendency of the case.^{n14a} Thus, a landlord with a warrant of eviction may utilize the warrant to compel a debtor-tenant to vacate the premises without first obtaining a modification of the automatic stay if the tenant is holding over after the stated expiration date of its lease. However, because of the use of the term "stated term" in section 362(b)(10), it is uncertain whether a landlord with a judgment of termination and warrant of eviction arising from a premature lease termination may utilize the warrant of eviction to compel a debtor-tenant to vacate the premises without first obtaining a court-ordered modification of the automatic stay. In any case, notwithstanding section 362(b)(10), as a practical matter, the power of the landlord to evict the holdover tenant may nonetheless be limited under the Bankruptcy Code because a trustee of a debtor-tenant that is holding over after a scheduled lease expiration can petition the bankruptcy court to issue an injunction under section 105(a) to prevent the landlord from enforcing its judgment and warrant of eviction.ⁿ¹⁵ The applicability of the automatic stay or the obtaining of a section 105(a) injunction against enforcement of a warrant of eviction does not necessarily mean that the lease with respect to which the warrant was issued has survived the commencement of the Bankruptcy Code case, but does mean that the trustee will be able to retain possession of the premises for a reasonable period required to marshal and preserve the property of the estate,ⁿ¹⁶ and, as an indirect consequence, the trustee will have negotiating leverage in connection with issues arising from the preexisting leasehold relationship, including the landlord's claims for damages and the status of any security deposits.

Section 362(a)(3) provides for a stay against "any act to obtain possession of property of the estate or of property of the estate or to exercise control over property of the estate."ⁿ¹⁷ This is a particularly important provision in the context of real property leases inasmuch as it enjoins a landlord from taking any action whatsoever to obtain possession of the landlord's property which is in the possession of a trustee. If read literally, section 362(a)(3) not only prevents landlords from reposing a leasehold that has terminated prior to the bankruptcy filing, but also prohibits a landlord from sending, after the commencement of the tenant's Bankruptcy Code case, a notice of default, a notice of acceleration or a notice of termination.ⁿ¹⁸ This of course places the landlord in a particularly difficult position if the default clause or termination clause in the lease provides for notice to the tenant before a default may be deemed to have occurred or requires the sending of a notice of termination following the running of any cure period. In this circumstance, a prudent landlord will apply to the bankruptcy court for modification of the stay to the extent required to initiate the default mechanisms of the lease. To substantially the same effect is section 362(a)(6), which enjoins "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title."ⁿ¹⁹ It should be noted, however, that the section 362(b)(10) exception to the applicability of the automatic stay, discussed in the preceding paragraph, will also apply to subsections 362(a)(3) and (a)(6) in the context of a debtor-tenant's lease which expires at its stated expiration date prior to or during the pendency of the debtor's Bankruptcy Code case.

Section 362(a)(4) includes within the ambit of the stay "any act to create, perfect, or enforce any lien against property of the estate,"ⁿ²⁰ and section 362(a)(5) enjoins "any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title."ⁿ²¹ Under these sections, a landlord may not, absent a modification of the stay, enforce against any security interest provided by the debtor or foreclose upon a security deposit or other property of the estate held by the landlord as security for the performance of the tenant's obligations under the lease.ⁿ²²

[b] Relief From the Stay

Section 362(d) provides:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay--

(1) for cause, including lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if--

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization; or

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later)--

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that--

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate; or

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a scheme to delay, hinder, and defraud creditors that involved either--

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable State laws governing notices of interests or liens in real property, an order entered under paragraph (4) shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.ⁿ²³

The reference in section 362(d)(1) to a lack of "adequate protection" relates to *section 361 of the Code*, which enumerates certain methods by which adequate protection may be provided. Section 361 states:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by--

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

It is clear that the automatic stay enjoins a landlord from enforcing its rights under state law--whether in state court or otherwise--with respect to a lease in default as of the filing of the tenant's Bankruptcy Code petition.ⁿ²⁴ It is also clear that the landlord must apply to the bankruptcy court for relief from the stay in order to enforce such rights.ⁿ²⁵ However, the grounds on which such relief is to be granted are not, in the case of real estate leases, set forth with particularity under the Code. Section 362(d), quoted above, appears to provide for two general grounds for relief from the stay: (1) "cause," including lack of adequate protection; and (2) with respect to the stay of an act against property, if the debtor does not have equity in the property and the property is not necessary for an effective reorganization. Section 362(d) also provides for two additional grounds for relief from the stay: (1) under section 362(d)(3) in the case of an act against "single asset real estate"; and (2) under section 362(d)(4) in the case of an act against real property if the court finds that the bankruptcy petition was part of a scheme to delay, hinder or defraud creditors.

[i] No Equity of the Debtor

The "no equity" provision in section 362(d)(2), taken without reference to the legislative history, may be read as dealing with the "equity" in a leasehold represented by the spread between the lease rental and the current market rental. Under this construction, section 362(d)(2) is available to a landlord seeking relief from the stay when the debtor-tenant will not realize any proceeds from an assignment of the lease because the lease rental is equal to or greater than the market rental of the premises, and the debtor does not require the premises as a necessary part of its continuing business. However, the legislative history indicates that the "no equity" provision in section 362(d)(2) was directed at cases dealing with undersecured real property mortgages rather than real property leases.ⁿ²⁶ In view of cases under Chapter XII of the former Bankruptcy Act, such as *In re Pinegate Associates, Ltd.*,ⁿ²⁷ an effort was made in the legislative process to exclude from the stay proceedings single asset debtors which had filed bankruptcy petitions primarily to avoid foreclosure of a mortgage on its property and the adverse federal income tax consequences attendant upon foreclosure.ⁿ²⁸ However, as the legislative process took its course, there was added to the section 362(d)(2) formulation the requirement that the property not be necessary to an effective reorganization.ⁿ²⁹ This addition appears to have substantially softened the impact of section 362(d)(2) as an exception to the automatic stay in single asset real estate mortgage cases, inasmuch as the single asset may be viewed as essential to an effective reorganization. In any event, section 362(d)(2) appears to be directed at situations in which the debtor is the owner of a property interest subject to a mortgage or security interest, and not to a case in which the debtor holds a leasehold interest and the landlord is seeking relief from the stay to enforce its rights under the lease.ⁿ³⁰ In one notable decision arising in the chapter 11 proceedings of the Winn-Dixie supermarket chain, the bankruptcy court held that a landlord's motion for relief from the stay under section 362 was generally procedurally improper and the customary remedy for a landlord seeking a determination of its rights prior to the debtor's decision to assume or reject was a motion under section 365, such as one seeking to compel an early decision on assumption or rejection.^{n30a}

[ii] Lack of Adequate Protection

Under section 362(d)(1), the stay may be lifted for cause, including lack of adequate protection.ⁿ³¹ Thus, absent special circumstances the providing of adequate protection will result in continuation of the stay. In opinions rendered prior to enactment of the 1984 Amendments, the courts were divided as to whether a landlord of a debtor-tenant was entitled to adequate protection if it sought and was denied modification of the automatic stay. There were holdings to the effect that landlords were never entitled to proceed under section 362(d) to seek relief from the stay, and were relegated exclusively to a motion under (former) section 365(d)(2) seeking an order directing the trustee to assume or reject the

lease within the time specified by the court.ⁿ³² These holdings viewed the landlord's rights to receive payments from the trustee on account of use and occupation of the leased premises as the sole basis of economic recompense for landlords during the postpetition period prior to rejection or assumption of the lease.ⁿ³³ These holdings also regarded the possibility that all prepetition and postpetition defaults would be cured upon an assumption of the lease as a type of "adequate protection."ⁿ³⁴ The contrary holdings appeared to require payment on a current basis of an amount equal to the full lease rent as the standard for adequate protection, or as the measure of use and occupation payments.ⁿ³⁵ Indeed, it has been held that, in the context of a below-market lease, use and occupation payments would be required on a market rate basis rather than at the rate specified in the lease.ⁿ³⁶

The argument in favor of application of the adequate protection requirement to landlords' interests under real estate leases was buttressed by section 363(d)(2), which provides that the trustee may use property of the estate "... only to the extent not inconsistent with any relief granted under subsection (c), (d), (e) or (f) of section 362."ⁿ³⁷ Similarly, section 363(e) provided that "at any time, on request of an entity that has an interest in property ... leased, or proposed to be ... leased, the court ... shall prohibit or condition such ... lease as is necessary to provide adequate protection of such interest."^{n37a} The argument was further enhanced on a pragmatic level by the infirmities of the use and occupation doctrine, which measured the trustee's liability by the value of the premises to the estate and permitted minimal or no payments if the estate had vacated the premises but had not surrendered possession or rejected the lease.ⁿ³⁸ Nevertheless, a review of section 361, which enumerates examples of methods by which adequate protection may be provided, indicated that the adequate protection standards were oriented to the protection of secured creditors and did not deal with the interests of landlords.ⁿ³⁹

The 1984 Amendments did not obviate the need to reconcile the divided authorities concerning a landlord's entitlement to adequate protection in the case of nonresidential real estate leases. Section 365(d)(3), as amended in 1984, provides that the trustee shall timely perform all the obligations of the debtor under a nonresidential real estate lease arising from and after the entry of the order for relief until the lease is assumed or rejected.ⁿ⁴⁰ The court may confer upon the trustee a grace period for such performance of up to 60 days after the date of entry of the order for relief, with the accrued and unpaid obligations being due and payable at the expiration of such period.ⁿ⁴¹

Moreover, section 365(d)(4), as amended by the 2005 Act, provides that an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall be required to immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of (1) the date that is 120 days after the date of the order for relief (which is the date of the filing of the petition in a voluntary case) or (2) the date of the entry of an order confirming a plan.ⁿ⁴² The initial 120-day deadline may be extended for an additional 90 days by the court for cause prior to the expiration of the 120-day period, but the court cannot grant any additional extensions without the written consent of the lessor.ⁿ⁴³ Nevertheless, the issue of the relationship between sections 362(a) and 365 remained open, with some courts holding that a landlord's right to payment under section 365(d)(3) constitutes an interest entitled to adequate protection under section 363(e).^{n43a}

Section 365(d)(3) entitles landlords under nonresidential leases to collect all rent—including additional rent, percentage rent and rental escalation charges—provided for in the leases of debtor-tenants accruing after the entry of an order for relief in the tenant's Bankruptcy Code case. This section has virtually eliminated any argument for measurement of the trustee's obligations by the value of the premises to the estate, and therefore requires payment of the full lease rent whether the space has a greater or lesser market rental value or whether the trustee is making full use or no use of the premises.^{n43b} Section 365(d)(4), by requiring a relatively fast decision by the trustee as to assumption or rejection of nonresidential real estate leases in cases under all chapters of the Code, may result in the rejection of a greater number of leases than prior to the enactment of the 1984 Amendments, given the requirement for cure of all past defaults upon assumption and the liabilities which attach to the estate as a consequence of assumption.^{n43c} Nevertheless, it cannot be said that the 1984 Amendments embodied in subsections (d)(3) and (d)(4) of section 365 had conferred upon landlords under nonresidential leases the full equivalent of the protections that may be afforded by specific grants of adequate protection.

To confuse the issue more, it is unclear whether the amendments to section 363(e) by the Bankruptcy Reform Act of 1994,^{n43d} which clearly specified that lessors of personal property were entitled to adequate protection payments,^{n43e} have the effect of supporting the argument that lessors of real property are also entitled to adequate protection. On the one hand, it is arguable that the specific reference to personal property leases, precludes application of the section to real property leases. On the other hand, the 1994 amendment to section 363(e) as it relates to personal property leases is best understood in the context of new section 365(d)(10), which provides lessors of personal property with similar protections to those already provided to landlords under section 365(d)(3), and it can be argued that the amendment to section 363(e) was merely meant to more comprehensively clarify the rights of equipment lessors rather than limit the rights of real property lessors. In fact, all courts that have addressed the issue subsequent to the Bankruptcy Reform Act of 1994 have held that a landlord was entitled to seek adequate protection, as a remedy to protect its rights under section 365(d)(3).^{n43f}

[iii] Relief for "Cause."

Returning to the provisions of section 362(d) and the grounds for relief from the automatic stay, the final general basis for relief is the category of "cause" under section 362(d)(1). Even if the trustee of a debtor-tenant is performing its obligations under section 365(d)(3), there may be other reasons why the landlord may seek relief from the stay. These reasons may include: (1) the existence of a substantial prepetition breach which has materially impaired a landlord's standing under a mortgage of the property; (2) the occurrence of a casualty to the property; (3) issues relating to administrative solvency; (4) issues relating to the condition of the leasehold or the existence of unreasonable risks, such as the failure to maintain insurance or adequate security on the premises; and (5) the demonstrable inability of the debtor to successfully reorganize.

Although the standard of "cause" clearly calls for a case-by-case determination of the equitable rights of the contending parties, certain generalizations may be offered. Thus, it is generally true that the stay will not be modified solely because:

- (1) There is an outstanding prepetition default under the lease;ⁿ⁴⁴
- (2) The landlord has a new tenant for the premises at an equal or higher rent;ⁿ⁴⁵
- (3) The prospects for a successful reorganization are not known in the early stages of the case;ⁿ⁴⁶
- (4) The debtor has many separate locations and loss of the subject premises would not be fatal to the reorganization effort;ⁿ⁴⁷ or
- (5) The trustee has not as yet found a prospective assignee of the lease.ⁿ⁴⁸

It is also generally true that the stay will be lifted or modified if:

- (1) The trustee is unable to pay current postpetition charges for the premises and the prospects for a reversal of fortunes are dim;ⁿ⁴⁹
- (2) The debtor engaged in inequitable conduct prior to the commencement of the Bankruptcy Code case and appears to have sought the protections of the Code to force the landlord into a settlement;ⁿ⁵⁰ or
- (3) There are issues of administrative solvency;^{n50a}
- (4) A warrant of eviction was issued prepetition (although not executed), and the debtor exhibited

extreme bad faith, such as by seeking to assign the lease on the eve of bankruptcy; orn50b

(5) It is reasonably clear that the trustee will be unable to effectuate a successful reorganization.n51

[3] Treatment of Lease Defaults and Postpetition Obligations

A number of differing fact patterns may obtain when a tenant under a real property lease becomes a debtor under the Code. These include the following, each of which assumes a material prepetition default by the debtor-tenant:

(1) The landlord has not sent a notice of default prior to the filing of the tenant's petition under the Code;

(2) The landlord has sent a notice of default prior to the filing of the petition, but the applicable period of grace has not expired as of the filing;

(3) The landlord has sent a notice of default prior to the filing of the petition, the applicable period of grace has expired, but the landlord has not sent a notice of termination of the lease prior to the filing;

(4) The landlord has sent notices of default and termination, but the debtor-tenant has not surrendered or been evicted from the premises prior to the filing;

(5) The lease has been terminated and the premises have been vacated prior to the filing of the tenant's petition; and

(6) the lease had expired by its own terms prior to the bankruptcy filing but the tenant remained in possession on the filing date.n51a

The ensuing discussion considers the effect of the Bankruptcy Code and the cases thereunder upon the rights of the landlord and debtor-tenant in the foregoing circumstances.

[a] Prepetition Termination of Leases

It is settled law that a trustee may not assume a lease that has expired or been terminated prior to the commencement of the tenant's case under the Bankruptcy Code.n52 Under the terminology of the Code, the debtor's leasehold rights do not become "property of the estate" within the meaning of section 541.n53 The 1984 Amendments have confirmed this settled law in section 365(c)(3), which provides that the trustee of a debtor-tenant under a nonresidential real property lease may not assume or assign the lease if it has been terminated under nonbankruptcy law prior to the order for relief,n54 and in section 541(b)(2), which excludes from property of the estate any interest of a debtor under a nonresidential real estate lease which terminated at its stated expiration date prior to or during the pendency of the debtor's Bankruptcy Code case.n55 Nevertheless, it is not always clear that a particular lease has been terminated before the filing of the tenant's petition, or that such termination will be recognized by the bankruptcy court.

Furthermore, section 362(b)(10) specifically provides that the automatic stay does not apply to any act by a lessor to obtain possession of nonresidential real property subject to a lease that has terminated by expiration of the stated term before commencement of the case.n55a Nevertheless, it is not always clear that a particular lease has been terminated before the filing of the tenant's petition, or that such termination will be recognized by the bankruptcy court. In light of the negative consequences of violating the automatic stay where the question is not free from doubt,n55b the prudent course of landlords is to seek determinations from the bankruptcy court as to the status of the lease.

The bankruptcy courts are to look to state law to determine whether a lease has been terminated before the

commencement of the tenant's case under the Code and the extent of the debtor's remaining interest, if any, under the lease.ⁿ⁵⁶ Under state law, leases may ordinarily be terminated (1) under properly drafted termination clauses, whether written as conditional limitations or otherwise, and (2) by invocation of state court procedures. In determining whether leases have been terminated through the use of state court procedures, bankruptcy courts have interpreted the same state statute in different ways under similar operative facts. Thus, in *In re GSVC Restaurant Corp.*,ⁿ⁵⁷ it was held that the issuance by a state court of a warrant of eviction effected a prepetition lease termination under Section 749(3) of the New York Real Property Actions and Proceedings Law. Thereafter, a second bankruptcy court held that the New York cases interpreting Section 749(3) provide that a lease is not extinguished until the warrant is executed, and determined that the lease could be resurrected inasmuch as the warrant had not been executed as of the date of filing of the tenant's petition.ⁿ⁵⁸ Subsequent cases have clarified that the execution of the writ is the critical step that divests the debtor of an interest under New York law, and that so long as the debtor has the ability to contest the execution of an eviction warrant or seeks its stay, the debtor still retained an interest in an unexpired lease under section 365(a).^{n58a} In *In re PJ Clarke's Restaurant Corp.*,^{n58b} the bankruptcy court permitted the tenant to stay in possession of a leasehold interest that had been declared terminated by the New York State Civil Court while that decision was on appeal, subject to the debtor's remaining current on its lease obligations during the pendency of the appeal.

Similarly, one bankruptcy court in Florida found that the prepetition issuance of a writ of possession by a Florida court terminated the debtor's lease without execution of the writ,ⁿ⁵⁹ and a second bankruptcy court in Florida held that even following the forfeiture and termination of a lease under Florida law a tenant may seek equitable relief under state law upon tender of the rent in arrears.ⁿ⁶⁰ It has been held in a case decided under Georgia law that termination of a lease through the notice mechanism set forth in the document was sufficient to effect a prepetition extinguishment of the debtor's leasehold rights.ⁿ⁶¹ The court noted but did not discuss the fact that dispossession proceedings were commenced by the landlord but were stayed by the debtor's Bankruptcy Code petition filed prior to the issuance of a writ by a state court. This case was cited as persuasive authority by a bankruptcy court in Virginia which found that the prepetition issuance of a writ of ejectment was sufficient to terminate the landlord-tenant relationship.ⁿ⁶² In a case decided under Massachusetts law, a court refused to recognize the effectiveness of a prepetition termination notice because the landlord's purported reason for the termination was not valid under the terms of the lease.^{n62a}

Apart from a review of the formal steps required to terminate a lease under state law, a bankruptcy court may look to equitable doctrines recognized under applicable state law to determine whether a prepetition lease termination purportedly effected under state law would be enforced by the courts of that state. Thus, in *In re Delta Motor Hotel of Syracuse, Inc.*,ⁿ⁶³ a case decided under Chapter X of the former Bankruptcy Act, the bankruptcy court found that (1) the conditional limitation clause in the lease, in referring to the landlord's subsequent right of re-entry, might be viewed under state law as a condition subsequent, thereby requiring the institution of formal ejectment proceedings; (2) even if the conditional limitation clause were properly written and complied with by the landlord in seeking to terminate the lease, (a) the landlord's acceptance of rent after the sending of notices of default constituted a waiver of the defaults under state law, and (b) the landlord's conduct in not insisting on strict compliance with the lease while the tenant was seeking to refinance the troubled project and continuing to pay general operating costs of the project created an estoppel against the landlord in seeking to enforce its notice of termination; and (3) the construction by the debtor of a hotel on the leased premises with related financing and other expenditures paid or incurred by the debtor gave rise to equitable considerations warranting the court's refusal to recognize the landlord's purported prepetition termination of the lease.^{n63a}

It further appears that a bankruptcy court, as a court of equity, may regard its powers as permitting the application of general equitable principles (without reference to state law) in avoiding lease terminations or even resurrecting leases terminated under state law. Under Section 70b of the former Bankruptcy Act, bankruptcy termination and *ipso facto* clauses were recognized as enforceable. In order to avoid lease forfeitures in cases under the Act, the federal courts developed and applied several doctrines which restricted the scope of Section 70b. These doctrines included strict construction of bankruptcy termination clauses,ⁿ⁶⁴ a waiver rule relating to the acceptance of rent checks after the tenant's filing of a petition under the Act,ⁿ⁶⁵ an equitable doctrine to prevent a windfall to the landlord when the tenant

had invested substantial sums to construct improvements on the premises,ⁿ⁶⁶ and a rule that avowedly read Section 70b out of the Act if the premises were essential to the continued operation of the debtor's business.ⁿ⁶⁷ Although these cases are seldom cited in connection with Bankruptcy Code lease litigation in view of the Code's invalidation of bankruptcy termination clauses, they demonstrate the courts' power and willingness to apply antiforeclosure doctrines without reference to state law.

In view of the Code's invalidation of both bankruptcy termination and anti-assignment provisions in leases, a trustee will often vigorously seek to avoid termination of leasehold interests to either retain the subject premises for its own operations, to transfer the leasehold as part of a sale of its business or to assign the lease to a third party for consideration. Accordingly, efforts by landlords to assert prepetition termination of leases often meet substantial resistance, and arguments not raised under the former Bankruptcy Act are now brought before the courts. In the absence of an available state law antiforeclosure rule in a particular case, a bankruptcy court may be asked to apply its own anti-foreclosure doctrines to deny effect to a prepetition lease termination. Although the precedents referred to in the preceding paragraph were designed to restrict a federally created foreclosure recognition rule under Section 70b of the former Bankruptcy Act, these cases may resurface in an effort by the federal courts to restrict state-created foreclosure rules as well.

The reach of federally created equitable powers is best illustrated in *In re Bronx-Westchester Mack Corp.* ⁿ⁶⁸ In that case, a licensor with a clear right to terminate a defaulted truck distributorship agreement orally agreed to forebear from terminating the agreement if the licensee refrained from filing a Bankruptcy Code petition. The licensee honored its agreement but the licensor nevertheless sent a notice of termination enforceable under state law. The bankruptcy court held that the licensor should be "estopped from asserting the effectiveness of the prepetition termination notice."ⁿ⁶⁹ The court cited the United States Supreme Court case of *Dickerson v. Colgrove*,ⁿ⁷⁰ which involved the doctrine of equitable estoppel, and also cited 28 U.S.C. § 1481 for the proposition that it exercises "the powers of a court of equity, law and admiralty."ⁿ⁷¹ No reference was made to any state law doctrine which may have invalidated the notice of termination.

In *In re GSVC Restaurant Corp.*,ⁿ⁷² the bankruptcy court appears to have assumed that under appropriate circumstances, not present in that case, the court could protect the possessory interests of a debtor notwithstanding that the landlord and a state court had terminated the debtor's lease. The court stated:

It is clear that the debtor has no legal interest in the property since "the issuance of a warrant for the removal of a tenant cancels the agreement under which the person removed held the premises and annuls the relationship of landlord and tenant" N.Y.R.P.A.P.L. § 749(3) (McKinney's) [ellipsis in original]. The debtor's sole interest in the property is predicated on its possession of the plaintiff's property in the face of a judicially ordered warrant of eviction. The debtor asserts that such possession constitutes an equitable interest deserving of protection under the automatic stay.

There is no question that equitable interest in property is regarded as property of the estate within the meaning of 11 U.S.C. § 541.ⁿ⁷³

The district court, in affirming the bankruptcy court's determination to lift the automatic stay to permit eviction, stated:

Moreover, contrary to the assertions of the debtor, the court below assumed that there might be some lingering equitable interest in the premises, but nevertheless determined under the facts established that the plaintiff was entitled to relief. Considering the continual tactics employed by the debtor in frustrating and delaying the plaintiff's attempts to evict it, in the absence of adequate protection for the plaintiff's interest in the property, this determination was clearly correct.ⁿ⁷⁴

Although the two opinions in *GSVC Restaurant Corp.* did not discuss the nature of the equitable interest in the leased premises that may survive a termination of a lease at law, the mere recognition of the interest evidences the courts'

assumption that they are empowered to deal with such interests in appropriate cases.

In summary, there appear to be at least four theories under which leases that are in the process of termination or that have been terminated prior to the filing of the tenant's petition may be preserved as "property of the estate." These are: (1) construction of the applicable state termination statute; (2) application of state-created equitable doctrines; (3) invocation of the power of the bankruptcy court as a federal court of equity; and (4) bankruptcy court determination on propriety of lease termination.^{n74a}

In view of the foregoing, prepetition termination of leases by landlords may require (1) the effective and final termination through the final stages required by state law, including the actual execution of a warrant of eviction and the conclusion of any appeal rights, and (2) the absence of any conduct on the part of the landlord that may engender the invocation of state or federal equitable principles. Although only rarely will an agreement duly terminated under state law be resurrected by a bankruptcy court,ⁿ⁷⁵ it may be prudent to consider the following procedures in connection with prepetition termination of real property leases:

(1) If a notice of default has been sent to a tenant, the landlord should not engage in any conduct evidencing an intention to waive the default. The deposit of any rent checks should be effected on notice to the tenant that it is being done without prejudice to or waiver of the landlord's rights. If applicable state law provides that deposit of rent checks will constitute a waiver, the checks should not be deposited without an appropriate stipulation or letter from the tenant or its counsel.^{n75a}

(2) The landlord should strictly comply with all procedures in the lease for termination, and document the basis for termination, particularly when the defaults constitute nonmonetary defaults. Particular attention should be made to the precise wording of termination notices to avoid any implication that the landlord is providing an unintentional additional cure period and to assuring that there is exact compliance with provisions providing for the manner of providing notice and the specific identity of notice parties under the lease.^{n75b}

(3) The landlord's conduct should minimize the possibility that it will later be found to have unclean hands, to have lulled the tenant into resting on its rights, to have caused the tenant to have relied upon promises of the landlord or to otherwise warrant the invocation of equitable doctrines. This would include the avoidance of any statements that could lead the tenant to believe that the landlord does not intend to pursue its remedies on account of a default, and the avoidance of any conduct that may be deemed to constitute harassment. There should also be no record that the landlord is seeking to recapture the premises in order to obtain higher rent.

(4) All state law procedures for termination of the lease should be followed strictly and promptly. If a writ of eviction has been issued it should be promptly executed. Extreme caution should be exercised in agreeing to forego execution of the writ in consideration of payments or other consideration.

[b] Postpetition Termination of Leases

[i] General Rules

[A] Prepetition Defaults Outstanding in the Postpetition Period

If a debtor-tenant's interest in a lease is found to be property of the debtor's estate, the treatment of the lease will be governed by *section 365 of the Code*. Under that section, an unexpired lease may be assumed or rejected by the trustee subject to the approval of the court.ⁿ⁷⁶ If the lease is rejected, the landlord may file a proof of claim for damages arising out of the rejection, which will be limited in amount under section 502(b)(6).ⁿ⁷⁷ If the lease is assumed by the

debtor during the case, but later rejected, the damages arising from such breach are entitled to administrative priority in an amount equal to the all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises with a general unsecured claim for the balance of the term, as limited by section 502(b)(6).ⁿ⁷⁸ This administrative claim is not subject to setoff or rejection for any reason whatsoever except for sums actually received from an entity other than the debtor.^{n78a} Any claim for remaining sums due for the balance of the term of the assumed lease is a claim under section 502(b)(6).^{n78b} This limitation on claims arising from the rejection of a previously assumed lease was added to the Code pursuant to the 2005 Act, effective for bankruptcy cases commenced on or after October 17, 2005.^{n78c} Previously, the Code provided for an unlimited administrative claim in the case of a previously assumed lease.^{n78d} and the cases indicated that the same result applied to a lease entered into following the petition date.^{n78e} It is unclear whether the new administrative claim limitation in section 503(b)(7) applies to new leases entered into by a debtor, since the limitation, by its terms only refers to "a non residential real property lease previously assumed under section 365."ⁿ⁷⁹

If a default has occurred under an unexpired lease of the debtor, and the trustee desires to assume the lease, the trustee must (1) cure, or provide adequate assurance of prompt cure of, the default; (2) compensate, or provide adequate assurance of prompt compensation to, the landlord for any "actual pecuniary loss" resulting from the default; and (3) provide adequate assurance of future performance under the lease.ⁿ⁸⁰ However, the trustee is not required to provide the cures and assurances if the default relates to (1) the insolvency or financial condition of the debtor at any time before the closing of the case; (2) the commencement of a case under the Bankruptcy Code in respect of the debtor; (3) the appointment of or taking possession by a trustee in the debtor's Bankruptcy Code case or the prepetition appointment of a custodian; or (4) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations.ⁿ⁸¹ If the lease covers real property in a shopping center, there are special standards for adequate assurance of future performance.ⁿ⁸² Moreover, if under applicable state law the lease involves a relationship between landlord and tenant of personal service, special trust or the like, the lease may not be assumed by the trustee absent the consent of the landlord.ⁿ⁸³

In a case under any chapter of the *Code*, section 365(d)(4), as amended by the 2005 Act, provides that an unexpired lease of nonresidential real property under which the debtor is the lessee is deemed rejected, and the trustee is required to immediately surrender the subject real property to the lessor, if the lease is not assumed or rejected by the earlier of (i) 120 days after the date of the order for relief (which is the date of the filing of the petition in a voluntary case) or (ii) the date of the entry of an order confirming a plan. The 120-day deadline may be extended for an additional 90 days by the court for cause prior to the expiration of the 120-day period, but the court cannot grant any additional extensions without the written consent of the lessor.ⁿ⁸⁴ This represents a significant change from prior law which provided for an initial 60-day period before the lease would be deemed rejected, but also permitted unlimited extensions of such period for cause. In a case under chapter 7 of the Code, a residential real estate lease will be deemed rejected within 60 days after the entry of the order for relief unless assumed within such 60-day period or such additional time as the court, for cause, may allow on application made within the 60-day period.ⁿ⁸⁵ If the case is under chapter 9, 11 or 13 of the Code, the trustee may assume or reject a residential real estate lease at any time before the confirmation of a plan.ⁿ⁸⁶ On request of the landlord, the court may order the trustee to determine prior to confirmation a specified period within which it will assume or reject a residential real estate lease.ⁿ⁸⁷

When an unexpired lease becomes property of the estate of a debtor under the Bankruptcy Code, the lease is regarded as being in suspension until the trustee rejects or assumes the lease.ⁿ⁸⁸ If the trustee assumes the lease, the assumption is deemed to have occurred as of the date of entry of the order of relief, and all prepetition defaults are cured (or adequate assurance of prompt cure is provided) at the time of assumption.ⁿ⁸⁹ In addition, all arrearages and unperformed obligations that accrued subsequent to the entry of the order for relief are likewise cured or subject to adequate assurance of prompt cure.ⁿ⁹⁰ If, on the other hand, the trustee rejects the lease, the rejection is regarded as occurring immediately prior to the entry of the order for relief,ⁿ⁹¹ and the landlord's claim for damages arising out of the rejection is given the status of a prepetition general claim rather than a claim entitled to priority as an expense of administration notwithstanding that the act of rejection in fact occurred during the period of administration of the estate.ⁿ⁹²

Therefore, during the period subsequent to the entry of the order for relief and prior to assumption or rejection, the trustee is in possession of the premises demised under a lease not as the tenant under the lease but pursuant to its statutory right to use and occupy the premises for the purposes of protecting, marshalling and preserving the assets of the estate.ⁿ⁹³ The use and occupation of the premises may take the form of continued use for the purposes to which the premises were devoted prior to the filing, or for storage of materials, liquidation of merchandise or other purposes required for the administration of the estate. Under section 365(d)(3), the trustee of a debtor-tenant under a nonresidential real estate lease must timely pay and perform all charges and obligations arising under the lease (as though the lease were not in suspension) accruing from and after the date of entry of the order for relief until assumption or rejection.ⁿ⁹⁴ The payment of these charges under section 365(d)(3) does not constitute payment of rent under the suspended lease, and the statute specifically provides that acceptance of such payments by the landlord does not constitute a waiver of the landlord's rights under the lease or the Bankruptcy Code.^{n94a} The failure to pay "actual rent" as the term may be defined in the lease (as distinguished from an amount equal to the "obligations" provided for in section 365(d)(3)) until the lease is assumed or rejected does not constitute a default under the lease.ⁿ⁹⁵ If the lease is assumed, the charges paid by the trustee during the period of suspension will be credited against the rental obligations accruing during such period.ⁿ⁹⁶

In view of the foregoing, it is necessary to recognize the distinction between prepetition defaults and the postpetition failure of the trustee to pay all monetary obligations and perform other lease covenants and obligations as required by section 365(d)(3). Prepetition defaults may provide a basis for the landlord's seeking modification of the automatic stay for the purpose of enforcing its remedies, including the termination of the lease. The postpetition failure to perform section 365(d)(3) obligations gives rise to a right of action against the trustee, including a possible basis for seeking adequate protection or relief from the stay, and possible termination of the trustee's right to use the premises.ⁿ⁹⁷ Only if the trustee has assumed the lease and thereafter failed to perform its obligations thereunder will the landlord have the right to claim a default under the lease arising during the postpetition period.ⁿ⁹⁸ Accordingly, prior to assumption, the landlord's postpetition remedies in respect of the lease itself will relate only to prepetition defaults.

If a debtor-tenant has failed to perform a prepetition lease obligation, but such failure has not ripened into an "event of default" under the lease as of the entry of the order for relief, *section 108(b) of the Code* extends the applicable grace period to the 60th day after the entry of the order for relief.ⁿ⁹⁹ If the sending of a notice of default is required to commence the running of a grace period and the notice has not been sent prior to the filing of the tenant's petition, the landlord may be required to apply for modification of the automatic stay to permit such notice to be given.ⁿ¹⁰⁰ Therefore, it cannot be assumed that a prepetition breach is equivalent to a prepetition default, and there may be a waiting period for a landlord until it is first entitled to claim the existence of a default under the lease.

If a prepetition default is outstanding as of the filing of the tenant's petition, or if events after the filing have resulted in a lease default (such as the lapse without cure of the section 108(b) 60-day period), the trustee may nevertheless be entitled to cure the outstanding defaults pursuant to the provisions of the Code.ⁿ¹⁰¹ Under section 365(b), the trustee may cure lease defaults, or provide adequate assurance of prompt cure, in connection with the assumption of a lease. Although section 365(d)(4) provides that an unexpired nonresidential real estate lease must be assumed or rejected by the trustee of the debtor-tenant within 120 days after the entry of the order for relief, the court may, under such section, extend the 120-day period for cause for an additional 90 days and, if the landlord consents in writing, for a further extension beyond the original 90-day extension. Under section 1123(b)(2), a lease may be assumed in a chapter 11 plan upon compliance with the assumption requirements of section 365. Under section 1121(b), the debtor has the exclusive right to file a plan until 120 days after the entry of the order for relief. Thus the Code in various places appears to permit a greater lapse of time than the 60-day section 108(b) period before a lease may be assumed (and defaults cured) in a chapter 11 case in the absence of affirmative action on the part of the landlord to bring the matter to an earlier conclusion.^{n101a}

The preceding discussion has addressed the Bankruptcy Code's treatment of prepetition defaults which are uncured as of

the entry of the order for relief in the debtor-tenant's Bankruptcy Code case. The seemingly ample latitude afforded by the Code to a trustee with respect to the cure of such defaults may not be available in the case of a conditional limitation or similar clause providing for the unconditional termination of the lease, without a right of cure, after an earlier cure period has lapsed. In the context of franchise and license agreements, the general rule appears to be that an automatic termination clause which is running as of the entry of an order for relief of the franchisee or licensee will not be disturbed by the court and that termination will be permitted.ⁿ¹⁰² In dealing with real estate leases, the bankruptcy courts apparently have been presented with a number of cases involving valid *prepetition* terminations, and have focused on redemption and other equitable doctrines as a means of avoiding forfeiture.ⁿ¹⁰³ The same approach presumably would be applied to a postpetition termination resulting from the lapse of a conditional limitation or similar clause.

[B] Requirements Under Section 365(d)(3) and (d)(4) (Performance of Postpetition Lease Obligations; Deadline for Assumption or Rejection)

Section 365(d)(3) and (d)(4) were added to the Code as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments").^{n103e} Although section 365(d)(4) was substantially amended by the 2005 Act^{n103f} to increase the initial period from 60 days to 120 days, but limit the absolute outside date for which a lease can be assumed to 210 days (by allowing only a single 90-day extension of the initial period), unless the landlord consents in writing to a further extension, it is likely that many of the issues under the former section 365(d)(4) will be present under the revised statute and that the approach of the courts to these issues under the former statute will remain highly relevant. Before the 2005 Act, these sections provided:

(3) 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.

(4) Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

Under the 2005 Act, section 365(d)(3) was unchanged, while section 365(d)(4) was revised to provide as follows:

(4)(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of--

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

These sections have engendered considerable litigation concerning, among other things, the effect of (1) an inadvertent failure to obtain a court order approving assumption within the initial period provided for in section 365(d)(4) (which initial period was 60 days, prior to the 2005 Act), or a failure to obtain an extension of the initial period, (2) the failure to make timely payments required under section 365(d)(3), and (3) the scope of the obligations under section 365(d)(3), particularly with respect to lease obligations that could be construed as spanning the prepetition and postpetition periods. In some cases, an automatic rejection of a lease under section 365(d)(4), arising from the debtor-tenant's failure to act timely in bankruptcy court, may result in the loss of the debtor's leasehold and only place of business.

In dealing with these problems under subsections 365(d)(3) and (d)(4), the courts have often resorted to legislative history. The legislative history reflects the lobbying activity of the shopping center industry with respect to the portions of the 1984 Amendments dealing with real estate leases. The following excerpts from a Senate Judiciary Committee report evidence the policy considerations underlying subsections 365(d)(3) and (d)(4):

a. Time limit to assume or reject lease.

i. Problem--Under the 1978 Act, in a Chapter 7 (liquidation) case the trustee is required to decide within 60 days of the order for relief whether to assume or reject an executory contract or unexpired lease. However, no time limit is established for cases outside Chapter 7. Consequently, an extended period of time often passes before the trustee makes such a decision in a Chapter 11 (reorganization) case. During this dead time, the trustee often does not operate the space, or operates it at a much reduced level, thereby causing substantial economic harm to other tenants in the shopping center ...

The shopping center landlord is injured in these circumstances because in many cases shopping center leases provide for rent as a percentage of revenues. These clauses are beneficial because they provide the landlord a financial incentive to preserve the most productive tenant mix. However, these clauses are often based on the calculation that tenant businesses will be in full operation. When a store is closed, or operated at a reduced capacity, the shopping center landlord's revenues also decline ...

During this time, the other tenants of a shopping center may be affected dramatically. The closing of even a single store in a shopping center may substantially reduce the revenues and increase the costs of the other tenants. Their revenues are reduced because the closing of a store in a shopping center, especially a major store, reduces the traffic flow through the shopping center.

The closing of a major tenant can also significantly increase the costs of the other tenants. In many shopping centers, common area charges are assessed each tenant on the basis of the tenant's percentage of total leased space. The closing of a major tenant substantially reduced the amount of total leased space. This increases the percentage of total leased space of all the remaining tenants and their share of the common area charge ...

ii. Solution--The bill reduces the severity of these problems by imposing a 60-day time limit on the trustee's decision to assume or reject a non-residential lease in cases under any chapter of the Code, unless the court, for cause, allows additional time. This puts the burden of justifying an extension on the party best equipped to gauge the length of time necessary to make an assumption decision, the non-residential leaseholder.

A distinction between residential and non-residential leases is made here and in other provisions of this subtitle. The application of these provisions is limited to non-residential leases in order to avoid depriving residential tenants of whatever consumer protections they may have under applicable

non-bankruptcy law.

In all but the most complicated reorganization cases 60 days should be a sufficient period to make this determination. Even in large reorganization cases, the debtor presumably knows his own business and understands the value of his assets well enough to make such decisions in 60 days. Also the debtor is generally well aware in advance that a bankruptcy may be necessary and can plan ahead to decide which leases should be retained. The debtor should consequently be able to make this determination shortly after the petition is filed and certainly within 60 days in all but the most complicated cases. Nonetheless, the court has authority to grant extensions for cause.

b. Failure to perform lease obligations, including the payment of rent and other charges when due.

i. Problem--During the time the trustee is deciding whether to assume or reject the lease, the trustee frequently does not meet the lease obligations, such as paying rent and other charges. As discussed above, the trustee's failure to pay common area charges often increase the costs of the shopping center's other tenants.

In addition, this situation often results in the landlord's providing current services--the use of his property, and the provision of utilities and security to protect and preserve the leased property--without current compensation, a burden imposed on no other class of creditor. This burden is particularly onerous where the landlord needs the rent payments provided in the lease in order to make tax or mortgage payments on the property ...

ii. Solution--The bill solves this problem by requiring the timely performance of the non-residential lease obligations, including the payment of rent and other charges. However, the bill permits the court to extend the time for performance of such payments to a date no later than 60 days after the order for relief. Such an extension could be granted where a trustee is unfamiliar with the operation of the debtor's business and there is no reason to question his legal duty to pay rent or other charges or perform other obligations under the lease.¹

The following is an excerpt from remarks by Senator Hatch during floor discussion of the 1984 Amendments:

The first problem which this bill would remedy is the long-term vacancy or partial operation of space by a bankrupt tenant. Although in a chapter 7 case the bankruptcy code presently requires that the trustee decide whether to assume or reject an unexpired lease within 60 days after the bankruptcy petition is filed, there is no deadline for this decision in a chapter 11 case. Because of the unprecedented number of bankruptcy cases and the consequent delays in the bankruptcy courts, tenant space has been vacated for extended periods of time before the bankruptcy court forced the trustee to decide whether to assume or reject the lease. During this time, the other tenants of the shopping center are hurt because of the reduced customer traffic in the shopping center. Tenants and landlords in other nonresidential structures have encountered similar problems.

The bill would lessen the problems caused by extended vacancies and partial operation of tenant space by requiring that the trustee decide whether to assume or reject nonresidential real property lease within 60 days after the order for relief in a case under any chapter. This time period could be extended by the court for cause, such as in exceptional cases involving large numbers of leases. One of the minor changes in this subtitle was to limit it to nonresidential real property leases. If the lease is not assumed or rejected within this 60-day period, or any additional period granted by the court, the lease is deemed rejected and the trustee must immediately surrender the property to the lessor.

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 due under the lease. These payments include rent due the landlord and common area charges which are paid by all the tenants according to the amount of space they 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 will insure that debtor-tenants pay their rent, common area, and other charges on time pending the trustee's assumption or rejection of the lease. For cause, the court can extend the time for performance of obligations due during the first 60 days would be required to be paid, and thereafter, all obligations must be performed on time. This permissible 60-day grace period is intended to give the trustee time to determine what lease obligations the debtor has and to locate the cash to make the required payment in exceptionally large or complicated cases. The bill does not require the performance of obligations specified in section 365(b)(2), which relate to solvency and financial condition. The performance by the trustee of the debtor's obligations has no effect on the performance of the trustee's obligations under subsections (b) or (f) of section 365. The acceptance by the lessor of any payments made by the trustee as required by this subsection does not constitute a waiver or relinquishment of the lessor's rights under such lease or under the bankruptcy code.^{n103f.2}

Notwithstanding the foregoing policy considerations, the courts have been required to deal with the consequences to the estate (and its creditors) of a debtor-tenant faced with an unintended rejection of its lease. Because the section provided for an initial 60-day period prior to the effective date of the 2005 Act (October 17, 2005), as of the date of the latest update to this volume, the courts have only addressed that issue in the context of a 60-day period. Nonetheless, that issue will still be present under the revised section 365(d)(4) which provides for a longer, but still limited, initial 120-day period in which the debtor must make a decision to assume or reject, or seek a single 90-day extension. Section 365(d)(4) clearly requires assumption of a nonresidential real estate lease within a limited number of days following the entry of the order of relief for a debtor-tenant unless an extension is obtained from the court within that time period. An issue arises, however, concerning the nature of the action required to constitute an "assumption" for the purpose of section 365(d)(4).

Under section 365(a), upon the satisfaction of the requirements of subsections 365(b), (c) and (d), "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."^{n103g}

Under Bankruptcy *Rule 6006(a)*, a proceeding to assume an unexpired lease, other than as part of a plan, is a contested matter under Bankruptcy *Rule 9014* initiated by a motion. The 1983 Advisory Committee Note to *Rule 6006* states, in pertinent part:

Section 365(a) of the Code requires court approval for the assumption or rejection of an executory contract by the trustee or debtor in possession. The trustee or debtor in possession may also assign an executory contract, § 365(f)(1), but must first assume the contract, § 365(f)(2). *Rule 6006* provides a procedure for obtaining court approval. ...

Subdivision (a) by referring to *Rule 9014* requires a motion to be brought for the assumption, rejection, or assignment of an executory contract. Normally, the motion will be brought by the trustee, debtor in possession or debtor in a chapter 9 or chapter 13 case. The authorization to assume a contract and to assign it may be sought in a single motion and determined by a single order.^{n103h}

In contrast to Bankruptcy *Rule 6006*, former Bankruptcy Rule 607, promulgated under the Bankruptcy Act, provided that "[w]henever practicable, the trustee shall obtain approval of the court before he assumes a contract."

Notwithstanding the apparent requirement under the Code and Bankruptcy Rules for court approval of every lease assumption effected prior to plan confirmation, some courts have held under section 365(d)(4) that the filing of a motion for assumption of a real estate lease within the 60-day period that was then provided for in the statute satisfies the time requirement even if a court order authorizing assumption is not entered within the 60-day period.ⁿ¹⁰³ⁱ Some of these courts have indicated that the act of assumption, and court approval of that act, are separate events, and that timely filing of the motion evidences the act of assumption required under section 365(d)(4). Other courts have stated that timely filing of the motion suffices because section 365(d)(4) cannot be read to mean that a debtor-tenant will lose its leasehold because the court calendar was too congested to allow an order approving assumption to be issued within the 60-day period. Other courts, however, in construing section 365(d)(4) to require entry within the 60-day period that was then provided for in the statute of a court order authorizing assumption, have voiced concern that mere filing of the motion may give rise to unlimited delay in the issuance of the order, thus denying landlords the expeditious determination that section 365(d)(4) was intended to provide.^{n103j}

The courts have also dealt on a number of occasions with lease forfeitures under section 365(d)(4) in the context of the debtor-tenant's failure even to file a motion for approval within the 60-day period that was then provided for in the statute. A number of courts have held that the automatic rejection under section 365(d)(4) does not constitute an abandonment, and that accordingly, the landlord required relief from the automatic stay in order to eject the tenant.^{n103j-1} A debtor-tenant's indication to a landlord that it intended to assume the lease has been found to constitute a timely assumption under section 365(d)(4). It has been held, contrary to the language of the Code, that a bankruptcy court has the equitable power to relieve a debtor-tenant from the consequences of the automatic rejection provisions of section 365(d)(4).^{n103k} Courts have found that a landlord's acceptance of payments pursuant to section 365(d)(3) following the expiration of the section 365(d)(4) initial period constituted a waiver of the landlord's right to claim that an automatic rejection of the subject lease had occurred.^{n103l} It has also been held that a landlord's assurances--made in open court--that it would consent to an assignment of a lease by a debtor-tenant estopped the landlord from later claiming an automatic rejection.^{n103m} The landlord's conduct was found to have led the debtor-tenant to believe that it was unnecessary to file a section 365(d)(4) assumption motion within the 60-day period that was then provided for in the statute.ⁿ¹⁰³ⁿ One court of appeals was apparently troubled by the application of a waiver doctrine to seemingly circumvent the congressional purpose in section 365(d)(4), but held simply that the landlord's postpetition conduct in accepting payment past the relevant 60-day period was insufficient to evidence an intent on the part of the landlord to relinquish its rights to demand surrender.^{n103n.1} The court held that on the record before it, the acceptance of payment was because of the landlord's good faith belief that the amounts paid represented rents to which it was entitled under section 365(d)(3), rather than the intentional relinquishment of a right. Some courts have indicated, however, that waiver and estoppel doctrines cannot be applied to lease rejections under section 365(d)(4) because the provision is self-operative and the court is without power to revive a lease under any theory once it is automatically rejected.^{n103o}

With respect to extension of the initial period, the weight of authority appears to hold that application within the initial period for an extension satisfies the section 365(d)(4) requirements even if the court grants the extension after expiration of the period.^{n103p} Under the text of the provision in effect before the 2005 Act, there was, however, an issue as to whether the court having timely granted one extension of the 60-day period, was permitted to grant a second extension once the 60-day period had lapsed.^{n103p.1} If the court's action in extending the initial 60-day period was viewed as an extension of the time in which the court may do all the things under section 365(d)(4) that it could have done during the initial period, there was no reason why the court cannot act during the extended period to grant a further extension. This interpretation of section 365(d)(4) was consistent with the proper administration of a Bankruptcy Code case in which changing circumstances, or indeed a delay or deferral of anticipated developments in the business or prospects of the debtor, would warrant a further continuation of the decision whether to assume or reject a nonresidential real estate lease. This approach contemplates that the requirement of the trustee's showing of "cause" for the extension not be taken lightly and that the deferral of the decision not be converted into a weapon for the trustee to compel a monetary

settlement from a landlord.n103p.2

In cases involving a substantial number of leased locations, it was argued that the tenant's trustee could not be fairly expected to select, within 60 days after the entry of the order for relief, those locations that should be the subject of a motion for lease assumption and those that should not. Accordingly, counsel had developed a practice in cases involving multiple leased locations of moving for an order extending the 60-day period then provided for under the statute (prior to the 2005 Act) until the date of plan confirmation, and establishing a procedure for landlords requiring earlier assumption or rejection to bring their matter before the court. Courts had routinely granted these motions in large chapter 11 cases where a debtor that is a party to numerous leases has requested time to evaluate which leases to assume and which leases to reject.n103p.3 A form of such a motion is set forth at the end of this chapter.n103q

This practice is likely to be substantially curtailed by the revisions to section 365(d)(4) put in place by the 2005 Act. The new provision, which is applicable to bankruptcy cases commenced on or after October 17, 2005, lengthens the initial period from 60 days to 120 days, but provides for only a single 90-day extension of that period for cause. If the court grants such an extension, the court can grant a subsequent extension only with the prior written consent of the lessor.

The revisions to section 365(d)(4) were contained in section 404 of the 2005 Act. The legislative history of the revised provision appears clearly to indicate that Congress intended to eliminate any judicial discretion to extend the outside period beyond 210 days:

Sec. 404. Executory Contracts and Unexpired Leases. Subsection (a) of section 404 of the Act amends *section 365(d)(4) of the Bankruptcy Code* to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected. If such lease is not assumed or rejected by such deadline, then such lease shall be deemed rejected, and the trustee shall immediately surrender such property to the lessor. Section 404(a) permits a bankruptcy trustee to assume or reject a lease on a date which is the earlier of the date of confirmation of a plan or the date which is 120 days after the date of the order for relief. An extension of time may be granted, within the 120 day period, for an additional 90 days, for cause, upon motion of the trustee or lessor. Any subsequent extension can only be granted by the judge upon the prior written consent of the lessor either by the lessor's motion for an extension or on motion of the trustee, provided that the trustee has the prior written approval of the lessor. This provision is designed to remove the bankruptcy judge's discretion to grant extensions of the time for the retail debtor to decide whether to assume or reject a lease after a maximum possible period of 210 days from the time of entry of the order of relief. Beyond that maximum period, the judge has no authority to grant further time unless the lessor has agreed in writing to the extension.n103q.1

The changes to the dynamics of cases imposed by the revisions to section 365(d)(4) and the preceding described legislative history is demonstrated by one case where the bankruptcy court held that new section 365(d)(4) required that the extension of the initial 120-day period actually be *granted* by a court prior to the expiration of the period; the filing of a motion within such period was not sufficient. In *In re Tubular Technologies, LLC*,n103q.2 the court acknowledged the hardship faced by the debtor from the automatic rejection on day 120 notwithstanding the filing of a possibly meritorious motion within the period, but stated that the time requirements set forth in subsections 365(d)(4)(A)(i) and (d)(4)(B) were clear and unambiguous.

Though many of the provisions revised by the [2005 Act] have been criticized by various courts for lacking clarity, Congress was precise with this particular section. The plain language of the statute and the legislative history each unambiguously indicate that Debtor may not obtain an extension to assume a lease if the extension is not granted within the first 120 days of this case.n103q.3

Given issues relating to the timing of hearings on extension motions, this decision highlights that as a practical matter

debtors may have to make their decisions regarding leases much earlier in the case than the initial 120 day period. In light of rulings such as the one cited above, a debtor cannot rely on a bridge order or other extension of time prior to a full evidentiary hearing on a motion to extend the initial period. Although courts may be inclined to hold hearings on expedited basis, as the *Tubular Technologies* court indicated it would have had such expedited hearing been sought,^{n103q.4} as a general matter, it would appear that the need of debtors to present evidentiary support for the required "cause" to trigger entitlement to a ninety day extension at such a hearing will, as a practical matter, further accelerate a debtor's decision making process regarding whether to assume or reject its leases.

In addition to the automatic rejection feature of section 365(d)(4), there is also a provision that upon rejection the "trustee shall immediately surrender ... [the] nonresidential real property to the lessor."^{n103r} The apparent purpose of this provision is to afford landlords the full measure of relief mandated by the policy of expeditious disposition of nonresidential real estate leases and to dispel any notion that the trustee could retain possession of the premises to the extent necessary to protect and preserve the other assets of the estate. Nevertheless, the courts appear to have some degree of reluctance to exercise their power over the estate and to order immediate surrender. Instead, there is a discernible tendency to lift the automatic stay to permit the landlord to pursue its state law eviction remedies against the debtor.^{n103s} This approach of course affords additional time to the debtor to find a new location or otherwise deal with the consequences of the eviction.

Another issue which has divided the courts is the effective time of a rejection of a lease. This issue is important because until such rejection is effective, section 365(d)(3) requires that the debtor timely perform all postpetition obligations, including the payment of rent. Although the time between the debtor's decision to reject and the court's approval of that rejection normally should not be lengthy, this might not be the case if (1) local bankruptcy rules require a relatively lengthy notice period, (2) there are objections to the relief sought or (3) the court calendar or the court's need to hold a hearing and evaluate evidence causes a delay in the entry of an order of rejection. The majority view appears to be that because "the court's approval" is, under section 365(a), a statutory prerequisite to rejection of an unexpired lease, such rejection is not effective until the date the rejection is formally approved by the court.^{n103t} As a policy matter, some courts espousing the majority view have asserted that only the formal entry on the docket of an order authorizing rejection provides parties in interest with the requisite certainty as to the status of the lease for purposes of administering the estate or, if applicable, formulating a chapter 11 plan.^{n103t.1} However, a number of courts have followed a minority view that treats rejection and court approval as separate acts and reasons that although the debtor's rejection is subject to court approval, this is merely a safeguard to assure that the rejection is in the best interests of the estate.^{n103u} Thus, under the minority view, the effective time of the rejection is the time that the debtor unequivocally demonstrates an intent to assume or reject, usually the time when the motion to reject is filed. One court found such an intent in a situation where the debtor surrendered the premises prepetition and the landlord in fact padlocked the premises before the petition date.^{n103u.1} The courts following the minority view have justified this result by the policy consideration of reducing the amount of priority expenses that do not in fact represent actual and necessary expenses of the estate under section 503(b)(1) and have reasoned that because courts traditionally grant a high degree of deference to a debtor's business decision to reject a lease, such that the denial of rejection is unlikely, the possibility that a court will not approve rejection is sufficiently remote to impose this slight risk on the lessor.

Several issues have arisen with respect to the interplay between sections 365(d)(4) and 365(d)(3). Section 365(d)(3) requires the trustee of a debtor-lessee under a nonresidential real estate lease to perform timely all of the debtor's lease obligations arising from and after entry of the order for relief until rejection or assumption.^{n103u.2} No remedy is prescribed for nonpayment. In the context of a section 365(d)(4) motion for authorization to assume a lease, it has been held that nonpayment under section 365(d)(3) does not alone mandate denial of the assumption motion, but is merely one factor in considering whether adequate assurance of future performance has been proffered to the extent required to permit assumption.^{n103v} In the context of a deemed rejection of a lease under section 365(d)(4), it has been held that the court may determine the reasonableness of the rent payable for the 60-day period following the entry of the order for relief, rather than order the payment of rent at the rate specified in the lease.^{n103w} However, the Court of Appeals for the Ninth Circuit has rejected that reasoning and held that the lessor is entitled to the full rent provided in the lease as an

administrative expense claim. The court observed that "section 365(d)(3) expresses the intent of Congress to secure for lessors the full amount of rent due under the 60-day period while the trustee determines to accept or reject the lease regardless of any benefit to the estate" and further that "[t]he statute does not require the lessor to take any action."^{n103x} It has also been held that if the debtor-tenant fails to immediately surrender the leased premises to the landlord, after an automatic lease rejection under section 365(d)(4), the trustee must continue to pay to the landlord an amount equal to the lease rental as though the rejection had not occurred and the section 365(d)(3) requirements were still applicable.^{n103y} On the other hand, a debtor-tenant who vacated the premises during the 60-day period under a lease providing for a penalty payment if the premises are no longer used for a specified purpose was held to be not responsible for such payment as a cost of administration.^{n103z}

Although not explicitly stated in the Code, the trustee's obligations under section 365(d)(3) appear to constitute expenses of administration cognizable under *section 503(b)(1) of the Code*. The language in section 365(d)(3), providing for timely performance "notwithstanding section 503(b)(1) of this title" is probably intended to mean that the section 503(b) requirement for notice and a hearing as a condition to payment of administration expenses is inapplicable to section 365(d)(3), although nothing in the Code or Rules prevents a court from ordering the landlord to disgorge any amount above its *pro rata* share. More broadly, the Court of Appeals for the Ninth Circuit and several lower courts have held that the reference to section 503(b)(1) required that unpaid rent during the postpetition period prior to rejection be treated as an administrative expense whether or not reasonable value is conferred on the estate and without regard to the other requirements for administrative expense status under section 503(b).ⁿ¹⁰⁴ In circumstances when it is ultimately determined that the estate has insufficient assets to pay all expenses of administration, but the trustee theretofore has been making timely payments under section 365(d)(3), the recipient of these payments appears to have benefitted from a *de facto* superpriority as a result of the timing of the section 365(d)(3) payments.^{n104a} If, however, section 365(d)(3) payments have accrued in a chapter 11 case which is then converted to a chapter 7 case, the administration expenses arising in the chapter 7 case will have priority over the chapter 11 administration expenses, including the section 365(d)(3) obligations that arose before the conversion.^{n104b}

Courts have held that section 365(d)(3) mandates current payment of lease obligations notwithstanding the prospect of administrative insolvency, but recognize the right of a trustee to seek recovery in the future of all or part of the payments in the event that there are ultimately insufficient funds to pay all other administrative expense claimants in full.^{n104c} Some courts have held that, by containing an explicit requirement that the "trustee shall timely perform," section 365(d)(3) contains an implicit superpriority for lease obligations and requires the trustee to immediately pay postpetition rent even though the estate is administratively insolvent.^{n104d} As a variation, one court has held that payments under 365(d)(3) are akin to "operational" payments under section 363 and, once made, can not be disgorged. However, to the extent a payment was not made, the landlord would have to share pro with other administrative creditors.^{n104d.1}

Another issue affecting the extent to which a trustee must perform obligations under section 365(d)(3) relates to obligations of a debtor-tenant that span the period prior to and after the date of entry of the order for relief. As a matter of statutory construction, the key issue is whether the reference in section 365(d)(3) to "obligations of the debtor ... arising from and after the order for relief under any unexpired lease of nonresidential real property" mandates a concept of an accrual of an obligation on a day-by-day basis during both the prepetition period and the postpetition period or makes the due date of the payment obligation, as provided by the terms of the lease, decisive.^{n104e} The two competing theories are often referred to by practitioners and courts as the "accrual" or "proration" theory on the one hand, and the "billing date" or "performance date" theory on the other hand.^{n104e.1}

This issue often arises under real estate leases that require the tenant to pay real estate taxes on the demised premises. In these cases, the applicable tax year for the premises will commence before the date of the order for relief, but taxes will not be billed by the landlord to the tenant until after that date. The question then arises as to whether the trustee is obligated to pay the full amount of the billing, as a postpetition administrative priority obligation, or only that part of the billing that may be prorated for the postpetition period. There appears to be a split among the courts on this issue. One

line of cases, exemplified by a decision of the Court of Appeals for the Seventh Circuit, has held that the proration or accrual of taxes over the entire period was proper, and has justified that analysis by noting the possibility that the billing method would lead to strategic behavior by debtors and landlords regarding the date of filing for bankruptcy or the date of sending a bill that was contrary to the statutory purpose of compensating landlords no more and no less than for their rendition of value during the postpetition period.^{n104f} Another line of cases, including a decision of the Court of Appeals for the Third Circuit, has held that the statutory reference to the debtor's obligations arising under the lease, rather than claim of a landlord, indicated that an obligation arises under a lease for the purposes of section 365(d)(3) when the legally enforceable duty to perform arises under that lease. Under that holding, the date on which the obligation was payable by the debtor under the terms of the lease is decisive in determining whether the item was within the scope of section 365(d)(3).^{n104g} Given the clear split among the circuits, the issue may well be one that will need to be resolved by the United States Supreme Court.

A similar issue arises under section 365(d)(3) under the circumstance in which a postpetition rent payment is due on the first day of a month and the trustee vacates the premises following such date but before the last day of the month. The issue is whether section 365(d)(3) mandates that the estate pay rent for the full month or *pro rata* to the date of vacation. The Court of Appeals for the Sixth Circuit, in a case involving rent due on December 1 and vacation of the premises on December 2, has held that section 365(d)(3) requires payment of the full amount due on the first of the month as an obligation under the lease to be performed in accordance with its terms.^{n104h} In response to the debtor's argument that such a holding would be contrary to generally accepted notions of equity and "common sense," the court observed that the debtor in possession had full control over the date selected for rejection of the lease and vacation of the premises and should be held to the consequences of its decision.ⁿ¹⁰⁴ⁱ A similar result was reached by the Court of Appeals for the Seventh Circuit, in connection with the debtor's vacatur of premises on the second day of the month.^{n104j} The court required the debtor to make the full month's rental payment because of the clear terms of the lease that made the rent payable on the first day of the month. The court rejected an argument that certain other provisions of the lease that contemplated the proration of rent in specified circumstances, such as upon the occurrence of a casualty or condemnation event, suggested that rent should be prorated in the situation before it--where the tenant rejects the lease during the pendency of a bankruptcy case.^{n104k}

In addition to real estate taxes and rent, similar issues have arisen in connection with the billing of insurance charges and common area maintenance (CAM) expenses. In the chapter 11 proceedings involving the Winn-Dixie supermarket chain, the bankruptcy court adopted the "accrual" approach and rejected the motion of a landlord seeking the current payment of such amounts under section 365(d)(4).^{n104l} The court reasoned that the accrual approach better implemented what it viewed as "the Code's overarching policies of equality among creditors and a fresh start for the debtor because landlords are fairly compensated for post-petition services provided to the debtor without imposing "sunk costs" on otherwise viable enterprises."^{n104m}

The factual situations in which the court's application of either the "accrual" or "billing date" method can be decisive are numerous and, given the clear split in the cases, including splits among the different courts of appeals, the issue may well be one that will need to be resolved by the U.S. Supreme Court.

These cases highlight, from the perspective of landlords, the importance of including a clearly drafted rent payment clause within a lease in order to avoid any ambiguity as to when rent and other amounts under the lease are in fact due and payable. In certain situations, for example, where "rent" is paid semi-annually or at other lengthy intervals, which is common with many leases supporting industrial revenue bond issues that have semi-annual payment requirements, it may be worthwhile to consider including in the lease a specific provision to provide for proration of rent on a daily basis in the event of a bankruptcy filing by the tenant. On the other hand, from the perspective of tenant-debtors involved in, or considering the commencement of, a bankruptcy case, these cases highlight the need to carefully consider the timing of actions such as filing of a bankruptcy petition and the vacatur of property in light of the impact that such timing could have on the financial requirements imposed by section 365(d)(3).

A similar but more complex issue arises in the context of percentage rent clauses in shopping center leases. Such provisions generally provide that percentage rent becomes payable as a percentage of gross sales after a specified "break point" in gross sales is attained during a "lease year." This rent is often paid in arrears, after the tenant has ascertained the amount of sales at a store location in a shopping center and has submitted to the landlord a report of such sales together with the percentage rent payment.

When a tenant under a percentage rent lease files a petition under the Bankruptcy Code, there are a number of ways to deal with percentage rent payments that come due after the filing of the petition but which relate to a lease year than spans the prepetition and postpetition periods. These methods include (1) requiring payment of all percentage rent coming due as temporal matter during the postpetition period as an administrative expense, based on the date when the rent payment is required to be made to the landlord under the terms of the lease; (2) prorating the entire amount of the percentage rent on the basis of the number of days respectively comprising the postpetition and prepetition periods; and (3) requiring payment of only that portion of the percentage rent coming due after the sales "breakpoint" has been reached (if this occurs in the postpetition period, then the percentage rent is given administrative claim priority).^{n104j} A similar complexity occurs under a lease that requires the tenant to reimburse the landlord for certain construction improvements, in which the timing of construction expenditures by the landlord spans both the prepetition and postpetition period, but the lease requires that the debtor make its reimbursement payment to the landlord following the completion of the work. In such a situation, a court has held that even where the "vast majority" of the reimbursable capital expenditures incurred by the landlord occurred prior to the petition date, under the lease, the debtor's reimbursement obligation was specifically bargained for to be contingent upon a future event--namely, the completion of the construction project and the opening for business.^{n104l}

[ii] The Procedural Framework

An unexpired lease may be terminated postpetition as follows: (1) by action on the part of the trustee to reject the lease; (2) in the case of a nonresidential real property lease, through a "deemed rejection" under section 365(d)(4); (3) in a chapter 7 case, through a "deemed rejection" under section 365(d)(1); (4) by an order of the bankruptcy court declaring the contract or lease to be terminated; or (5) through utilization of state law termination procedures authorized by the bankruptcy court in connection with a modification of the automatic stay. Action on the part of the trustee to reject a lease may be triggered by steps taken by the landlord rendering assumption undesirable or the determination by the trustee that the lease is without value to the estate.

The landlord's right to timely payment and performance by the trustee with respect to a nonresidential real estate lease of the debtor has been discussed above.^{n104m} If the trustee does not effect such performance, and does not obtain an extension of time for performance under section 365(d)(3), it appears that the landlord may apply to the court to compel performance. If the trustee is unable to perform, the landlord may seek an order of the court compelling surrender of the premises and rejection of the lease.

In the case of residential real estate leases, the trustee is obligated after the entry of the order for relief to pay to the landlord, on a current basis, charges on account of use and occupation of the premises in accordance with the terms of the lease.ⁿ¹⁰⁵ If the trustee does not make such payments, the landlord may apply to the court to compel payment of these charges. If the trustee is unable to make the payments, the landlord may seek an order of the court compelling the trustee to surrender the premises and to reject the lease. The landlord may also file a motion under section 365(d)(2) and under Bankruptcy Rules 6006(b) and 9014 in a chapter 9, 11, 12 or 13 case seeking an order directing the trustee to assume or reject a residential lease within a specified period. Such orders had been issued in several commercial (*i.e.*, nonresidential) lease cases prior to enactment of the 1984 Act.ⁿ¹⁰⁶ The grounds for issuance of these orders have included findings that (1) the use and occupation payments have not been made;ⁿ¹⁰⁷ (2) there is little likelihood that a viable assignee of the lease or subtenant of the premises will be found within a reasonable time;ⁿ¹⁰⁸ (3) there is little likelihood of an effective reorganization of the debtor;ⁿ¹⁰⁹ and (4) the landlord is being prejudiced by the delay in assuming or rejecting the lease.ⁿ¹¹⁰ In one case, the debtor in possession was given 20 days in which to assume or

reject, in another case 37 days and in yet another case 60 days.ⁿ¹¹¹ Although, since the enactment of the 1984 Act, section 365(d)(2), by its terms, only applies in the case of executory contracts and unexpired leases of residential real property, these factors can still be cited by landlords in connection with urging that the court authorize a short decision period by the debtor in connection with the debtor's request for extension of the 60-day period under section 365(d)(4).^{n111a}

The landlord may also seek a modification of the automatic stay to permit invocation of state law remedies.ⁿ¹¹² The grounds for seeking relief from the stay will ordinarily be similar to those set forth in the preceding paragraph in respect of a motion under section 365(d)(2), with the added requirement that the landlord receive adequate protection of its interest in the premises if the requested relief is denied. As discussed above, the section 361 enumeration of methods of providing adequate protection appears directed toward secured parties rather than landlords, and thus the measure of adequate protection for landlords in respect of leased real property has not been firmly established.ⁿ¹¹³ In the case of nonresidential real estate leases, the section 365(d)(3) requirement for timely performance by the tenant's trustee may be viewed as the measure of adequate protection to be provided, but the trustee may be required to segregate specified assets to provide assurance that the section 365(d)(3) payments will be made.ⁿ¹¹⁴

The landlord may also commence a contested matter under section 363(e), seeking adequate protection of its interest in the property leased by the trustee.

In any event, the use by a landlord of (1) a proceeding (in the form of a contested matter under Bankruptcy *Rules* 4001(a) and 9014) to lift or modify the stay, in addition to (2) a motion for rejection or assumption under section 365(d)(2), or, in the case of a nonresidential real estate lease, a contested matter to enforce the provisions of section 365(d)(4), and (3) a contested matter under section 363(e), will bring the matter under the time deadlines imposed by *section 362(e) of the Code*, and may therefore result in a more expeditious determination of the landlord's requests.ⁿ¹¹⁵

If the trustee has applied to the court for authority to assume a lease, a landlord may induce rejection of the lease by demonstrating that the standards for assumption of a defaulted lease set forth in *section 365(b)(1) of the Code* have not been satisfied. Thus, the landlord may seek to show that (1) the trustee has not and cannot cure an outstanding default under the lease, or the trustee has not provided adequate assurance of prompt cure of a specified default; (2) the trustee has not compensated or provided to the landlord adequate assurance of prompt compensation for damages or other "actual pecuniary losses" under section 365(b)(1)(B) that have been suffered by the landlord as a result of the existence of a default under the lease (for example, a prepetition rent default may have compelled the landlord to borrow funds to pay the mortgage on the premises, to incur interest charges on the loan and to pay late charges on the mortgage); or (3) the trustee has not provided adequate assurance of future performance under the lease.ⁿ¹¹⁶ If the landlord prevails in this effort, the trustee should have no choice but to reject the lease in lieu of assumption. Similarly (but probably only in rare instances), the landlord may demonstrate that the lease involves such a particular relationship between landlord and tenant that the lease falls under section 365(c) as an agreement that cannot be assumed without the landlord's consent. This could conceivably occur when a specialized operation has resulted in a unique percentage rent clause, or when the lease involves a single purpose building that can be operated and maintained only by the debtor.ⁿ¹¹⁷

[iii] Litigation Strategy

The postfiling procedures to be followed by a landlord for obtaining an adjudication of its rights under the Code may be explained in the context of the following fact pattern: A tenant under a nonresidential real property lease has defaulted in the payment of two months' rent immediately preceding the filing of its petition under chapter 11 of the Bankruptcy Code. The landlord has sent out a termination letter prior to the filing of the petition. The property is one of 15 locations leased by the debtor for use in its business, has been operated at a loss during the six-month period preceding the filing, and has been held by the trustee for 50 days after the entry of the order for relief. The trustee wishes to have time to seek an assignee of the lease but so far has been unsuccessful in generating any indications of interest. Following the filing of the petition, the trustee has failed to pay the rental and other charges provided for in the lease. The landlord has

received an offer from an unrelated third party to purchase the premises if title can be conveyed free of the lease. The sale will yield a substantial profit to the landlord.

Three principal devices may be employed by a landlord seeking to terminate or compel the termination of a nonresidential real estate lease after the filing of a Bankruptcy Code petition by or against the tenant, and to obtain possession of the premises.ⁿ¹¹⁸ These are: (1) a motion to compel rejection or assumption of the lease under section 365(d)(4) (requiring assumption or rejection within 120 days of the entry of the order for relief subject to certain extensions), and invoking the automatic rejection provisions of section 365(d)(4), or an objection to a request by the debtor to extend the 120-day period under such section; (2) a motion seeking a modification or lifting of the automatic stay under section 362(d) and *Rules 4001(a)* and *9014*; and (3) a motion under section 365(d)(3) to compel the trustee to pay and perform on a timely basis the tenant's obligations under the lease. The motion seeking modification or lifting of the stay may be accompanied by a request for adequate protection under section 363(e) with respect to the trustee's continued use of the property.ⁿ¹¹⁹

Each of the three proceedings will ordinarily support and supplement the others.ⁿ¹²⁰ First, the motion to compel rejection or assumption, and to invoke the automatic rejection provisions of section 365(d)(4), will force the trustee to seek an extension of the time to reject or assume under section 365(d)(4) and to assert that the landlord will not be prejudiced by any delay in deferring the decision. However, in order to support that argument, the trustee will in all likelihood be constrained to respond affirmatively to the motion to compel payment and performance of the lease obligations and offer payment of past due amounts and its commitment to pay in the future. With respect to the loss of the potential purchaser of the property, the trustee will argue that the sale transaction free of the lease would not have been available had there been no chapter 11 case and that the landlord has created its own potential prejudice and has sought to reap a windfall in seeking a transaction that would not have been available had the debtor not run into financial difficulties.

However, if the trustee cannot provide assurance of its ability to pay and perform future lease obligations, the landlord will be able to assert

(1) in its motion to compel assumption or rejection, that there is little likelihood that the trustee will be able to cure past defaults and provide adequate assurance of future performance if the trustee ultimately seeks to assume the lease, so that no actual benefit accrues to the trustee in deferring the decision to assume or reject;

(2) in its motion to enforce the automatic rejection provisions of sections 365(d)(4), that the trustee's inability to provide assurance of payment and performance of the lease obligations when balanced against the loss of the potential sale of the property shows clearly that the landlord will be prejudiced by delay, and that the court should not grant the trustee an extension under section 365(d)(4); and

(3) in the proceeding for modification of the automatic stay, and for adequate protection under section 363(e), that the trustee's inability to provide assurance of payment and performance of the lease obligations requires a finding that there can be no adequate protection of the landlord's interest in the property and that the stay should be lifted so as to permit the landlord to pursue its state court lease termination remedies.ⁿ¹²¹

The alternative ground for relief from the automatic stay--that the debtor has no equity in the property and the property is not necessary to an effective reorganization--also provides interesting possibilities for the landlord in the fact pattern set out above. It may be argued that in a leasing situation, the debtor has no "equity" in the property, and, under the fact pattern, the property is not necessary for an effective reorganization because it has been operated at a loss over a substantial period. The trustee will argue in opposition that the debtor does have an "equity" in the property if there is a possibility that its leasehold estate can be assigned for consideration and that, in any event, this second ground for relief

from the automatic stay was intended to deal with the rights of secured parties and not of landlords.¹²²

Whatever the outcome, the use of the three proceedings in combination may at best result in an expeditious determination freeing the subject property from the hold of the trustee and the court, and may at worst result in a commitment for payment and performance of the lease obligations. The principal element governing the outcome of the above-described motions appears to be the trustee's ability to effect performance under the lease to compensate the landlord for the delay in rejecting or assuming the lease, and to provide adequate protection in respect of the automatic stay and section 363(e). A form of motion incorporating each of the three procedural mechanisms is provided at the end of this chapter.¹²³

[iv] Other Strategies for the Landlord

[A] Deprivation of Services and Supplies

Under section 365(b)(4), if the debtor as lessee has committed a nonbankruptcy default under a lease, the landlord cannot be compelled to provide services or supplies "incidental" to the lease prior to the assumption thereof unless the landlord is compensated under the terms of the lease for any such services and supplies provided thereunder before assumption of such lease. There are a number of unanswered questions under the statute, many resulting from imprecise drafting. For example, section 365(b)(4) does not by its terms require that the default relate to payment for the services and supplies, nor does it require that the default relate to the payment of money. Indeed, the section does not provide that the default must be cured as a condition to the landlord's obligation to furnish services and supplies--it provides only that the services and supplies must be paid for by the trustee of the debtor-lessee under the terms of the lease. If the lease does not allocate values to services or supplies, it is not clear whether the landlord may claim the benefits of section 365(b)(4) inasmuch as the trustee will be unable to make payment "under the terms of such lease." Moreover, it is not clear what is meant by "incidental" services and supplies, and, thus, no guidance is given as to which services may be withheld. In the case of a typical lease of space in an office building, the landlord will be required to furnish heat, air conditioning, electrical service, elevator service, cleaning services and perhaps parking and security services. If a trustee is denied heat, air conditioning or elevator service, the premises may become untenable. Accordingly, the trustee may argue that such services go to the essence of its occupancy and are not merely incidental and cannot be withheld by the landlord under section 365(b)(4). On the other hand, cleaning services and supplies and perhaps security service may be deemed "incidental" inasmuch as the trustee may be able to function in the premises notwithstanding the loss of these services. It is clear, however, that if the lease allocates a part of the rent or other charges to incidental services or supplies, and a default has occurred, the landlord may as a postfiling tactic withhold some services until it is compensated therefor.

It should also be noted that in the case of an unexpired nonresidential real estate lease, the trustee is obligated to pay and perform all lease obligations prior to rejection or assumption, subject to the possibility of a court-ordered 60-day grace period for performance running from the entry of the order for relief. If the trustee is not compensating a landlord for incidental services or supplies under the terms of the lease, the landlord may proceed under section 365(d)(3) to recover such payments and also withhold performance under section 365(b)(4). If the court has granted a grace period for the trustee's performance under section 365(d)(3), nothing in section 365(b)(4) compels the landlord to provide incidental services and supplies during the grace period.

[B] Postpetition Waiver and Estoppel Issues

Section 70b of the former Bankruptcy Act provided that bankruptcy termination clauses in leases were enforceable. This rule was applicable notwithstanding the trustee's ability to cure any lease defaults and to pay and perform all of its future obligations under the lease. It permitted landlords to deprive debtor-tenants of possession of their principal or sole places of business, to the detriment of all other creditors and any shareholders of the debtor. If the debtor had improved the leased premises at its own cost, the premises as improved would upon the termination of the lease revert

to the landlord with no requirement of compensation to the debtor. In a rising rental market, the landlord could elect to trigger the termination clause and relet the premises to a new tenant at a higher rental. In a declining market, the landlord could permit the lease to remain in effect, knowing that in the case of a default or liquidation of the debtor the property would eventually revert to the landlord.

In order to avoid one or more of the above consequences, the courts developed several doctrines under Section 70b of the Bankruptcy Act designed to avoid lease forfeitures. The rule of strict construction was applied to bankruptcy termination clauses to read out termination rights in circumstances not specifically enumerated in the clauses.ⁿ¹²⁴ The courts held that when a landlord accepted payments following the filing of a petition by the lessee under Chapter XI of the former Bankruptcy Act, it waived its right to assert the termination of the lease.ⁿ¹²⁵ It was also held that a landlord was estopped from invoking a termination clause in the lessee's Bankruptcy Act case when it engaged in conduct that could be construed as affirming the existence of the lease.ⁿ¹²⁶

With the advent of subsections 365(b) and (e), which render unenforceable bankruptcy termination clauses, it may have appeared that there was no longer a need to be concerned with the consequences of a landlord's accepting a payment from a trustee of the lessee following the filing of a petition or otherwise doing an act to recognize the lease, inasmuch as the bankruptcy termination clause will be unenforceable in any event. However, before enactment of the 1984 Amendments, there were several reasons why a landlord's acceptance, without a proper reservation of rights or mutual stipulation, of postpetition payments and performance from the trustee of a debtor-tenant could impair the landlord's legal position.

First, if there had been a nonbankruptcy default, the lease could not be assumed or assigned without cure of the default or adequate assurance of prompt cure, and adequate assurance of future performance under section 365(b)(1). If the landlord may have been deemed to have waived the *nonbankruptcy default* by acceptance of postpetition payments, or to be estopped from asserting the default by reason of conduct evidencing affirmation of the lease after the occurrence of the default, it may have been argued that the landlord had likewise relinquished the right to receive adequate assurance of prompt cure and of future performance.ⁿ¹²⁷

Second, if the landlord was claiming that it effectively terminated the lease before the filing of the petition,ⁿ¹²⁸ acceptance of rent or other affirmative conduct subsequent to the time of the claimed termination may have given rise to waiver and estoppel arguments by the trustee if it were seeking to assume or assign the lease.

The foregoing waiver issues appear to have been substantially reduced, if not eliminated, with respect to nonresidential real estate leases by section 365(d)(3), as enacted in the 1984 Amendments. This section provides for the postpetition performance by the trustee of a debtor-tenant of all of the obligations under a nonresidential real estate lease of the debtor, and provides further that acceptance of such performance by a landlord does not constitute a waiver or relinquishment of the landlord's rights under the lease or the Bankruptcy Code. This provision obviates the need for letters of reservation, or stipulations between counsel for the landlord and the debtor (in the context of a contested matter), stating that (1) the landlord's acceptance of postpetition payments are on account of use and occupation charges and not as rent, and (2) such acceptance is without prejudice to the landlord's rights under the lease or otherwise available at law or in equity. It should be noted, however, that some affirmative act of a landlord--beyond the mere acceptance of postpetition performance--can still give rise to an assertion of estoppel and similar arguments affecting the landlord's rights to adequate assurance of cure and of future performance, and affecting the landlord's claim of a prepetition lease termination.^{n128a} Thus, in an abundance of caution, it would appear to be prudent practice to consider documenting a reservation of rights in any postpetition correspondence from the landlord to the debtor or in any orders or stipulations that may be entered by the court in connection with the premises.

Notwithstanding the protections afforded by section 365(d)(3), a landlord should take protective measures to avoid waivers, estoppel arguments and similar pitfalls. If landlords' counsel are consulted before the filing of the petition, they will have the opportunity to consider the following:

(1) Preparation of default letters if required by the terms of the lease. It should be noted that defaults other than nonpayment will support termination if of sufficient materiality. For example, failure to make essential repairs may be grounds for termination of real property leases under state law. Such default letters should clearly indicate the landlord's full reservations of rights under the lease and the nonwaiver of any defaults that are not specifically addressed in the letter.

(2) Acceleration of rent.

(3) Termination of the lease.

(4) Paying careful attention to the precise wording of any termination notices to avoid any implication that the landlord is providing an unintentional additional cure period and to assure that there is exact compliance with provisions providing for the manner of providing notice and the specific identity of notice parties under the lease.^{n128b}

(5) Protecting against waivers if the lease has theretofore been declared to be in default. This would include advice under state court waiver cases as well as cases under the former Bankruptcy Act.

(6) Counseling against any affirmation of the lease, whether or not there has been a default, and against any agreement to forebear from seeking to terminate the lease.ⁿ¹²⁹

[4] The Trustee's Courses of Action After Filing

After the filing of a petition, a trustee should consider the possible courses of action which may be taken with respect to unexpired leases of the debtor. If leases are being considered for rejection, the trustee should determine, among other things, whether:

(1) The claim for damages arising out of the rejection, notwithstanding the cap in section 502(b)(6), will be in an amount that will impair the debtor's ability to promulgate a plan (if the debtor is in a reorganization case);

(2) The benefits that were theretofore available to the debtor under the lease may be obtained at other or new locations;

(3) In the case of a landlord facing a relatively weak market for the debtors premises, the ability to reject the lease provides possible leverage to renegotiate favorable modifications, including lower rents;

(4) The rejection of the lease will impair future dealings with the landlord in respect of any other leases or agreements between the landlord and the debtor, and whether such dealings would be of material benefit to the reorganization effort;

(5) In the case of a lease of nonresidential real property, the continued costs of timely compliance with the lease terms compels prompt rejection notwithstanding other considerations;

(6) In the case of a lease of nonresidential real property, the priority status of postpetition obligations compels accelerated or premature decision making on whether to assume or reject the lease even in the absence of enhanced and timely information such as an updated business plan that could impact the desirability of the debtor retaining the premises and the priority status provided to postpetition lease obligations;

(7) The lease may be assigned rather than rejected so that (a) there will be no damage claim arising out of a rejection and (b) the trustee may receive consideration from the assignee; and

(8) The lease may be surrendered to the landlord in exchange for a release of all claims against the estate, or even for consideration from the landlord, in view of the liberal assumption and assignment provisions of the Code.ⁿ¹³⁰

If the landlord is willing to accept surrender of the lease and to release any of its claims against the estate, it must be determined whether there are third-party assignees of either the debtor's or landlord's rights under the lease, who may have a right to be heard, or whose consent may be required, or who may have an allowable claim against the estate arising out of the surrender of the lease notwithstanding the release of all claims by the landlord.ⁿ¹³¹ If the debtor as tenant has executed an acknowledgment of an absolute assignment of rents to the landlord's mortgagee, will the tenant be able to surrender the lease without the consent of the mortgagee and without giving rise to a claim from the mortgagee? If the debtor as tenant has executed a leasehold mortgage and has agreed with the mortgagee not to surrender the lease, will the surrender be effective?ⁿ¹³²

If unexpired leases are being considered for assumption, the trustee should determine, among other things, whether:

- (1) The cost of curing past defaults, if any, under the lease is within the debtor's financial capabilities;
- (2) The trustee will be able to provide adequate assurance of future performance, if required, and the type of adequate assurance that it will be prepared to offer;
- (3) Application should be made to the court for additional time to cure defaults;
- (4) In the case of a nonresidential real estate lease, application should be made to the court as promptly as possible after entry of the order for relief for extension of the 60-day period after which the lease is deemed rejected unless theretofore assumed;
- (5) The potential consequences to the estate and its creditors of a postassumption default by the debtor outweigh the benefits of assumption;
- (6) The landlord is likely to seek termination of the lease in opposition to the trustee's application to the court for authority to assume the lease;
- (7) The landlord in opposing the assumption is likely to succeed; and
- (8) The cost and delay of litigating with the landlord outweigh the benefits to be attained by assumption.

If the trustee will be required to provide adequate assurance of future performance in connection with assumption of an unexpired lease, alternative proposals should be prepared if the trustee contemplates opposition from the landlord. The alternatives may include (1) evidence of the debtor's projected net worth, working capital, or earnings,ⁿ¹³³ (2) security deposits,ⁿ¹³⁴ (3) liens on other property of the estate, (4) the likelihood of confirmation of a plan,ⁿ¹³⁵ (5) a third-party guarantyⁿ¹³⁶ and (6) combinations of two or more of the foregoing.

[5] Assumption and Assignment of Leases; Adequate Assurance of Cure and of Future Performance

The Code employs without definition the term "adequate assurance" in the context of setting forth conditions to a trustee's assumption and assignment of a lease. If a lease is in default, the trustee must as a condition of assumption (1)

cure or provide adequate assurance of prompt cure of the outstanding defaults, (2) compensate or provide adequate assurance that the trustee will promptly compensate a landlord or other nondebtor party to the lease for actual pecuniary loss resulting from the defaults and (3) provide adequate assurance of future performance under the lease.ⁿ¹³⁷ It is critical to note that for a lease that is merely assumed (rather than assumed and assigned), the requirement of providing adequate assurance only applies to leases that are in default. Absent the existence of a default at the time of proposed assumption, the Bankruptcy Code does not protect landlords or counterparties to executory contracts from an increased theoretical risk of a future default *following* assumption, resulting from, for example, the diminished financial strength of the debtor at that time as compared to the strength at the time the lease was originally executed.^{n137a}

By contrast, if the lease is to be assumed *and* assigned, adequate assurance of future performance by the assignee must be provided even though the lease is not in default.ⁿ¹³⁸ Clearly a distinction must be drawn between the term "adequate assurance" as employed in the context of the cure of outstanding defaults and as used in the context of future performance under a lease. In addition, a distinction should be drawn between adequate assurance of future performance as it relates to the financial capacity of a party to perform its obligations under a lease and the ability of any party, however financially capable, to cure outstanding defaults under, or to perform certain covenants in, a lease.

[a] Adequate Assurance of Prompt Cure

The language of *section 365(b)(1)(A) of the Code*, providing for cure or adequate assurance of prompt cure of outstanding lease defaults as a condition to assumption, clearly contemplates that something less than immediate payment or performance of defaulted obligations will be sufficient. In the case of an assumption of a lease followed by an assignment, the outstanding monetary defaults under the lease will ordinarily be cured by disbursement to the landlord of a portion of the consideration paid by the assignee upon consummation of the assignment transaction. Thus, the matter of adequate assurance of prompt cure will generally arise only in the cases of an assumption without an assignment, or an assumption and a subletting when there is no immediate cash infusion to the trustee, or an assumption where the cure amount is disputed and the cash being provided or set aside is insufficient to cover the maximum cure asserted cure claim, or an assumption and assignment where there are nonmonetary obligations to be cured. What are the standards and considerations employed by the courts in determining whether a trustee has provided adequate assurance of prompt cure of an outstanding default?

In *Motor Truck & Trailer Co. v. Berkshire Chemical Haulers, Inc. (In re Berkshire Chemical Haulers, Inc.)*,ⁿ¹³⁹ the debtor was in arrears under leases of four trucks, and proposed to return one truck to the lessor and to pay the arrearages on the other leases over the remaining 18-month term of the leases, with the final payment to come upon the expiration of the leases. The court denied the debtor permission to assume the leases on the grounds that the debtor had provided neither adequate assurance of prompt cure of the outstanding defaults nor adequate assurance of future performance. The court's discussion of the relevant considerations is instructive:

Turning to the first issue, whether the debtor's plan offers adequate assurance of a prompt cure of its default under the lease, the debtor has offered to pay all outstanding pre- and postpetition arrearages by the end of the lease period, namely by October, 1983.

"Section § 365(b)(1) attempts to strike a balance between two sometimes competing interests, the right of the contracting nondebtor to get the performance it bargained for [footnote omitted] and the right of the debtor's creditors to get the benefit of the debtor's bargain. [Citations omitted.] Nowhere is the tension between these interests, and the difficulty in striking the balance, more apparent than in trying to determine whether there is the requisite adequate assurance of future performance." *In re Luce Industries, Inc.*, 3 Collier Bankr. Cas. 2d (MB) 574, 8 B.R. 100, 107 .

In *Luce Industries* it was held that a promise or similar lesser assurance will not be adequate to cure monetary default. In the case of *In re Bronx-Westchester Mack Corp.*, 4 B.R. 730 (Bankr. S.D.N.Y. 1980) it was held that adequate assurance requires cash or collateral that is nonspeculative, positive and

sufficiently substantial so as to assure [the Lessor] that it will realize the amount of the default. On the other hand, the *Luce Industries* case did say that "the assurance required will fall *considerably short* of an absolute guaranty of performance." *In re Luce Industries, Inc.*, *supra* at 107 .

In the case at bar, the debtor has offered to return one of the four tractors to Motor Truck, and to pay \$4,438.35 per month on the remaining three tractors until October 1983, when all arrearages will have been cured. The debtor's plan certainly does not provide for full payment of the arrearage, but at the hearing on March 23, 1982, the debtor indicated that other monies would be available to cure its arrearage. Where these monies are to come from is not clear, but apparently the debtor anticipates that over the next 18 months, it will generate more than \$50,000 in new profits to pay Motor Truck.

The Bankruptcy Code speaks of a "prompt cure," or "adequate assurance of a prompt cure." In at least one case, prompt cure meant an immediate payment. *In re Lafayette Radio Electronics Corp.*, [4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981)]. However, what is a prompt cure can often vary according to the circumstances of a given case. I therefore would disagree with the holding of *General Motors Acceptance Corp. v. Lawrence*, 11 B.R. 44, 45 (Betsy. N.D. Ga. 1981) , where the Court felt it unlikely that a period of time in excess of one year would ever be considered a "prompt cure." For instance, a debtor with 90 years remaining on a 99-year lease, who proposes to cure its arrearage by monthly payments over an 18-month period, might be found to have offered adequate assurance of a *prompt cure*. On the other hand, where in this case the debtor's offer to cure its lease default over the next 18 months contemplates the final payment being made contemporaneously with the expiration of the lease term, I cannot say that any Court, under any circumstances, would find that such a proposal qualifies as a "*prompt*" cure under § 365(b)(1).

Even if the time period were found to be prompt, there would be the additional question of whether a prompt cure was "adequately assured." The viability of the debtor's business and the accuracy of its business projections would be factors in any such determination.

The debtor's financial statements reveal that through February 1982, representing approximately 21½ years of operation, the debtor had suffered a net loss of more than \$24,000. However, the debtor is quick to point out that during the Chapter 11 proceeding its monthly net loss has been reduced to the point that in February, 1982, the debtor suffered only a \$696.88 loss, indicating that the debtor is ready to break into the profit column. Nevertheless, the debtor's economic resurgence has come at the expense of Motor Truck, who was not paid for almost one year. Thus, even without making payments to Motor Truck, the debtor was unable to make a profit. It now asks Motor Truck to accept its prognosis of future profitability in return for continued performance under the lease.

This Court can envision many cases where the promise to cure a default out of future profits might be sufficiently assured as to warrant approval of such a proposal. But, in the case before the Court there is no past history of profitability, there is no competent evidence of future profitability, and the debtor's projections seem nothing more than pipe dreams. For instance, the debtor's own sales records indicate that total revenues for the period ending September 30, 1981 were \$403,674.05, which is a monthly average of \$33,639.50 per month. For the period October 1, 1981 through February 28, 1982, a period of five months, the debtor's total revenues were \$176,645.32, or a monthly average of \$35,329.06. Thus, the debtor's records indicate only a \$1700 increase in monthly revenues, from which it must fashion \$58,000 over the next 18 months. Assuming, as the debtor has argued, that it has already reduced its operating costs substantially, the only means left for generating sufficient profit to pay off Motor Truck is through a sufficient increase in sales revenue. While I have no doubt that the debtor is confident of its ability to expand its operations, I also have no doubt that such "confidence" is not the stuff of which "adequate assurance" is meant to consist. This Court, in ruling on the question of assumption of a lease, must be *reasonably* satisfied that if the debtor is not going to cure immediately, that it will be *able* to do so within

a period of time deemed to be prompt. What is adequate assurance, both for purposes of a prompt cure and for future performance, will depend again on individual circumstances. However, it is this Court's ruling that a debtor who seeks to provide adequate assurance of payment, both on its defaulted lease obligations and on its future lease obligations, out of future business operations, must show a sufficient likelihood of profitability such that the Court would be reasonable in assuming that the debtor could satisfy its obligations under § 365(b)(1). Here, not only has the debtor not shown that it can provide adequate assurance of prompt cure, but it has failed even to show that it could meet its future obligations currently. This debtor has never had a profitable month of operations, even with 12 months of protection from this Court, and has failed to show that it can ever be sufficiently profitable as to warrant the continuing burden of the lease in question. This Court cannot gamble on the business judgment of a debtor at the risk of continuing harm to a creditor who would otherwise be entitled to the return of its property.ⁿ¹⁴⁰

Although *Berkshire* involved an equipment lease, *Luce Industries* a licensing agreement and *Bronx-Westchester Mack* a franchise agreement, the *Berkshire* opinion should be applicable to (and indeed it so discusses) the concept of adequate assurance of prompt cure with respect to real estate leases. The opinion indicates that something less than immediate payment will be permitted, that even a long-term payment may be permitted in the case of a long-term lease and that the trustee must demonstrate prospects for financial viability of the debtor sufficient to justify the stretch-out of the defaulted obligation.

[b] Adequate Assurance of Future Performance

[i] Generally

The requirement of adequate assurance of future performance with respect to real estate leases has received a relatively uniform interpretation in the cases and commentary.ⁿ¹⁴¹ This interpretation and the legal reasoning behind it may be summarized as follows:

- (1) The term "adequate assurance of future performance" was contained in the bankruptcy legislation originally proposed in 1973 by the Commission of the Bankruptcy Laws of the United States (the "Commission");
- (2) The report of the Commission accompanying its proposed bill (the "Commission Report"), as it related to this language, cited to *section 2-609 of the Uniform Commercial Code*, and to Comment 4 relating to that section;
- (3) Comment 4 to section 2-609 sets forth a doctrine under which a party under a contract for the sale of goods is not required to perform unless it is reasonably certain that the other party will perform;
- (4) The concept of adequate assurance of future performance must therefore be given a "practical pragmatic construction," taking into account "the nature of the parties involved, their prior dealings, the present contract and what solution is truly 'equitable' given the composition of the mix of facts";ⁿ¹⁴² and
- (5) The concept of adequate assurance "will fall considerably short of an absolute guaranty of performance."ⁿ¹⁴³

The Commission's proposed bill submitted to Congress provided, in pertinent part:

Section 4-602 Executory Contracts and Unexpired Leases.

... (b) *Unenforceability of Certain Contractual Provisions.* A provision in a contract or lease, or in

any law applicable thereto, which terminates or modifies, or permits a party other than the debtor to terminate or modify, the contract or lease because of the insolvency of the debtor or the commencement of a case under this Act by or against the debtor or which prohibits, restricts or conditions the assignment of the contract or lease

... (2) is not enforceable in a case under Chapter VI, VII, or VIII to prevent assumption or assignment by the trustee or debtor of a contract or lease if, when the contract or lease is assumed or assigned or within a reasonable time thereafter, any defaults in prior performance of the debtor are cured and, *for the assumption or assignment of a contract but not a lease*, adequate assurance of future performance is provided.ⁿ¹⁴⁴

The Commission's comment to this section is as follows:

11. *Clause (2) of subdivision (b)* does impose, in place of any rights a nonbankrupt party may or may not have under the contract or lease or under applicable nonbankruptcy law, certain obligations. In order to assume a contract or lease, past defaults must be cured and, for contracts but not leases, "adequate assurance of future performance" must be given. The language quoted is adapted from *Uniform Commercial Code § 2-609(1)*. What constitutes "reasonable time thereafter" for curing defaults or an "adequate assurance of future performance" must be determined by consideration of the facts of the proposed assumption. *Cf.* Official Comment 4 to *Uniform Commercial Code § 2-609* (1972 ed.). It is not intended, however, that any non-debtor party should acquire greater rights in a case under the Act than he has outside the Act.ⁿ¹⁴⁵

Section 2-609(1) of the Uniform Commercial Code provides:

§ 2-609. *Right to Adequate Assurance of Performance*

(1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

Comment 4

to section 2-609 states:

4. What constitutes "adequate" assurance of due performance is subject to the same test of factual conditions. For example, where the buyer can make use of a defective delivery, a mere promise by a seller of good repute that he is giving the matter his attention and that the defect will not be repeated, is normally sufficient. Under the same circumstances, however, a similar statement by a known corner-cutter might well be considered insufficient without the posting of a guaranty or, if so demanded by the buyer, a speedy replacement of the delivery involved. By the same token where a delivery has defects, even though easily curable, which interfere with easy use by the buyer, no verbal assurance can be deemed adequate which is not accompanied by replacement, repair, money-allowance, or other commercially reasonable cure.

A fact situation such as arose in *Corn Products Refining Co. v. Fasola*, 94 N.J.L. 181, 109 A. 505 (1920) offers illustration both of reasonable grounds for insecurity and "adequate" assurance. In that case a contract for the sale of oils on 30 days' credit, 2% off for payment within 10 days, provided that credit was to be extended to the buyer only if his financial responsibility was satisfactory to the seller. The

buyer had been in the habit of taking advantage of the discount but at the same time that he failed to make his customary 10-day payment, the seller heard rumors, in fact false, that the buyer's financial condition was shaky. Thereupon, the seller demanded cash before shipment or security satisfactory to him. The buyer sent a good credit report from his banker, expressed willingness to make payments when due on the 30-day terms and insisted on further deliveries under the contract. Under this Article the rumors, although false, were enough to make the buyer's financial condition "unsatisfactory" to the seller under the contract clause. Moreover, the buyer's practice of taking the cash discounts is enough, apart from the contract clause, to lay a commercial foundation for suspicion when the practice is suddenly stopped. These matters, however, go only to the justification of the seller's demand for security, or his "reasonable grounds for insecurity."

The adequacy of the assurance given is not measured as in the type of "satisfaction" situation affected with intangibles, such as in personal service cases, cases involving a third party's judgment as final, or cases in which the whole contract is dependent on one party's satisfaction, as in a sale on approval. Here, the seller must exercise good faith and observe commercial standards. This Article thus approves the statement of the court in *James B. Berry's Sons Co. of Illinois v. Monark Gasoline & Oil Co., Inc.*, 32 F.2d 74 (C.C.A.8, 1929), that the seller's satisfaction under such a clause must be based upon reason and must not be arbitrary or capricious; and rejects the purely personal "good faith" test of the *Corn Products Refining Co.* case, which held that in the seller's sole judgment, if for any reason he was dissatisfied, he was entitled to revoke the credit. In the absence of the buyer's failure to take the 2% discount as was his custom, the banker's report given in that case would have been "adequate" assurance under this Act, regardless of the language of the "satisfaction" clause. However, the seller is reasonably entitled to feel insecure at a sudden expansion of the buyer's use of a credit term, and should be entitled either to security or to a satisfactory explanation.

The entire foregoing discussion as to adequacy of assurance by way of explanation is subject to qualification when repeated occasions for the application of this section arise. This Act recognizes that repeated delinquencies must be viewed as cumulative. On the other hand, commercial sense also requires that if repeated claims for assurance are made under this section, the basis for these claims must be increasingly obvious.

As noted, the Commission's proposed bill and its report expressly excluded all leases from the requirement of adequate assurance of future performance upon assumption. The citations to *Uniform Commercial Code section 2-609(1)* and Comment 4 thereto clearly related to contracts for the sale of goods, and to the continuing relationship between the seller and purchaser thereunder.^{n145a} In any event, both the Uniform Commercial Code and the Comment appear to be dealing with assurances of a commercially reasonable type that the original contract will be performed in accordance with its terms and are not saying that the party requiring assurance is entitled only to assurance that there is a reasonable prospect of future performance. In other words, the cited provision and Comment appear to be speaking to the reasonableness of the *form* of the assurances to the end that the assured party is given grounds to believe that the assuring party is as capable of performing the contract as it was on the day the contract was signed.

Sections 365(b) and 365(e) of the Code as ultimately enacted include leases within the classes of agreements that are assumable and whereunder assumption (in the case of an agreement in default) and assignment (in all instances) require adequate assurance of future performance. Nevertheless, the House Report,ⁿ¹⁴⁶ in discussing adequate assurance of future performance, contains no references to the Uniform Commercial Code, the Comments thereto or the Commission's bill and report. Instead, the House Report states:

The unenforceability of ipso facto or bankruptcy clauses proposed under this section [365(e)] will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the courts will have to insure that the trustee's

performance under the contract or lease gives the other contracting party the full benefit of his bargain.ⁿ¹⁴⁷

This language, calling for "insur[ance]" of the "full benefit of the bargain" for the other contracting party, may be contrasted with the Commission Report, which even if applicable to leases, provided only that "adequate assurance of future performance" must be determined by consideration of the facts of the proposed assumption.ⁿ¹⁴⁸

It may be argued, in sum, that the accepted interpretation of "adequate assurance of future performance," depending as it does on the references to the Commission's bill and the Commission Report, is incorrect inasmuch as (1) the concept of adequate assurance of future performance in the Commission's bill did not apply to leases, (2) even if the concept did apply to leases, it did not allow for a diminution of the obligor's abilities to perform the contract, but only for the right of the other contracting party to receive assurances of a reasonable nature that the obligor's capacity to perform remained undiminished, (3) the inclusion in the Bankruptcy Code of leases within the class of agreements under which adequate assurance of future performance is required could not, and in fact did not, refer to Uniform Commercial Code antecedents dealing with contracts for the sale of goods and (4) the Code's legislative history, in ignoring prior references to the Uniform Commercial Code, sets forth a more stringent standard providing for "insurance" that the nondebtor party will receive the full benefit of its bargain. Under this argument, the requirement of adequate assurance of future performance would mean, in the case of an assumption of a real property lease, that the trustee would be required to demonstrate that he remains fully able to perform his obligations under the lease without a greater likelihood of default than originally contemplated by the parties. In the case of an assumption and assignment to a third party, the trustee would be required to show that the financial and operating wherewithal of the proposed assignee is at least equivalent to that of the debtor as of the commencement of the lease. Thus, the landlord would be insured of the full benefit of its bargain if it is given a new tenant which meets the criteria imposed by the landlord in leasing the premises to the debtor in the first instance.

[ii] Financial Capacity as an Element of Adequate Assurance of Future Performance

A landlord seeking to resist assumption and assignment of a lease may raise the issue of the financial capacity of the proposed assignee to pay the rental and other charges provided for in the lease. The resolution of this issue is a matter for the bankruptcy court, which therefore is required to engage in a review and analysis of the proposed assignee's financial condition. Although the determination of an assignee's financial wherewithal is of course a matter for case-by-case analysis, it is helpful to review certain precedents to ascertain the factors considered by the courts.

In *In re Sapolin Paints, Inc.*ⁿ¹⁴⁹ the debtor and its subsidiary were constrained by financial considerations to sell within the context of their chapter 11 cases substantially all of their assets, including a plant, a retail store, inventory and several leases of real property. The successful bidder for the package, at \$2,600,000, had a net worth, excluding unspecified long-term indebtedness to its parent corporation, of \$800,000, with earnings of \$190,000 for the fiscal year ended December 31, 1979, \$185,000 for the five months ended May 31, 1980, and projected aggregate earnings for 1980 of \$1 million. A landlord of a 69,350 square foot manufacturing warehouse and office facility located in California objected to the designee as the proposed assignee. The lease of the facility provided for fixed rent of approximately \$56,000 per annum, or \$.81 per foot, on September 30, 1989, and provided for a 10-year renewal option. The prevailing market rental for the property was \$2.88 per foot. The president of the proposed assignee testified that he had no doubt of his company's ability to meet the fixed rental obligations provided for in the lease. The court held that adequate assurance of future performance had been provided.

In *In re Lafayette Radio Electronics Corp.*,ⁿ¹⁵⁰ the debtor in possession under chapter 11 of the Code sought to assume a lease of retail store premises and to sublease the premises at a profit of \$894,792 over the sublease term. The proposed sublessee was a shell corporation formed for the purpose of the subject transaction, and was an affiliate of four other corporations, each of which leased other retail stores for the sale of women's clothes and accessories. The debtor in possession received a \$10,000 security deposit on the sublease and a \$10,000 note of certain principals of the sublessee

guaranteeing performance under the sublease. The landlord objected to the proposed transaction, arguing, among other things, that there was inadequate assurance of future performance under the prime lease inasmuch as there was uncertainty of performance under the sublease. The debtor countered that adequate assurance of future performance had been provided by virtue of (1) the security deposit, (2) the \$10,000 guarantee note, (3) the fact that the proposed sublessee's affiliates were operating their respective stores at a profit and (4) the fact that the fair rental value of the premises exceeded the prime lease rent, so that upon a default under the sublease, the premises could be relet at a rate in excess of the rental reserved under the prime lease. The debtor also asserted that inasmuch as the proposed transaction was a subletting rather than an assignment, the debtor would therefore remain liable under the lease, and that the debtor's overall subleasing program covering several locations was generating \$700,000 in annual income and was projected to increase to \$900,000. The court held that the debtor had provided adequate assurance of future performance on a financial basis.

Finally, it may be noted that the court in *Motor Truck & Trailer Co. v. Berkshire Chemical Haulers, Inc. (In re Berkshire Chemical Haulers, Inc.)*, n151 also considered the financial requirements for adequate assurance of future performance as well as for adequate assurance of prompt cure and ultimately found in favor of the landlord.

The following should be noted in comparing *Sapolin Paints*, *Lafayette Radio* and *Berkshire Chemical Haulers*:

(1) In *Sapolin* and *Lafayette Radio*, there was no problem relating to the cure of outstanding monetary defaults, and there was apparently no issue relating to any nonmonetary defaults. The debtor in *Lafayette Radio* was prepared to disburse the necessary funds from its bank account.

(2) In *Sapolin*, the assignee's net earnings projections were accepted by the court, while in *Berkshire Chemical Haulers* they were dismissed as "pipe dreams."ⁿ¹⁵² In *Lafayette Radio*, the debtor's projected increases in subletting profits were challenged by the landlord but apparently were accorded substantial weight by the court.

(3) In both *Sapolin* and *Lafayette Radio*, the market rental for the premises was higher than the rental reserved under the leases. Implicit in both cases is the fact that if there were to be a failure of future performance by the debtor, the landlord could recapture the premises and relet at a higher rental, thus substantially mitigating the risks to the landlord. This element apparently was absent in *Berkshire Chemical Haulers*.

(4) In *Sapolin* and *Lafayette Radio*, the debtor was to receive substantial consideration for the leasehold in question, thus enhancing its future prospects (in *Lafayette Radio*) and the distribution to its creditors (in *Sapolin*). *Berkshire Chemical Haulers*, in contrast, did not involve a proposed assignment of the leases, but only an assumption of those leases. Thus there was no consideration flowing to the debtor or its estate in return for the assumption of the lease and the deprivation to the lessor of the return of the equipment.^{n152a}

It would be improper to generalize that the courts will permit lease assignments to prospective assignees without substantial net worth but which hold out a promise of successful future operations, especially when the property may in all likelihood be relet by the landlord at a higher rental in the event of an ultimate default by the assignee. It may be fair to say, however, that the prospect of substantial cash consideration for a trustee and the estate on account of a proposed assignment or subletting transaction may tip the balance in favor of approval in a close case.

It may also be interesting to speculate as to the applicability of the requirement for adequate assurance of future performance in the case of a nonrecourse ground lease. Such leases often freely permit assignment, contemplate release of liability of the assignor after consummation of the assignment and limit the current lessee's liability to its interest in the property. A trustee of a lessee seeking to assign this type of lease may argue that the requirement of adequate assurance of future performance is wholly inapplicable in this context inasmuch as the landlord's only assurance of

performance in the initial transaction was its right to recover the property upon default. The trustee may also argue in the alternative that if the requirement for adequate assurance of future performance is applicable, a minimal showing of the proposed assignee's willingness and expectations of performance will suffice. The landlord, on the other hand, will assert that a limitation as to recourse does not constitute a relinquishment of its right to a substantial lessee able to operate the property, and that adequate assurance of future performance relates to the lessee and any proposed assignee and not to the fact that it may recapture the property without further recourse if the lease ultimately lapses into default.^{n152b}

[iii] Performance of Lease Covenants Not Requiring the Payment of Money

The traditional doctrine relating to assumption of unexpired leases is that the lease is assumed with all of its burdens and obligations, that the trustee cannot select certain obligations that it is willing to perform and reject others and that the lease as assumed becomes a contract binding on the trustee enforceable in the same manner as any legally valid and binding agreement.ⁿ¹⁵³ This doctrine appears to have been recognized and approved in the House Report's discussion of the invalidation of *ipso facto* (bankruptcy termination) clauses:

The unenforceability of *ipso facto* or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the courts will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.ⁿ¹⁵⁴

The invalidation of *ipso facto* clauses, together with the similar invalidation of anti-assignment provisions, in section 365(f)(1) has given rise to the widespread practice by debtors and trustees of assigning leases of unwanted locations for cash consideration. These assignment programs in an appreciated rental market have brought substantial sums into debtors' estates and have accordingly resulted in enhanced distributions to creditors.ⁿ¹⁵⁵ However, in the course of administering such programs, the courts have had to deal with instances in which a proposed assignee of a lease is unwilling or unable to comply with certain covenants in the lease, or in which future compliance is uncertain.ⁿ¹⁵⁶ Application of the traditional assumption doctrine in such instances would clearly result in the courts' denial to the trustee of authority to assume and assign the lease, thereby depriving the estate of the anticipated consideration. It therefore appears that the traditional assumption doctrine is being eroded to the extent required to permit certain lease assignments and that the courts are effectuating this change by application of equitable doctrines in modifying the offending lease covenants.

The antecedents for these assignment cases may be found in the anti-forfeiture decisions rendered under the former Bankruptcy Act. Under Section 70b of the Act, *ipso facto* clauses were expressly deemed to be enforceable. However, in an important line of cases, the United States Supreme Court and various Courts of Appeals refused to enforce Section 70b and the related *ipso facto* clauses when enforcement would frustrate the reorganization effort and would work a forfeiture on outside investors and creditors. In *Smith v. Hoboken Railroad, Warehouse & Steamship Connecting Co.*,ⁿ¹⁵⁷ a railroad reorganization case, the United States Supreme Court declared Section 70b applicable to railroad reorganizations but would not permit forfeiture of a railroad line lease in view of the substantial public interest involved and the inability of the debtor to reorganize absent the property. In *In re Fleetwood Motel Corp.*,ⁿ¹⁵⁸ the Court of Appeals for the Third Circuit, in a Chapter X case, denied enforcement of an *ipso facto* clause in a ground lease when the debtor had built on the land a motel building, placed a mortgage on the building, incurred indebtedness for equipment and fixtures and issued stock and debentures in a public distribution. The court stated:

We think that the rationale of *Smith*, coupled with the inherent equity powers of a court of bankruptcy, see *McDonnell v. Bucks County Farms, Inc.*, 334 F.2d 763, 766 (C.A. 3, 1964), provide abundant support for the conclusion of the district court in the case at bar. For here the public, represented by the Securities and Exchange Commission, has invested over a half million dollars in the debtor corporation. And obviously no plan of reorganization could be formulated if forfeiture were

permitted, for the property which the landlord would obtain by such action is the only property of the debtor. Moreover, we have already recited in detail the factual circumstances attending the execution and operation of this lease [the landlord knew that there would be a public offering], as well as the obligations contained therein. ... Suffice it to say that they amply warranted the exercise of the equitable power of the bankruptcy court to deny the landlord's petition for possession of the premises.ⁿ¹⁵⁹

Fleetwood Motel was followed by *Weaver v. Hutson*,ⁿ¹⁶⁰ in which the Court of Appeals for the Fourth Circuit, on facts substantially similar to those in *Fleetwood Motel*, denied enforcement of the *ipso facto* clause and stated, on a motion for rehearing, that "[t]he fundamental bases of decision throughout was that the Landlords' insistence upon a forfeiture was highly unconscionable and inequitable in the circumstances--a demand for blood."ⁿ¹⁶¹

In *Queens Boulevard Wine & Liquor Corp. v. Blum*,ⁿ¹⁶² the Court of Appeals for the Second Circuit held in a Chapter XI case that when the leased premises represented the debtor's only business location, the court would not enforce Section 70b of the Bankruptcy Act and would not permit enforcement of the bankruptcy default clause in the lease so as to frustrate implementation of the plan of arrangement. The landlord's conduct in that case evidenced a desire to recapture the premises in order to relet them at a higher rent, and the court found that this kind of benefit, although distinguishable from the *Fleetwood Motel* and *Weaver* windfalls, was an element in applying the *Fleetwood Motel* and *Weaver* rationales to the facts under consideration.

Each of these cases involved the threat of total loss of the debtor's only asset or operating facility, and of any meaningful distribution to creditors. Although none of the cases involved a lease assignment, they nevertheless appear to stand for the proposition that the court may deny enforcement of a lease termination clause which would frustrate the plan of reorganization, even if the clause is expressly rendered enforceable by statute. Thus, if a lease assignment is involved, and the consideration to be derived therefrom is crucial to the success of the rehabilitation effort, the rationale of these cases would appear to apply to other types of lease clauses which if enforced would render the assignment impossible. In *Fisher v. City of Huntington Beach (In re The Huntington Ltd.)*,ⁿ¹⁶³ a case under Chapter XI of the Bankruptcy Act, the City of Huntington was the landlord under a long-term ground lease. The tenant improved the property, encountered financial difficulties and in its Chapter XI case sought to assign the lease to a new operator for substantial consideration which would satisfy all existing claims. The lease required the landlord's consent to hypothecation of the leasehold, and the proposed assignee sought the consent of the City to a leasehold mortgage in excess of the \$2.1 million mortgage that had theretofore been approved by the City. The court held that it could "order additional hypothecation of the lease if that action is required to culminate a sale of the leasehold interest."ⁿ¹⁶⁴ The court's language is instructive:

We recognize that in ordering a sale of the leasehold interest and by permitting additional hypothecation, the bankruptcy court decision impacts upon the property interests of the City by altering the contractual rights to which it originally agreed under the terms of the lease with the debtor. The fact that the court's order alters the City's property rights is not, standing alone, impermissible, however, for it has long been recognized that "[b]ankruptcy proceedings constantly modify and affect the property rights established by state law." *Wright v. Union Central Life Ins. Co.*, 304 U.S. 502, 517, 58 S. Ct. 1025, 1033, 82 L.Ed. 1490 (1938) . The power given Congress by Article I, section 8, of the Constitution to establish uniform laws relative to bankruptcy gives it broad latitude to affect both contract and property rights. *Wright v. Union Central Life Insurance Co.*, *supra* ; *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 452, 57 S.Ct. 298, 301, 81 L.Ed. 340 (1937) ; *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*, 294 U.S. 648, 55 S.Ct. 595, 79 L.Ed. 1110 (1935) .

Effective exercise of the jurisdictional authority under §§ 311 and 313(2) conferred upon the bankruptcy courts by Congress pursuant to its Article I power, requires that the court have the authority to fashion flexible and equitable remedies to meet the exigencies of each particular situation. In the instant case, the court did not exceed its authority by ordering a sale of the debtor's leasehold interest on

terms which it found to be reasonably necessary to effectuate the sale. Without such authority, §§ 311 and 313(2) would be empty jurisdictional shells and the court would be rendered impotent to advance effectively and realistically the rehabilitative purposes of the Bankruptcy Act.

Nothing in our decision should be construed as a judicial expansion of the bankruptcy court's jurisdiction which would enable the court to adjudicate the rights of third parties to future transactions not directly connected with the debtor's leasehold interest. See *PIC Realty Corp. v. Evans*, 605 F.2d at 481-82. We simply hold that pursuant to §§ 311 and 313(2) of the Act, the bankruptcy court did not exceed its jurisdiction in authorizing sale of the leasehold interest without the City's consent. Permitting the City to impose conditions on the sale of the leasehold would seriously impede the purposes of the Bankruptcy Act, the major objective of which "is the equitable distribution of the debtor's assets amongst his creditors." *Kuehner v. Irving Trust Co.*, 299 U.S. at 451, 57 S.Ct. at 301. Allowing the City to impose conditions on the assignment of the lease or to prevent an assignment by virtue of a general anti-hypothecation clause would frustrate the purpose of § 70(b) of the Act. It logically follows that if a bankruptcy court has the authority under § 70(b) to render ineffective a general anti-assignment clause, it must also possess the authority to render ineffective a general anti-hypothecation clause which would operate to prevent an otherwise valid assignment of a lease.

There may be circumstances where a lessor would be so prejudiced by the assignment of a lease that such an assignment would be inequitable. This, however, is not such a case. There is no evidence in the record that the City would be unduly prejudiced. Mayer, the assignee, is a firm with a sound financial basis. Moreover, the bankruptcy court specifically found that the additional hypothecation sought by Mayer would encumber only Mayer's interest in the property. The City will not be required to subordinate its position as lessor to the encumbrances sought to be placed on the property by Mayer. Furthermore, nothing in the judgment of the bankruptcy court would preclude the City from exercising its rights and protecting its interests once Mayer becomes the lessee. If any of the terms of the lease are subsequently violated, including any attempt by Mayer to further hypothecate the leasehold beyond the amount approved by the bankruptcy court to effect the sale, the City will be fully able to avail itself of the panoply of appropriate actions to protect its interests pursuant to the terms of the lease.ⁿ¹⁶⁵

If a bankruptcy court under the former Act had the authority to order a sale of a debtor's property on terms reasonably necessary to effectuate the sale, including the nullification of an anti-hypothecation clause, then under the Bankruptcy Code a court will have no less authority. In view of the provisions of section 365 which preserve leases notwithstanding monetary defaults, covenant defaults and defaults under bankruptcy termination clauses, and which invalidate any kind of anti-assignment clause, a court applying the Bankruptcy Code in a lease assignment case may indeed view itself as having greater authority than was conferred under the former Act.

In *In re U.L. Radio Corp.*,ⁿ¹⁶⁶ a chapter 11 case under the Bankruptcy Code, the debtor proposed a 100 percent liquidating plan that was contingent upon the consummation of the assignment of the lease of the debtor's only location. The use clause in the lease provided that the premises were to be used only for television repair service and sale of electrical appliances. The proposed assignee intended to use the store as a small bistro, and had allocated \$20,000 for soundproofing and other improvements in order to eliminate any disturbance to the apartment building located above the store and the adjacent store premises. The principal of the proposed assignee was prepared to guarantee payment of the first two years of rental, and there was accordingly, in the view of the court, no issue of adequate assurance of future performance relating to the assignee's financial capacity. Thus the sole issue was whether compliance with the use clause should be required to provide adequate assurance of future performance. The court held that compliance with the use clause was not required in view of the landlord's failure to demonstrate "actual or substantial detriment to him from the proposed assignment."ⁿ¹⁶⁷ The court found that the provisions of section 365 of the Code evidenced a clear congressional policy in favor of assumption and assignment of leases as a means of realization by debtors upon valuable assets, represented by leasehold estates, that nothing in section 365 required literal compliance with all lease terms, and

that lease terms could be modified to facilitate a lease assignment in the absence of demonstrable prejudice to the landlord. The court's opinion is largely founded on statutory interpretation of section 365, read in the light of the perceived congressional policy of fostering lease assignments.

The opinion does not rest upon the equitable considerations set forth in *Fleetwood Motel, Weaver, Queens Boulevard* and *Huntington*, although the distinction between a 100 percent liquidating plan with the lease assignment and a presumably insignificant distribution absent the assignment appears to fit perfectly into the policy considerations underlying those decisions. Had the court in *U.L. Radio* employed the equitable doctrines underlying these decisions--that the court will not permit a lease forfeiture that would frustrate the rehabilitation effort--then *U.L. Radio* would be limited as a precedent to cases in which the particular lease assignment is essential to the success of the plan. However, the employment of the statutory interpretation approach, together with the requirement that a landlord demonstrate substantial prejudice to successfully oppose a lease modification that will permit consummation of the transaction, can make *U.L. Radio* applicable to lease assignment situations involving less than the entire success of the rehabilitation effort. Thus, in instances in which a debtor has many leased locations that are to be disposed of, and will not be materially affected if one proposed lease assignment is not consummated by reason of an incompatible use clause, *U.L. Radio* may be employed in support of the proposed assignment to compel the landlord to accept the new use.ⁿ¹⁶⁸

U.L. Radio may be contrasted with *In re Pin Oaks Apartments*,ⁿ¹⁶⁹ in which a trustee in a chapter 11 case sought to assume a ground lease of an apartment complex and sublease the premises on substantially less favorable terms than were provided in the ground lease. The proposed transaction also contemplated that the terms of the sublease would, as between ground lessor and lessee, control over any inconsistent terms of the ground lease. The ground lease rental would accordingly have been lower, the percentage rental clause would have been eliminated, there would have been a free right of assignment and subletting and there would have been certain rental abatements and certain other new provisions that would have radically and adversely altered the transaction for the ground lessor. The court denied the request for authority to assume and sublease, stating:

The debtor and trustee argue that enforcement of the percentage rental clause is inequitable because it results in ICM [the ground lessor] receiving increased rentals greatly out of proportion to what it originally bargained for, due to changing economic climate and high rate of inflation. This, in turn, makes it impossible for the tenant to pay the fixed rental fee, operating expenses, the percentage rental fee, and make necessary improvements. The property would be, if not already is, economically impossible to operate. It would also be impossible for the debtor to complete a successful reorganization under Chapter 11, making enforcement of the provision even more inequitable.

It would be dangerous precedent, however, for this Court to be in the business of reforming contracts and leases because of changing economic conditions. Depending on the peaks and valleys of our economic circumstances, the courts would be considering in every case whether a contract was equitable or inequitable. In three years, ten years, the other party could return to court arguing that the contract required reformation again. The battle could continue during the entire life of the contract. It was not the intent of Congress for the courts to interfere so drastically in the commercial dealings of parties, negotiated in arms' length transactions. The equities in *Queens Boulevard* are simply not present here. And as already outlined, the Tesch sublease [the proposed sublease] eliminates other important provisions of the ICM Lease [the ground lease], further distinguishing *Queens Boulevard*.

Sections 365 and 363(b) of the Code do not give the trustee the power to assume the ICM Lease and then change its provisions. The trustee is bound by the terms of the Lease. He must assume and adhere to all its provisions other than "ipso facto" clauses and any restrictions against assignments. The two (2) ICM Lease clauses of particular interest are the subleasing restriction and the percentage rental fee. The trustee is bound not to sublease the apartments without the landlord's consent. ICM does not consent to

the Tesch sublease. The Code provides that an assignment by a trustee can be made notwithstanding language in the lease to the contrary or language requiring the lessor's consent. There is no Code provision or case law allowing a sublease despite language to the contrary in the lease.ⁿ¹⁷⁰

Pin Oaks and *U.L. Radio* are clearly distinguishable on the basis that direct and substantial detriment could be demonstrated by the landlord in *Pin Oaks* if the proposed transaction were approved, while the landlord in *U.L. Radio* was apparently unable to do so. However, the language of *Pin Oaks*, set forth above, seems to preclude any modification of leases for the purpose of assignment or subletting and indeed enumerates policy considerations against such modifications. Moreover, to distinguish *U.L. Radio* and *Pin Oaks* on the basis of prejudice to the landlord is to accept the *U.L. Radio* conclusion that a lease may be modified if prejudice is not shown instead of the *Pin Oaks* conclusion that nothing in section 365 authorizes or warrants such modifications. Hence the issue, which must await further judicial resolution, is whether a bankruptcy court, for the purposes of effectuating a lease assumption and ensuing assignment or subletting, may invalidate any provisions in a lease that would prevent consummation of the proposed transaction other than the *ipso facto* and anti-assignment clauses expressly invalidated by the Bankruptcy Code.

Another matter relating to the provision of adequate assurance of performance of nonmonetary covenants in leases is the language of *section 365(b)(2)(D) of the Code*, which was added by the 1994 Amendments to the Code and amended by the 2005 Act.^{n170a}

As part of the Bankruptcy Reform Act of 1994,^{n170a-1} Congress first enacted *section 365(b)(2)(D) of the Code*, which originally provided:

(2) Paragraph (1) of this subsection [setting forth the conditions to be executory contract or unexpired lease under which a default has occurred] does not apply to a default that is a breach of a provision relating to ...

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

One of the issues presented by the language employed in section 365(b)(2)(D) prior to the 2005 Act was whether the phrase "penalty rate or provision" employed the term "penalty" as an adjective for both the words "rate" and "provision," or whether the term "penalty" was solely an adjective for the word "rate," with the term "provision" standing alone with a separate meaning. If the later reading was correct, then this section did two things--it provided first that in curing or providing adequate assurance of prompt cure of a default under an executory contract or unexpired lease, a trustee need not pay any penalty rate provided for in the agreement, and second, that in so curing or providing adequate assurance of prompt cure under such a contract or lease, the trustee need not cure any nonmonetary defaults of any nature whatsoever. If, however, the first reading was correct, then the section means only that in effecting a cure or providing adequate assurance of prompt cure of a default under an executory contract or unexpired lease of the debtor, the trustee need not pay an amount otherwise payable under a penalty rate clause or other penalty provision relating to a nonmonetary default under the contract or lease.

The legislative history for this section (as originally enacted) is limited to the following statement in the House Report for the Bankruptcy Reform Act of 1994: "[S]ection 365(b) is clarified to provide that when sought by a debtor, a lease can be cured at a nondefault rate (i.e., it would not need to pay penalty rates)."^{n170a-2} Prior to an amendment pursuant to the Bankruptcy Code of 2005 that added the word "penalty" before the second reference to "provision," there was an issue arising under this Code section as whether the use of the disjunctive "or" separating the words "rate" and "provision" meant that a trustee assuming an executory contract or unexpired lease (1) need not cure a default under a penalty rate clause or penalty rate provision or (2) need not cure a default under a penalty rate clause, and also, as a separate matter, need not cure any type of nonmonetary default under such executory contract or unexpired lease.

The better reading of section 365(b)(2)(D) was that it eliminated the requirement to pay a contractually prescribed and otherwise enforceable penalty rate relating to the occurrence of a nonmonetary default in connection with an assumption of an executory contract or unexpired lease. As a drafting matter, given that the introductory language in section 365(b)(2) refers to a "breach of a provision relating to--," a disjunctive reading of the term "provision" in section 365(b)(2)(D) prior to the 2005 Act would have resulted in an unusual redundancy in the statutory language providing that paragraph (1) of subsection 365(b) does not apply to a default that is a breach of a provision relating to "a provision relating to a default." Moreover, the elimination of the requirement to cure all nonmonetary defaults as a condition to assumption would have represented a significant change in the law under the Code, and most likely would have engendered considerable comment and debate both among members of the bar and in Congress, all of which were absent. Finally, the legislative history, as minimal and inarticulate as it may be, made no reference to general nonmonetary default provisions and instead deals only with penalty rate provisions.

Nonetheless, before the enactment of the 2005 Act, the deficient drafting of section 365(b)(2)(D) engendered litigation concerning the obligation of a trustee of debtor in possession to cure nonmonetary defaults.^{n170a-3}

In the leading pre-2005 case, *Claremont Acquisition Corp. v. General Motors Corp. (In re Claremont Acquisition Corp.)*,^{n170b} the debtor in possession sought to assign to a third party its automobile dealership franchise agreements with General Motors. General Motors opposed the assignment, asserting that the debtor had breached the agreements by failing to operate the dealership for two weeks prior to the commencement of the case, that such default could not be cured and that therefore the agreement could not be assumed under section 365(b)(1) and could not be assigned under section 365(f)(2)(A) of the Code. The debtor argued that section 365(b)(2)(D), read in the disjunctive, had eliminated from section 365(b)(1) any requirement for cure of nonmonetary defaults. The Court of Appeals for the Ninth Circuit, in reversing the holding of the bankruptcy court, rejected this argument, stating:

GM's interpretation of § 365(b)(2)(D) is further supported by consideration of the general structure of § 365 which suggests that Congress intended subsection (D) to address a single issue: the payment of penalties. In each instance that Congress added a separate or independent exception to § 365(b)(1), it created a separate subclause in § 365(b)(2). The bankruptcy court's interpretation, however, requires a deviation from that general construction principle, as it results in a single subclause containing two completely different and unrelated exceptions. Furthermore, if subsection (D) is a catch-all provision, as Worthington contends, then subsections (A) through (C) of § 365(b)(2) would be superfluous, as they would be encompassed by subsection (D). Conversely, applying the terms "satisfaction" and "penalty" to both clauses in subsection (D) unifies the single provision. The first clause addresses penalty rates which are commonly imposed where a debtor's breach was monetary in nature. The second clause addresses the payment of penalties under liquidated damage provisions where the debtor's breach was nonmonetary in nature.

Finally, the limited legislative history of § 365(b)(2)(D) supports GM's construction of the section and suggests that Congress intended only to relieve debtors of the obligation to pay penalties. The House Report to the Bankruptcy Reform Act provides: "[S]ection 365(b) is clarified to provide that when sought by a debtor, a lease can be cured at a nondefault rate (i.e., it would not need to pay penalty rates)." 5 U.S. Congressional & Administrative News at 3357 (1994) (H.R. No. 103-835 (1994)) (parenthetical in original). By only referring to the payment of penalties, this legislative history lends weight to GM's construction of subsection (D).^{n170c}

The court's reasoning appeared to be correct as a matter of statutory interpretation as applied to the words of the statute then in effect. In addition to the arguments articulated above, the use of an exception for all nonmonetary defaults in section 365(b)(2)(D) would have virtually swallowed all of the affirmative cure and adequate assurance requirements of section 365(b)(1), other than requirements for the cure of monetary defaults and for adequate assurance of performance

of future monetary obligations.^{n170d} Thus, although the less than precise drafting contained in the statute created uncertainty in jurisdictions that had not decided the issue, it appears that section 365(b)(2)(D) did not eliminate the general requirement in section 365(b)(1)(A) that debtors cure or provide adequate assurance of cure with respect to all nonmonetary defaults.

It appears that the issue addressed in *Claremont* has been resolved in accordance with that court's interpretation by reason of the insertion of the word "penalty" before "provision" pursuant to the 2005 Act.^{n170e} The result of the addition of this single word to *section 365(b)(2)(D) of the Code* is to eliminate the statutory argument that debtors do not have to cure *any* defaults arising from a failure to perform nonmonetary obligations, even nonmonetary defaults that are capable of cure.

However, in one other important amendment to section 365, which added an exception to the general cure obligation in section 365(b)(1)(A), the 2005 Act has limited the debtor's cure obligations with respect to certain types of defaults relating to nonmonetary obligations in cases where cure would be impossible at and after the time of assumption. This amendment should have important implications to debtors seeking to assume real property leases by permitting the debtors to assume the leases notwithstanding the occurrence of a nonmonetary default that is impossible to cure by performance in connection with an assumption.

As amended by the 2005 Act, section 365(b)(1)(A) now provides (new language is in *italics*):

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph*].^{n170f}

The purpose of the provision, which was included in section 328 of the 2005 Act, is stated succinctly in the legislative history:

Sec. 328. Defaults Based on Nonmonetary Obligations. Subsection (a)(1) of section 328 of the Act amends section 365(b) to provide that a trustee does not have to cure a default that is a breach of a provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform a nonmonetary obligation under an unexpired lease of real property, if it is impossible for the trustee to cure the default by performing such nonmonetary act at and after the time of assumption. If the default arises from a failure to operate in accordance with a nonresidential real property lease, the default must be cured by performance at and after the time of assumption in accordance with the lease. Pecuniary losses resulting from such default must be compensated pursuant to section 365(b)(1).^{n170g}

[6] Assumption and Assignment of Leases; Shopping Centers

The Code as in effect prior to enactment of the 1984 Amendments contained special provisions setting forth standards for adequate assurance of future performance of shopping center leases. Before such amendments, section 365(b)(3) provided:

(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--

(A) of the source of rent and other consideration due under such lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use, or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.

There was legislative history directly relating to this provision. The House Report stated:

The unenforceability of ipso facto or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the courts will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain. An example of the complexity that may arise in these situations and the need for a determination of all aspects of a particular executory contract or unexpired lease is the shopping center lease under which the debtor is a tenant in a shopping center.

A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement. Thus, in order to assure a landlord of his bargained for exchange, the court would have to consider such factors as the nature of the business to be conducted by the trustee or his assignee, whether that business complies with the requirements of any master agreement, whether the kind of business proposed will generate gross sales in an amount such that the percentage rent specified in the lease is substantially the same as what would have been provided by the debtor, and whether the business proposed to be conducted would result in a breach of other clauses in master agreements relating, for example, to tenant mix and location.¹⁷¹

Although it was clearly the intention of the persons who favored the inclusion of section 365(b)(3) in the statute and the language of the related legislative history to protect shopping center landlords against uncontrolled use and disposition of premises occupied by debtors in Bankruptcy Code cases, the language employed in the Code, as in effect before the 1984 Amendments, may have had precisely the opposite effect. Section 365(b)(3)(C) provided that assumption and assignment of a shopping center lease could not breach "substantially" any provision "*in any other lease, financing agreement or master agreement*" relating to the shopping center, such as a radius, location, use or exclusivity provisions. However, nothing in section 365 provided that assumption and assignment of a shopping center lease would not violate a use or other clause in the lease that was itself being assumed and assigned. It was therefore asserted that the statutory concern with other leases and agreements in section 365(b)(3)(C) evidenced an intention that a debtor's lease could be changed, for otherwise the continuation of the debtor's lease in strict accordance with its terms would not give rise to concerns about other leases and agreements.¹⁷² The landlord was presumed to have drafted its other leases and agreements in a manner consistent with the use contemplated in the debtor's lease, so that only a variation from that use could result in a violation of such other leases and agreements. Thus, the argument ran, shopping center leases of Bankruptcy Code debtors could be modified by the court to the extent they do not substantially breach other leases and

agreements.ⁿ¹⁷³ Moreover, if shopping center leases can be so modified under a Code provision that was intended to protect the synergy of the various shopping center tenants, then surely non-shopping center leases may be modified to an even greater degree inasmuch as there are no interdependent relationships to protect.ⁿ¹⁷⁴

The emergence of a divergent interpretation of section 365(b)(3), and of a series of holdings permitting changes of use in connection with assumption and assignment of shopping center leases and non-shopping center leases, engendered efforts on behalf of the shopping center industry to include in the 1984 Amendments revisions to section 365(b)(3) and to other provisions of the Code to eliminate a series of perceived abuses which had occurred under the Code. Section 365(b)(3), as revised by the 1984 Amendments, provides that adequate assurance of future performance in the case of a shopping center lease includes assurance as to (1) the source of rent and other consideration due under the subject lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and any guarantors shall be similar to the financial condition and operating performance of the debtor and any of its guarantors, as of the time the debtor became the lessee under the lease; (2) that percentage rent would not decline substantially; (3) that assumption or assignment of the debtor's lease would be subject to all of the provisions of that lease, including, without limitation, radius, location, use and exclusivity provisions, and would not breach any provision contained in any other lease, financing agreement or master agreement relating to the shopping center; and (4) that assumption or assignment of the debtor's lease would not disrupt any tenant mix or balance in the shopping center. The principal differences between the new and old formulations were that (1) there is an express requirement of equivalence as to financial condition and operating performance for any proposed assignee, (2) assumption and assignment is made expressly subject to all of the terms of the lease being so assigned, including its use clause, and not simply the other leases in the shopping center and (3) the "substantiality standard" has been eliminated from the provision requiring adherence to other agreements affecting the shopping center and from the requirement for preservation of the tenant mix and balance in the shopping center.

Although there is substantial legislative history relating to these amendments, certain passages appear designed to provide specific guidance in the interpretation of section 365(d)(3) as amended by the 1984 Amendments. The following excerpt from the report of the Senate Judiciary Committee deals with the enforceability of use clauses in shopping center leases, and the deletion of the word "substantially" from the prohibition against disruption of the tenant mix, in the context of assumption and assignment of such leases:

By deleting the word "substantially," the bill makes clear that important lease provisions such as the use clause are to be honored and that the tenant mix is not to be disrupted. Not all shopping center leases contain restrictive use clauses, but where they are included in a lease they are necessary to define the tenant's business in relation to the other stores in the shopping center. Restrictions on the assignability of shopping center leases are justified by the need to protect the interests of the other tenants in the shopping center.

This provision does not unduly restrict the assignment of shopping center leases. Use clauses cannot be overly restrictive because they must permit enough flexibility to allow for the normal conduct of the original tenants' business

Use clauses are not intended to prevent the assignment of leases and practice in the shopping center industry shows that they will be interpreted reasonably. Any attempt to preclude assignment by drafting a use clause which would apply only to the original tenant would be *de facto* prohibitions of assignment, and, therefore, would be unenforceable under section 365(f)(1).

Where the trustee is unable to find an assignee within the use clause who is willing to pay what the trustee considers an acceptable price for the lease, the Committee believes that it is appropriate for the lease to revert to the landlord.

Even where the landlord also is unable to find a replacement tenant with the same business use as

the debtor, the Committee believes that it is preferable to have an alternate use determined by the landlord rather than by the trustee and the Bankruptcy Court.ⁿ¹⁷⁵

The following statement of Senator Hatch also relates to the treatment of use clauses in shopping center leases, and to the section 365(b)(3)(A) provision requiring that a proposed lease assignee have a similar "financial condition" and "operating performance" to the debtor measured as of the time the debtor first entered into the lease:

A third problem occurs when shopping center leases are assumed or assigned and then used in ways which violate the use clause of the lease and disrupt the tenant mix. The bankruptcy code currently provides that when a shopping center lease is assumed or assigned, assurances must be given that the lease provisions will not be substantially breached and that the tenant mix will not be substantially disrupted. Unfortunately, courts have misapplied these provisions in ways which have deprived shopping centers and their tenants of the protections which Congress intended to provide them.

This bill would delete the word "substantially" from these provisions, thus requiring that any clause in the lease be adhered to. It is especially important that any use clause in the lease be strictly adhered to and that the tenant mix not be disrupted. The bankruptcy courts will still retain the flexibility to determine whether or not a proposed new use for the premises falls within any use clause of the lease and whether or not the new use would disrupt the tenant mix. This amendment requires strict compliance with the provisions of use clauses in shopping center leases and prohibits any changes in the use of the tenant's space not permitted by the use clause. This amendment is intended to stop courts from creating new leases by changing essential lease terms to facilitate assignments. It is intended to stop the practice of some courts to determine whether there has been a disruption by reference to the amount of space to be assigned as a percentage of the total area in the shopping center. This amendment is not intended to enforce requirements to operate under a specified trade name

The bill requires the trustee to provide adequate assurance that an assignee of a shopping center lease has a financial condition and operating performance similar to that of the original tenant when the lease was executed. This is to insure that the assignee itself will not soon go into bankruptcy and will provide operating and advertising benefits to the other tenants similar to those provided by the original tenant when its lease was executed.ⁿ¹⁷⁶

The preceding passages make clear that the amendments to section 365(b)(3) were not intended to permit a shopping center landlord to prevent assumption and assignment of a lease by the trustee of a debtor-tenant through the invocation of a use clause which is so narrowly and specifically drawn that it could be complied with only by the specific debtor. Thus, there is little doubt that a use clause that requires the conduct of business under a specified trade name will not be enforced to the extent necessary to permit an assignment to a third party which will conduct the same business as the debtor but under a different trade name, assuming that the other requirements of section 365(b)(3) are satisfied.^{n176a} On the other hand, the preceding passages evidence that the amendments to section 365(b)(3) were intended to require a prospective assignee of a shopping center lease from a trustee of a debtor-tenant to adhere to a use clause which reflects the landlord's judgment of the proper tenant mix and synergy in the shopping center, and do not permit a court to change the use prescribed in the lease in order to facilitate an assignment.

Similarly, other covenants in shopping center leases involving financial performance standards should be upheld in the context of a proposed assignment if such covenants bear a reasonable relationship to the landlord's need for a high volume sales tenancy. For example, it has been held that a provision in a percentage rent shopping center lease permitting termination of the lease by either the landlord or tenant if gross sales at the premises did not exceed a specified level will not be excised from a lease to facilitate a proposed assignment. In *In re Joshua Slocum, Ltd.*, the Court of Appeals for the Third Circuit reversed a bankruptcy court's finding that such a provision constituted a disguised anti-assignment clauses.^{n176b} The court stated:

The bankruptcy court does have some latitude in waiving contractual provisions when authorizing a trustee to assume and assign an unexpired lease. Section 365(b)(2) on its face permits the court to ignore so-called *ipso facto* and forfeiture clauses. See *In re TSW Stores of Nanuet, Inc.*, 34 B.R. 299, 305 (Bankr. S.D.N.Y. 1983); *In re U.L. Radio Corp.*, 19 B.R. 537 (Bankr. S.D.N.Y. 1982). However, the court's authority to waive the strict enforcement of lease provisions in the context of shopping center cases like this one is further qualified by § 365(b)(3) of the *Bankruptcy Code*. Even under the tightly drawn definition of "adequate assurance" in the shopping center context, Congress did not envision literal compliance with all lease provisions; insubstantial disruptions in, *inter alia*, tenant mix, and insubstantial breaches in other leases or agreements were contemplated and allowed. [footnote number omitted] [text of footnote: The court's authority to waive strict enforcement of lease provision in the non-shopping center cases will permit deviations which exceed those permitted in shopping center cases. *U.L. Radio*, 19 B.R. 537, 544. See also *In re Petersons, Ltd.*, 31 B.R. 524 (Bankr. S.D.N.Y. 1983) (a change in use was authorized to permit an assignment of a so-called high class tobacco shop to an assignee who sold discounted cigars); *In re Fifth Avenue Originals*, 32 B.R. 648 (Bankr. S.D.N.Y. 1983) (a lease assumption and assignment from a high-class boutique selling clothing and accessories for both sexes to Diane von Furstenberg, a designer offering women's clothing and accessories, was approved).] 11 U.S.C. § 365(b)(3)(C), (D); see also *U.L. Radio Corp.*, 19 B.R. 537, 544; *TSW Stores*, 34 B.R. 299.

In this case, however, the bankruptcy court did not have the authority to excise paragraph 20 of the shopping center lease which addresses the landlord and/or tenant's option to terminate dependent upon the average sales generated by the tenant. We note that even if the Denney Block were not a shopping center, the bankruptcy court's authority to excise paragraph 20 of the lease is questionable. That paragraph must be read in conjunction with paragraph 4, the percent rent clause of the lease which provides a formula requiring Joshua Slocum, Ltd. to pay a percentage of the lease as specified on any amount in excess of the designated gross sales threshold for a given lease-year (See Appendix at pp. 3-4). These two clauses taken together clearly indicate that a bargained for element in this contract was that tenant, Joshua Slocum, Ltd., average a certain volume of sales as specified in paragraph 20 of the lease so that the Landlord could accurately calculate the minimum total rent expected pursuant to paragraph 4 of the lease. Even standing alone, paragraph 20 is an essential bargained for element of this lease agreement because it governs occupancy. We also note that paragraph 20 of the lease falls within the statutory meaning of "other consideration due" under the lease, and without this clause the trustee could not give adequate assurance as to its future performance.

Congress has suggested that the modification of a contracting party's rights is not to be taken lightly. Rather, a bankruptcy court in authorizing assumptions and assignment of unexpired leases must be sensitive to the rights of the non-debtor contracting party (here, George Denney) and the policy requiring that the non-debtor receive the full benefit of his or her bargain. See *U.L. Radio Corp.*, 19 B.R. 537; *TSW Stores of Nanuet*, 34 B.R. 299

In excising paragraph 20, the bankruptcy court undermined both the Congressional policy and the statutory requirement under § 365(b)(3)(A) that the trustee give adequate assurance of "other consideration due" under an unexpired lease. We find that the bankruptcy court did not have the authority to excise paragraph 20 of the lease.

D. Materiality

Appellant takes issue with the bankruptcy court's conclusion that paragraph 20 of the lease at issue, allowing for the termination of the lease by either the landlord, Denney or the debtor-tenant, Joshua Slocum, Ltd., if certain minimum sales figure were not realized, was not enforceable. Central to the bankruptcy court's view was the notion that unless the landlord establishes that a leasehold is in a "shopping center," such a restrictive clause is only enforceable if the landlord is able to establish that

such terms are material and jeopardize the economic position of the landlord and/or the landlord's other tenants. The bankruptcy court, working from the premise that the Denney Block is not a "shopping center," looked to case law interpreting § 365 of the *Bankruptcy Code* and distilled the concepts of "materiality and economic significance." Those cases state that "the [bankruptcy] court does retain some discretion in determining that lease provisions ... may still be refused enforcement in a bankruptcy context in which there is no substantial economic detriment to the landlord shown, and in which enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets." *In re Mr. Grocer, Inc.*, 77 B.R. 349, 354 (Bankr. D.N.H.1987) ; see also *In re Tech Hifi, Inc.*, 49 B.R. 876, 879 (Bankr. D. Mass. 1985) .

... We find that although the bankruptcy court was correct in its reliance on those legal precepts in this context, it was incorrect in finding that on these facts, paragraph 20 of the lease, addressing the right of the parties to terminate the leasehold is not "material or economically significant." That conclusion flies in the face of logic and simple common sense. The average sales provision of the lease is material in the sense that it goes to the very essence of the contract, i.e., the bargained for exchange. This clause, intended to benefit both the landlord and the tenant, was negotiated at arms length to accommodate the commercial expectations of the parties. This average sales provision is also reflective of the economic terms of the lease agreement governing occupancy. However, most importantly, the materiality and economic significance of paragraph 20 turn on the fundamental right to remain in or end a contractual relationship.

We find that the average sales provision of paragraph 20 was not merely inserted as an escape hatch in the event that the location became unprofitable for the protection of the tenant. But rather, that particular clause is of financial import to the landlord in insuring occupancy by high volume sales, viable businesses, thus increasing the rent received under the percentage rent clause. The combination of paragraph 4 and paragraph 20 acts as a minimum income guarantee for the landlord. Certainly nothing could be as material or economically significant to landlords as some minimal assurance that there will be a positive return on their investments. The clause is also significant to landlord as well as the other tenants because customers will be attracted to stores where business is perceived as booming. We conclude, therefore, paragraph 20 is a material and economically significant clause in the leasehold at issue.n176c

One recent court of appeals case has expressly interpreted section 365(b)(3) in light of the above legislative history and in a manner that resolved the apparent conflict between those provisions and the restrictions on anti-assignment clauses contained in section 365(f)(1). In *In re Trak Auto Corporation*, the Court of Appeals for the Fourth Circuit was faced with a situation in which a debtor--a retailer of auto parts and accessories--sought to assign one of its leases to A&E Stores, Inc., a discount clothing store.n176c The subject lease contained a provision that limited "PERMITTED USES" to the "sale at retail of automotive parts and accessories and such other items as are customarily sold by Tenant at its other Trak Auto stores" and contained a specific covenant to use the leased premises only as a Trak Auto Store and for the uses contemplated by the permitted use provision.n176d Both the bankruptcy court and the district court on appeal permitted the assignment by the debtor, holding, first, that the use restriction in the lease amounted to an anti-assignment provision that was prohibited by section 365(f)(1) and, second, that there was insufficient evidence that the proposed assignment to A&E would disrupt the tenant mix at the shopping center, as contemplated by section 365(b)(3)(D). On appeal, after reviewing the legislative history cited above in this volume, and applying the statutory canon that a specific provision controls over a more generalized provision, the court of appeals held that the shopping-center specific provision of section 365(b)(3)(C), which includes a requirement "that assumption or assignment of such lease is subject to all provisions thereof, including (but not limited to) provisions such as radius, location, use or exclusivity," controlled over the requirements of 365(f)(1) which prohibit anti-assignment clauses in leases in general:

Congress's purpose is clear from the [legislative history] that culminated in the 1984 shopping center amendments to the Bankruptcy Code and from the language of § 365(b)(3)(C) after those amendments. Specifically, when a shopping center lease is assigned in bankruptcy, Congress's purpose in § 365(b)(3)(C) is to preserve the landlord's bargained-for protections with respect to premises use and other matters that are spelled out in the lease with the debtor-tenant. We therefore hold that because A&E does not propose to take the West Town lease subject to the specific restrictions limiting use of the premises to the sale of auto parts and accessories, Trak Auto's motion to assume and assign the lease must be denied.^{n176e}

In effect, the *Trak Auto* court interpreted the reference in section 365(b)(3)(C) to "*all of the provisions [of the lease], including ... use*" as requiring that Courts enforce as written all but the most restrictive anti-assignment clauses--those that prevent any assignment whatsoever. It specifically cited the floor statements of Senator Hatch for the proposition that this interpretation would not permit a landlord to reject any assignment, but only those that violated the use provision. The court recognized the far reaching consequences of its decision, but relied on what it viewed as the expanded protections intended for shopping center landlords under the statute:

Our decision to block Trak Auto's lease assignment is not an attempt on our part to water down one of the important purposes of Chapter 11. That purpose is to give business debtors with some prospects the opportunity to reorganize, revive their operations, and continue in existence. The assumption and assignment of leases can be an important part of this effort. See *Three Sisters Partners, L.L.C. v. Harden (In re Shangra-La, Inc.)*, 167 F.3d 843, 849 (4th Cir. 1999). Shopping center leases are in a special category, however, because Congress has made it more difficult for debtor-tenants to assign these leases in Chapter 11. This special protection for shopping center landlords, as spelled out in § 365(b)(3)(C), dictates the result in today's case. But this does not mean that § 365(f)(1) can never be used to invalidate a clause prohibiting or restricting assignment in a shopping center lease. But see *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1090 (3d Cir. 1991) (concluding that § 365(b)(3) (1982) rendered § 365(f)(1) inapplicable to shopping center leases). A shopping center lease provision designed to prevent any assignment whatsoever might be a candidate for the application of § 365(f)(1). For example, Senator Hatch, in explaining the 1984 amendment to § 365(b)(3)(C), said that the "amendment is not intended to enforce requirements to operate under a specified trade name." 130 Cong. Rec. S8891 (daily ed. June 29, 1984), reprinted in 1984 U.S.C.C.A.N. 590, 600. Senator Hatch's comment suggests that Congress did not intend to make § 365(f)(1) completely inapplicable to shopping center leases. Of course, the issue of when § 365(f)(1) might apply is a subject for some future case.^{n176f}

In sum, the *Trak Auto* decision can be read to hold that in the case of a shopping center lease, any assignment restriction that may be difficult, but not impossible, for an assignee to fulfill--such as a trade name restriction--will be honored in favor of the landlord notwithstanding the general anti-assignment provisions of section 365(f)(1).^{n176g}

[7] Lease Assignment Programs

[a] Practical Considerations

The provisions of the Bankruptcy Code permitting leases to remain in effect notwithstanding prepetition defaults, rendering unenforceable *ipso facto* and similar bankruptcy default provisions and rendering unenforceable prohibitions and limitations on assignment, have converted leasehold liabilities into substantial assets in circumstances in which the lease rental is less than the current market rental of the leased premises.ⁿ¹⁷⁷ In cases in which a debtor is a lessee of one or more facilities that it no longer desires to operate as part of its continuing business (assuming a reorganization proceeding), or if the trustee is liquidating the entire business of the debtor, the trustee should consider a lease assignment program as an important element of the reorganization or liquidation effort.

It should be noted that the flexibility and level of efficiency of lease assignment programs likely have been diminished as a result of the 2005 amendments to section 365. As previously noted, section 365(d)(4), as amended by the 2005 Act, provides that an unexpired lease of nonresidential real property under which the debtor is the lessee is deemed rejected, and the trustee is required to immediately surrender the premises to the lessor, if not assumed or rejected by the earlier of (1) the date that is 120 days after the commencement of the bankruptcy case or (2) the date of the entry of an order confirming a plan.ⁿ¹⁷⁸ The initial 120-day deadline may be extended for an additional 90 days by the court for cause prior to the expiration of the 120-day period, but the court cannot grant any additional extensions without the written consent of the lessor.^{n178a}

This amendment represents a monumental change from prior law by removing what had been a discretionary right of the court to grant unlimited further extensions for cause beyond an initial 60-day period.^{n178b} Prior to 2005 Act, debtors were able to implement a drawn-out lease assignment program, encompassing a lengthy and comprehensive marketing and appraisal process, and evaluate options, including decisions on whether to remain in a location, in a relatively deliberative manner so long as the debtor continued to timely perform its lease obligations during that decision-making period as required by section 365(d)(3). As a practical matter, debtors were often permitted to delay decisions on assuming or rejecting a lease until confirmation of a plan of reorganization. Often, the debtors would not implement a full marketing effort until the case was well underway because of both a need to focus on other more pressing issues in the early stages of a chapter 11 case, and a desire, particularly in the case of large retail debtors, to test business plans for a reasonable period of time (for example, a full retail cycle) in order to make considered decisions on which locations should be retained by the debtor, and which locations should be the subject of the lease assignment program. As a result of the amendments, the debtor must now make all decisions relating to all of its leases within a fixed 120 days, or, if extended, 210 days, unless the landlord consents in writing. This compressed time period requires that debtors begin focusing on a potential lease assignment program very early in the case, if not almost immediately after commencement. Nonetheless, although the amendments have compressed the time periods, the basic permissive provisions for curing defaults and overriding most anti-assignment provisions remain unchanged. Thus, the value and potential benefits of a lease assignment program are still present and one primary result of the amendments may be to place a premium on pre-bankruptcy planning so that a program of lease assignments can be implemented relatively quickly, and within the temporal confines of amended section 365(d)(4).

The first substantial lease assignment program appears to have been conducted in the *W.T. Grant Co.* proceedings under Chapter XI of the former Bankruptcy Act.ⁿ¹⁷⁸ Although *ipso facto* and bankruptcy termination clauses were generally enforceable under the Act, W.T. Grant, as a major tenant in many shopping centers, was frequently able to obtain landlord agreement to the Grant standard lease, which included a provision negating the effect of a Grant bankruptcy if the lease rental was being paid and the other lease covenants were being performed on a timely basis. In addition, the Grant standard leases contained a use clause permitting general retail operations and a general right of assignment. At the time of the Chapter XI filing, Grant had approximately 1,200 retail stores under lease. As the company contracted, it eliminated unprofitable regions consisting of hundreds of store locations. The leases of these stores, and ultimately the leases of all Grant locations following the conversion of the Chapter XI case to a liquidation proceeding, were sold to various bidders at "lease auctions" held in the bankruptcy court, with an aggregate return to creditors of approximately \$20 million.

The Grant lease assignment program was followed under the former Act by several other substantial programs, including the notably successful *Food Fair* ⁿ¹⁷⁹ assignment program, which produced a gross return to the estate of approximately \$115,382,000 based on assignment of approximately 250 leases.ⁿ¹⁸⁰ This return, together with the proceeds of sale of fee properties of Food Fair, was primarily responsible for Food Fair's ability to promulgate a plan and to achieve rehabilitation.

It is fair to generalize that most companies with a substantial number of leased locations are retail companies and do not perceive themselves as being in the real estate business. Although such companies may have highly sophisticated real estate departments, these departments are generally oriented towards the identification and securing of new locations,

and to the handling of the necessary legal work to consummate such acquisitions. If such a company becomes a debtor in a case under the Code, and if it becomes necessary to dispose of a number of the company's locations, the company has entered the real estate business as a volume seller rather than as an acquirer and an operator. Accordingly, it is often advisable for the debtor and its creditors to authorize the trustee to retain the services of a real estate consultant to assist in the successful prosecution of the disposition program. There are several consulting firms that have acquired considerable experience in the field of real estate dispositions for Bankruptcy Code debtors.

The engagement of a consultant requires the trustee to solicit and consider proposals from a fair sampling of consulting firms, to negotiate a consulting agreement, to submit the proposed agreement to the creditors' committee and to obtain approval by the bankruptcy court of the consulting agreement.

A consulting agreement will ordinarily provide for (1) the engagement of the consultant on an exclusive basis; (2) the initial preparation by the consultant of an appraisal of the real property, including leasehold interests, of the estate; (3) the payment to the consultant of an initial retainer fee in respect of the appraisal work; (4) the development of the disposition program, including (a) consultation with the trustee as to the properties to be disposed of, (b) establishing upset prices for the properties, (c) contacting prospective bidders for the properties, (d) advertising and (e) scheduling auctions for the properties in concert with counsel for the consultant, the trustee and the creditors' committee; (5) a fee structure for the consultant in respect of the dispositions, which may be based upon a percentage of net proceeds realized by the trustee, with the percentage to increase as net proceeds achieve specified levels; and (6) a fee arrangement in respect of leases that are not assigned but with respect to which a release of liability is negotiated by the consultant with the landlord.ⁿ¹⁸¹

The agreement may also contain provisions for the payment of specified fees in the event that the consultant successfully renegotiates the rent under leases for premises that are ultimately retained by the debtor either through assumption of the original lease, as modified, or through rejection of the original lease coupled with entering into a new lease containing the renegotiated terms. Net proceeds realized by the trustee, which may be the basis for computation of the consultant's fee, should be defined carefully and will ordinarily mean the amounts actually received by the trustee for a lease assignment, including deferred payments as and when received, plus the amount of any postpetition liabilities for which the estate may be liable but which have been either released by the landlord or assumed by the assignee, less the carrying costs of the property paid by the trustee (including use and occupation charges) subsequent to the retention of the consultant. The agreement should of course have a termination provision, which in view of the bankruptcy proceedings could be exercisable by the trustee upon notice and the lapse of a specified time period. The consultant will ordinarily bargain for a reciprocal right of termination.

A form of consulting agreement is provided at the end of this chapter.ⁿ¹⁸²

It is clear that the 1984 Amendments have made lease assignment programs more costly and difficult to administer. In addition to the amendments to section 365(b)(3) discussed above, section 365(d)(3) must also be taken into account. Before enactment of the 1984 Amendments, a trustee for a debtor-tenant with many leased locations could vacate the unwanted locations, hold the leases out for assignment and withhold payment of use and occupation charges under the theory that the vacant premises were of no value to the trustee. However, under section 365(d)(3), as added by the 1984 Amendments, the trustee must in the case of a nonresidential real estate lease provide timely postpetition performance of the debtor's lease obligations, subject to a court-ordered grace period not to extend beyond 60 days after the entry of the order for relief. This requirement is applicable to vacant as well as occupied premises until the trustee assumes or rejects the relevant lease.

Moreover, under section 365(d)(4), as added by the 1984 Amendments, and as further amended by the 2005 Act, a trustee for a debtor-tenant must assume or reject the debtor's nonresidential real estate leases within 120 days after entry of the order for relief unless an extension is obtained from the court for cause within the 120-day period. As a result of the 2005 Act, the extension can be for only a single 90-day period unless the lessor consents in writing. Nonresidential

real estate leases not assumed or rejected within the section 365(d)(4) period are deemed rejected, and the trustee is thereupon required to promptly vacate the leased premises. Accordingly, a trustee contemplating a lease assignment program will be constrained as a practical matter to seek an extension of the 120-day period for "cause" on the basis that (1) a lease assignment program cannot be successfully concluded within the 120-day period, and (2) the program, if successful, will benefit the estate and its creditors. The trustee's application to the court presumably will be made on notice to each landlord under an affected lease.

In view of the financial and time pressures created by subsections 365(d)(3) and (d)(4)--pressures which have greatly increased as a result of the final deadline of 210 days now imposed by the 2005 Act--with respect to valuable leases of unwanted premises that may be held for assignment, it is necessary to plan a lease assignment program as early as possible and even before the filing of the debtor's Bankruptcy Code petition if feasible.

[b] Assignment and Subletting Compared

A threshold determination with respect to the disposition of leaseholds by a trustee is whether the disposition will be accomplished by means of assignment or subletting. Section 365(f), which invalidates prohibitions and limitations on assignment, does not speak to the question of subletting. Accordingly, if a lease prohibits or restricts subletting, the question of the trustee's right to sublet the premises may be governed by state law. In addition, section 365(k) provides that upon an assignment of a lease that has been assumed under section 365, the trustee and the estate are relieved of liability for post-assignment defaults. However, section 365(k) is silent as to subletting, so that an assumption and subletting transaction results in (1) the estate's assuming administrative priority liability in the event of a postassumption breach of the lease;ⁿ¹⁸³ (2) the elimination of section 502(b)(6) as a full limitation on the estate's liability for damages if the lease is subsequently breached or rejected, and the substitution of a much larger potential damage amount of up to two years of monetary obligations following the later of the rejection date or actual turnover as the measure of the estate's liability;ⁿ¹⁸⁴ and (3) the continuation of the liability of the debtor under the lease after the close of the Bankruptcy Code case. Moreover, in an assignment program, the estate will ordinarily receive sorely needed cash consideration for a leasehold upon the consummation of the assignment transaction, whereas in a subleasing transaction, the benefit to the estate and the debtor will usually come more slowly in the form of the spread between the sublease rental installments and the prime lease rental installments. On the positive side of a subleasing program, it should be noted that under section 365(b), adequate assurance of future performance is required only if there has been a default under the lease. Under section 365(f)(2), adequate assurance of future performance is required for any assignment of a lease, whether or not a default has occurred. Therefore, in the subletting context, if the prime lease is in good standing with no outstanding defaults, it appears that the trustee can obtain the economic benefits of a tenant willing to pay full market to the debtor in relation to a below-market prime lease without needing to provide adequate assurance of future performance under the prime lease.

A sublease program may be useful in cases in which the debtor's leased locations are not sufficiently attractive to draw substantial bidders prepared to offer up-front cash consideration. Instead, these locations may tend to draw smaller and less well-capitalized enterprises seeking a subletting opportunity with minimal initial investment. Moreover, a sublease program, particularly if the subleases are relatively short term, will permit the debtor the possibility of retaining for its own purposes an attractive prime lease if business conditions change or entering into a new sublease if the differential between the prime lease and the market value becomes even more favorable. In these circumstances, if the court is willing to find that the trustee has provided adequate assurance of future performance (if a default under the lease has occurred), the trustee may be willing to risk the negative aspects of a subleasing program.ⁿ¹⁸⁵

[c] Procedure

The procedure for a lease assignment program in the context of a Bankruptcy Code case may be divided into four segments: (1) the approval by the court of the process of soliciting bids; (2) the establishment by the court of a hearing date for the lease auction; (3) the conduct of the lease auction; and (4) the assumption of a lease by the trustee and

concurrent assignment to the successful bidder.

Bankruptcy *Rule 6004(a)* provides that notice of a proposed sale of property other than in the ordinary course be given pursuant to Bankruptcy *Rule 2002(a)(2)*, (c)(1), (i) and (k). Bankruptcy *Rule 2002(a)* provides for not less than 21 days' notice to the debtor, the trustee and all creditors and indenture trustees of a sale outside of the ordinary course. Under Bankruptcy *Rule 2002(c)*, the notice shall include the time and place of any public sale, the terms and conditions of any private sale and the time fixed for filing objections. A general description of the real property is sufficient for purposes of the notice. Bankruptcy *Rule 2002(i)* provides that copies of all Bankruptcy *Rule 2002* notices shall be sent to each committee appointed in the case or to its authorized agent, and provides further that the court may dispense with the broad notice requirements of Bankruptcy *Rule 2002(a)(2)* and instead require notice only to the committees or their authorized representatives and to creditors and equity security holders who have filed a request for notices with the court. In cases involving numerous sales, such as multiple lease dispositions, the truncated notice procedure is more economical and simpler to administer.

Bankruptcy *Rule 6004(b)* provides for objections to proposed sales to be filed and served not less than seven days before the proposed sale date. In the case of lease dispositions, objections will be filed ordinarily by landlords and mortgagees. Bankruptcy *Rule 6004(b)* does not mean that the objection will be heard on the sale date; the court is free to approve a bid on a lease subject to the disposition of an objection at a later-scheduled hearing. Under Bankruptcy *Rule 6004(e)*, the notice of sale may establish a date for hearing of objections.

Bankruptcy *Rule 6004(f)(1)* provides that sales outside the ordinary course may be by public auction or private sale. Local court rules may prescribe sale by public auction unless otherwise specified by the court. Sale by public auction does not necessarily entail conduct of the sale by a professional auctioneer; indeed, in the case of lease dispositions, the sale is ordinarily conducted by counsel to the trustee or counsel to a consultant retained by the trustee.ⁿ¹⁸⁶ In practice, the auction often takes place at the office of the debtor's counsel. Upon completion of the sale, the auctioneer, if any, or the trustee, debtor in possession or chapter 13 debtor is required to file with the court a statement itemizing the property sold, the purchaser and the price.^{n186a} Under Bankruptcy *Rule 6004(f)(2)*, following the sale, the trustee or debtor in possession is authorized and directed to execute any instrument necessary or ordered by the court to effectuate the transfer to the purchaser.

The use of an auction process is often the best method of assuring that the disposition of a debtor's assets is being administered openly, fairly and with the best possible prospects for a reasonable realization on the value of those assets. The use of the auction system for leaseholds of course creates potentially massive organizational and logistical problems for a trustee, its real estate consultant, and their respective counsel, inasmuch as each lease will have its special variations, its particular defaults and its separate landlord-instituted objections to the proposed transfer. Nevertheless, it is possible to establish "assembly line" procedures for lease auctions by the trustee's use of standardized documentation and by dealing with groups of leases in a consolidated auction process.

Thus, the first segment identified above--the approval by the court of the bid solicitation process--is often handled by a mass production method. The trustee applies to the court for an order approving the solicitation of bids for leases identified on a schedule to the application. Annexed to the application as a separate exhibit is the form of bid solicitation notice that the trustee intends to publish in specified newspapers, and which will be served (by mail) upon the landlord of each leased property, the creditors' committee, persons who have theretofore expressed an interest in bidding, the United States trustee and parties who have filed requests for notices in the case. The bid solicitation notice sets forth the date, time and place of the auction, and identifies the respective properties and the method for submitting a written bid and deposit thereon. The notice will further set forth the terms and conditions of the trustee's offer, which, therefore, creates the standardization necessary for the efficient administration of the auction process. The terms and conditions of the offer may include the following provisions:

- (1) the making of a deposit by the successful bidder at the hearing;

- (2) payment of the balance on closing;
- (3) time and place of closing;
- (4) the execution by the successful bidder at closing of a prescribed form of assignment and assumption agreement;^{n186b}
- (5) the payment by the trustee at the closing of outstanding amounts under the lease, and the effectuation of appropriate adjustments between the trustee and the successful bidder;
- (6) limitation of the trustee's liability to the return of the deposit;
- (7) the trustee's right to demand financial and other business information relating to any bidder (for purposes of demonstrating adequate assurance of future performance);
- (8) the place at which bidders may examine the underlying lease documents and conduct other due diligence;^{n186c} and
- (9) the trustee's unfettered right to withdraw properties from the sale, to vary the terms and conditions of the offer, and to determine which are the highest and best bids.

In some cases, the terms and conditions require that the second highest bidder for a leasehold hold its bid open until a specified date. This enables the trustee to consummate a transaction with such bidder if the high bidder fails to close.

A form of order approving solicitation of bids on leases, the trustee's application for the order, and the form of bid solicitation (including detailed terms and conditions of the offer) is set forth at the end of this chapter.ⁿ¹⁸⁷

After the notice of solicitation has been circulated and published the trustee and its consultant will usually receive inquiries from prospective bidders, requests for additional information, requests for permission to inspect the premises and actual bids and deposits. The landlords will often likewise contact the trustee or its counsel, seeking further information and perhaps setting forth objections to the procedure and possible results thereof. In some instances, the landlord might itself seek to bid at the auction in order to recapture a portion of the excess value in the lease or assure that the lease will not be assigned to an objectionable party that cannot be excluded under the assignment limitations of the Bankruptcy Code. In any event, assuming an active market for the properties, the trustee and consultant will be in a position to come to the auction with firm bids on the properties, indications of additional interest for certain properties and expectations of either landlord resistance or landlord cooperation.

At the auction hearing, the trustee or real estate consultant, through its counsel, will conduct the auction procedure on a property-by-property basis. The court will hear objections by landlords, mortgagees and other interested parties to the proposed assignment of particular leases. If there is a large number of leases to be dealt with in the auction, such objections will usually be set down for hearing at a later date following the actual auction, with the court specifying a time within which the objecting party is to file any pleadings in opposition. If there is no opposition and the trustee determines to accept a bid on a property, the trustee will promptly submit to the court an application and proposed order authorizing the assumption and assignment of the lease.ⁿ¹⁸⁸ The application will specify the parties to receive notice of entry of the order, including the landlord, the creditors' committee (which usually consents to the order by signing a legend inscribed thereon) and the successful bidder. The application will also enumerate any outstanding defaults under the lease, the payments to be made and other actions to be taken by the trustee to cure the defaults, the facts required to demonstrate adequate assurance of future performance by the proposed assignee and the date of consummation of the proposed assignment transaction. The application will typically provide the landlord with an opportunity to object to a

proposed cure amount well in advance of the hearing so that the parties have an opportunity to resolve any differences, and the debtor/prospective assignor has an ability to withdraw a lease from a program or delay the hearing if it turns out that the cure amount to be paid by the debtor is greater than anticipated. In view of the definition of "notice and a hearing" set forth in *section 102(1) of the Code*, if no person requests a hearing, none will be conducted and the transaction will proceed to consummation. The order of the court will usually provide for, among other things:

- (1) authorization for the trustee to assume the lease and assign the lease to the successful assignee;
- (2) a recitation of the outstanding defaults under the lease;
- (3) a declaration of the payments to be made and other actions to be taken by or on behalf of the trustee to cure such defaults and the time within which the payments are to be made and the actions are to be completed;
- (4) a declaration that compliance with the cure provisions of the order shall constitute a complete cure of all outstanding lease defaults and that the lease will be in good standing as a result thereof and fully enforceable by the assignor; and
- (5) a declaration that the requirements for adequate assurance of future performance have been satisfied.

The transaction will be consummated as promptly as possible after the entry of the order. Under *section 363(m) of the Code*, the reversal or modification on appeal of an authorization under subsection (b) or (c) of section 363 of a sale or lease of property does not affect the validity of the sale or lease to an entity that purchased or leased the property in good faith, whether or not such entity knew of the appeal, unless such sale or lease had been stayed. Although lease assignment transactions are effected under *section 365 of the Code* and not under section 363, counsel often seek to have lease assignment transactions fall under 363 by including as part of a lease transfer certain items of personal property of the assignor that are deemed to be sold to the assignee under section 363. In addition, it is arguable that the consummation of a lease assignment constitutes both an assumption of the lease under section 365 and a subsequent assignment coming under the rubric of not only section 365 but *section 363(b)(1) of the Code* since it involves a sale of estate property out of the ordinary course of business. The relevance of section 363(b)(1) is particularly applicable to an assignment under a program of the type discussed here where the presence of active marketing, detailed bidding procedures and auctions intended to maximize proceeds to the debtor represent elements which seem to have more in common with a sale or estate property than a simple assignment.^{n188a}

Inasmuch as section 365 has no counterpart to section 363(m), the hoped-for effect of obtaining an order authorizing a lease assignment transaction under both sections 363 and 365 is to achieve finality in the face of a threatened or actual appeal by an objecting party (in the absence of an actual stay).^{n188b} Therefore, it is also common practice to request that the court include in the authorizing order a finding that the assignee/purchaser is acting in good faith. In such instances, it is usually good practice for the purchaser's counsel to present evidence to the court on the record (either by eliciting direct testimony under oath or by proffering such testimony) to support such a good faith finding in the event that the approval order is later appealed. This practice assures that there is sufficient evidence in the record to support the bankruptcy court's finding of good faith and minimize the risk that an appellate court would reverse the good faith determination under the clearly erroneous standard of appellate review of factual findings. This is, of course, intended to incorporate the good faith standard set forth in section 363(m).ⁿ¹⁸⁹ Provided at the end of this chapter are a form of order approving assumption and assignment of a lease, together with the application therefor,ⁿ¹⁹⁰ and a form of assignment and assumption agreement employed in connection with the closing of an assignment transaction.ⁿ¹⁹¹

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. §§ 108(b), 363(1), 365(a), (b), (e), (f) and 541(c).

(n2)Footnote 2. *Queens Blvd. Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974) (termination of lease denied on equitable grounds in light of landlord's desire to relet at a higher rental and impossibility of rehabilitation without the premises); *Weaver v. Hutson*, 459 F.2d 741 (4th Cir.) , cert. denied, 409 U.S. 957, 93 S. Ct. 288, 34 L. Ed. 2d 227 (1972) (enforcement of bankruptcy termination clause denied on basis of waiver); *Speare v. Consolidated Assets Corp. (In re Speare)*, 360 F.2d 882 (2d Cir. 1966) (termination of lease denied on equitable grounds in light of debtor's substantial investment in the property, total loss to equity investors and windfall to landlord); *In re Fleetwood Motel Corp.*, 335 F.2d 857 (3d Cir. 1964) (termination denied on facts similar to those in *Speare*); *The Valley Fair Corp.*, 19 C.B.C. 50 (Bankr. S.D.N.Y. 1978) (termination denied because interests of third-party plan proponent would be adversely affected).

(n3)Footnote 3. See, e.g., *Queens Blvd. Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974) ; *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala 2003) .

(n4)Footnote 4. See P 3.01[3][a] *infra*.

(n5)Footnote 5. See P 3.01[2] *infra*.

(n6)Footnote 5a. See P 3.01[3][b][i][b] *infra*.

(n7)Footnote 6. See P 3.01[5] *infra*.

(n8)Footnote 7. See P 3.01[5] *infra*.

(n9)Footnote 8. Pub. L. No. 98-353 (1984), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n10)Footnote 9. See P 3.01[3][b] *infra*. The 1984 Amendments also included a new section 365(m), which provides that for purposes of sections 365, 541(b)(2) and 362(b)(10), the term "lease" includes any rental agreement to use real property. Nevertheless, the determination of whether an agreement constitutes a real property lease is to be made with reference to state law. *Baker v. Harris Pine Mills (In re Harris Pine Mills)*, 862 F.2d 217 (9th Cir. 1988) .

(n11)Footnote 9a. Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised); Pub. L. No. 109-8 (2005), reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n12)Footnote 10. 11 U.S.C. § 362(a).

(n13)Footnote 11. 11 U.S.C. § 362(a)(1).

(n14)Footnote 12. *Allied Tech., Inc. v. R.B. Brunemann & Sons, Inc. (In re Allied Tech., Inc.)*, 25 B.R. 484 (Bankr. S.D. Ohio 1982) ; *In re Hawaii Mini-Storage Systems, Inc.*, 2 C.B.C. 2d 151 (Bankr. D. Haw. May 2, 1980) .

(n15)Footnote 13. 11 U.S.C. § 362(a)(2).

(n16)Footnote 14. 11 U.S.C. § 362(b)(10); *Robinson v. Chicago Housing Auth.*, 54 F.3d 316, 318 (7th Cir. 1995) ; *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala 2003) (containing thorough discussion of issue) *In re Hejco, Inc.*, 87 B.R. 80 (Bankr. D. Neb. 1988) .

(n17)Footnote 14a. 11 U.S.C. § 541(b)(2).

(n18)Footnote 15. 11 U.S.C. § 105(a).

(n19)Footnote 16. *In re Lane Foods, Inc.*, 213 F. Supp. 133 (S.D.N.Y. 1963) . See P 3.01[3][a] *infra* for a

discussion of the bankruptcy court's treatment of state law prepetition lease termination issues.

(n20)Footnote 17. 11 U.S.C. § 362(a)(3).

(n21)Footnote 18. See cases cited at P 2.01 note 2 *supra* ; *In re 48th Street Steakhouse, Inc.*, 835 F.2d 427 (2d Cir. 1987) (notice of lease termination violated automatic stay). However, section 362(a) does not toll the running of contractual cure periods. The only express tolling provision in the Code affecting contractual cure periods is section 108(b). *In re Maanum*, 828 F.2d 459 (8th Cir. 1987) . The provision will also not toll the expiration of a termination by a date certain, where there is no cure period at the time of notice of termination. See *In re Policy Realty Corp.*, 242 B.R. 121, 128 (S.D.N.Y. 1999) , *aff'd*, 2000 U.S. App. LEXIS 8846 (2d Cir. 2000) (unpublished decision); *In re Musikhahn Corp.*, 57 B.R. 938, 940 (Bankr. E.D.N.Y. 1986) .

(n22)Footnote 19. 11 U.S.C. § 362(a)(6).

(n23)Footnote 20. 11 U.S.C. § 362(a)(4).

(n24)Footnote 21. 11 U.S.C. § 362(a)(5).

(n25)Footnote 22. See P 3.04 *infra*. 11 U.S.C. § 545(3) and (4) permits the trustee to avoid all statutory liens for rent and of distress for rent.

(n26)Footnote 23. 11 U.S.C. § 362(d). The last ground for relief, with respect to the "stay of an act against single asset real estate" was added to section 362(d) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). As discussed at P 2.06, *supra*, the potential application of this ground for stay relief was considerably expanded by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), Pub. L. No. 109-8 (2005), which eliminated a \$4,000,000 secured debt limitation previously included in the definition of "single asset real estate." In one published case interpreting the requirement of newly enacted 362(b)(4) that the filing of the petition "be part of a scheme to delay, hinder and defraud creditors," the court imposed a high evidentiary standard on the creditor, and held that the transfer by an individual to a pre-existing corporation of real property subjected to a defaulted mortgage, following default and shortly prior to the initiation of a bankruptcy filing by the corporation, did not constitute such a scheme. *In re Duncan & Forbes, Dev., Inc.*, 368 B.R. 27 (Bankr. C.D. Cal. 2007) . The court also noted that the requirement of section 365(d)(4)(A) that the transfer be "without the consent of the secured creditor" required that the mortgage explicitly require the creditor's consent to a transfer, and the existence of a due on sale clause in the mortgage at the creditor's option or the mere failure of the transferor to seek the mortgagee's consent was insufficient. 368 B.R. 27, 35 .

(n27)Footnote 24. *E.g.*, *In re Mimi's of Atlanta, Inc.*, 2 C.B.C.2d 805, 5 B.R. 623 (Bankr. N.D. Ga. 1980) , *aff'd*, 11 B.R. 710 (N.D. Ga. 1981) .

(n28)Footnote 25. See, *e.g.*, *Alvarez v. McSwiggen (In re Alvarez)*, 319 B.R. 108 (Bankr. W.D. Pa. 2004) .

(n29)Footnote 26. 11 U.S.C. § 362(d)(2) "is intended to solve the problem of real property mortgage foreclosures of property where the bankruptcy petition is filed on the eve of foreclosure. The section is not intended to apply if the business of the debtor is managing or leasing real property, such as a hotel operation, even though the debtor has no equity if the property is necessary to an effective reorganization of the debtor." 124 Cong. Rec. H11,092-93 (Sept. 28, 1978); see *In re Koopmans*, 6 C.B.C.2d 1414, 1417-21, 22 B.R. 395, 405-08 (Bankr. D. Utah 1982) . Section 362(d)(2) has been applied in connection with the equity that a lessee may have under a sublease, in which the debtor/lessee is the landlord under the sublease. See *In re Policy Realty Corp.*, 242 B.R. 121, 125 (S.D.N.Y. 1999) , *aff'd*, 2000 U.S. App. LEXIS 8846 (2d Cir. May 2, 2000) (unpublished decision).

(n30)Footnote 27. 10 C.B.C. 581 (Bankr. N.D. Ga.) , *aff'd*, 10 C.B.C. 613 (N.D. Ga. 1976) .

(n31)Footnote 28. *In re Koopmans*, 22 B.R. 395, 405, 6 C.B.C.2d 1414, 1426 n.18 (Bankr. D. Utah 1982) .

(n32)Footnote 29. *See* notes 26 and 28 *supra*.

(n33)Footnote 30. *In re R.H. Neil, Inc.*, 58 B.R. 969 (Bankr. S.D.N.Y. 1986) ; *cf.* *Bankers Life Ins. Co. v. Alyucan Interstate Corp.* (In re *Alyucan Interstate Corp.*), 4 C.B.C.2d 1066, 1069, 12 B.R. 803, 806 n.5 (Bankr. D. Utah 1981) .

(n34)Footnote 30a. *In re Winn-Dixie Stores, Inc.*, 345 B.R. 402, 406 (Bankr. S.D. Fla. 2006) .

(n35)Footnote 31. 11 U.S.C. § 362(d)(1).

(n36)Footnote 32. *In re Wheeling-Pittsburgh Steel Corp.*, 54 B.R. 385 (Bankr. W.D. Pa. 1985) , *aff'd*, 67 B.R. 620 (W.D. Pa. 1986) (computer lease); *Harris Int'l Telecommunications, Inc. v. Three Star Telecast, Inc.* (In re *Three Star Telecast, Inc.*), 73 B.R. 270 (Bankr. D.P.R. 1987) (equipment lease); *In re Sweetwater*, 10 C.B.C.2d 985, 40 B.R. 733 (Bankr. D. Utah 1984) (equipment lease); *In re Attorneys Office Mgmt., Inc.*, 10 C.B.C.2d 1430, 40 B.R. 127 (Bankr. C.D. Cal. 1983) ; *In re Easthampton Sand & Gravel Co.*, 7 C.B.C.2d 903, 25 B.R. 193 (Bankr. E.D.N.Y. 1982) ; *In re Belize Airways, Ltd.*, 5 B.R. 152, 156, 2 C.B.C.2d 657, 661-62 (Bankr. S.D. Fla. 1980) ("In this instance, the 'adequate assurance' to be provided pursuant to § 365(b)(1) is 'adequate protection' within the meaning of § 361. The full extent of any correlation between 'adequate assurance' and 'adequate protection' need not be decided now."). *Contra In re Reice*, 19 C.B.C.2d 206, 88 B.R. 676 (Bankr. E.D. Pa. 1988) .

(n37)Footnote 33. *In re Sweetwater*, 10 C.B.C.2d 985, 40 B.R. 733 (Bankr. D. Utah 1984) .

(n38)Footnote 34. *See* note 32 *supra*.

(n39)Footnote 35. *In re Ernst Home Ctr., Inc.*, 209 B.R. 955, 965-67 (Bankr. W.D. Wash. 1997) ; *In re Rose Dabney*, 45 B.R. 312 (Bankr. E.D. Pa. 1985) (residential lease); *In re Fred Sanders Co.*, 7 C.B.C.2d 421, 22 B.R. 902 (Bankr. E.D. Mich. 1982) (equipment lease); *see In re Inn at Longshore, Inc.*, (Bankr. D. Conn. 1983) . The *Sanders* holding was followed in *In re GHR Energy Corp.*, 41 B.R. 668 (Bankr. D. Mass. 1984) .

(n40)Footnote 36. *In re Xonics, Inc.*, 65 B.R. 69 (Bankr. N.D. Ill. 1986) ; *In re Mastercraft Record Plating, Inc.*, 32 B.R. 112 (Bankr. S.D.N.Y. 1983) .

(n41)Footnote 37. 11 U.S.C. § 363(d)(2).

(n42)Footnote 37a. 11 U.S.C. § 363(e).

(n43)Footnote 38. *American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A.*, 280 F.2d 119, 124-26 (2d Cir. 1960) ; *120 Wall Assocs. v. Schilling*, 266 F.2d 548, 550 (2d Cir. 1959) , *aff'g In re North Atl. & Gulf S.S. Co.*, 166 F. Supp. 29 (S.D.N.Y. 1958) .

(n44)Footnote 39. Section 361(2) deals expressly with additional or replacement *liens*, and is clearly directed toward the protection of secured parties rather than landlords. Section 361(3) is a codification of the "indubitable equivalence" standard of *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935) , which involved the rights of a mortgagee to resist a cramdown in a proceeding under Section 77B of the former Bankruptcy Act in effect prior to the 1938 Chandler Act amendments. The legislative history for section 361(3) does not evidence an intention to deal with the protection of landlords under real estate leases ("Section 361(4) of H.R. 8200 as passed by the House is modified in section 361(3) of the House Amendment to indicate that the court may grant other forms of adequate protection other than an administrative expense, which will result in the realization by the secured creditor of the indubitable equivalent of the creditor's interest in property." 124 Cong. Rec. H11,098 (Sept. 28, 1978) (statement of Representative Edwards); *see also In re Alyucan Interstate Corp.*, 4 C.B.C.2d 1066, 12 B.R. 803 (Bankr. D. Utah 1981) . Although section 361(1) by its terms appears to come closest to a standard for adequate protection for landlords under real estate leases

by providing for periodic payments by the trustee for the use of property, the legislative history for this section also evidences an intention to deal with secured creditors and not landlords. See S. Rep. No. 95-989, 95th Cong., 2d Sess. 54 (1977), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n45)Footnote 40. 11 U.S.C. § 365(d)(3). The courts in *In re Care Givers, Inc.*, 113 B.R. 263 (Bankr. N.D. Texas 1989), and *In re Independence Vill., Inc.*, 13 C.B.C.2d 476, 52 B.R. 715 (Bankr. E.D. Mich. 1985), held that a lease of premises occupied by elderly people as a residence was not a lease of nonresidential real property. *Contra In re Sonora Convalescent Hosp., Inc.*, 69 B.R. 134 (Bankr. E.D. Cal. 1986). The concept of a nonresidential real estate lease appears to relate to real property rental agreements in which the character of the property covered by the agreement is other than that of a personal residence. See *In re Bonita Glenn II*, 152 B.R. 751 (Bankr. S.D. Cal. 1993) (ground lease for land on which debtor later built apartment building was a lease of residential real property); *In re Emory Props., Ltd.*, 106 B.R. 318 (Bankr. N.D. Ga. 1989) (lease of property on which debtor operated hotel was a lease of nonresidential real property); *In re Lippman*, 122 B.R. 206 (Bankr. S.D.N.Y. 1990) (holding that a lease of a cooperative apartment used for commercial purposes is a residential lease); see also *In re Designer Doors, Inc.*, 389 B.R. 832 (Bankr. D. Ariz. 2008).

(n46)Footnote 41. 11 U.S.C. § 365(d)(3).

(n47)Footnote 42. 11 U.S.C. § 365(d)(4). A monumental amendment was made to this section under the 2005 Act to remove the discretionary right of the court to grant unlimited further extensions for cause beyond an initial 60-day period. Pub. L. No. 109-8, § 404 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The legislative history makes clear that the amendment was intended "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected." See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-354 (Matthew Bender 15th Ed. Revised).

(n48)Footnote 43. 11 U.S.C. § 365(d)(4).

(n49)Footnote 43a. *In re RB Furniture, Inc.*, 141 B.R. 706, 714 (Bankr. C.D. Cal. 1992); *In re Mr. Gatti's, Inc.*, 164 B.R. 929, 946 (Bankr. W.D. Tex. 1994); cf. *In re Larson*, 128 B.R. 257, 262 (Bankr. D.N.D. 1990) (equipment lease); *In re Tudor Motor Lodge Assocs., L.P.*, 102 B.R. 936 (Bankr. D.N.J. 1989) (adequate protection required to preserve value of franchisor's name and marks).

(n50)Footnote 43b. *In re P.J. Clarke's Rest. Corp.*, 265 B.R. 392, 397 (Bankr. S.D.N.Y. 2001) (citing this publication); *In re D'Lites of Am., Inc.*, 86 B.R. 299 (Bankr. N.D. Ga. 1988). It should be noted, however, that there may be an issue as to the measurement of the trustee's payment obligations if a lease is rejected under section 365(d)(4) and the trustee nevertheless fails promptly to surrender possession of the premises. See *In re Cornwall Paper Mills Co.*, 169 B.R. 844, 851 (Bankr. N.D. Ga. 1994) (debtor required to pay rent reserved in the lease after automatic rejection "so long as the debtor is occupying the premises and using it to help preserve the estate [and] regardless of whether the property is being put to the same use as it was prepetition"; court held that rental value fixed in lease would control unless there was "convincing evidence" that such rental rate was unreasonable); *In re Longua*, 58 B.R. 503 (Bankr. W.D. Wis. 1986) (trustee must continue to pay an amount equal to lease rental); *In re Chandel Enter., Inc.*, 64 B.R. 607 (Bankr. C.D. Cal. 1986) (court raises a question whether lessor is entitled to any lease or use and occupation payments following automatic rejection of debtor-tenant's lease as of expiration of section 365(d)(4) 60-day period). In *In re Designer Doors, Inc.*, 389 B.R. 832 (Bankr. D. Ariz. 2008), the court held that, although section 365(d)(3) required debtor to "timely perform all obligations," where work was performed prepetition, but the mechanics lien is not perfected until postpetition, the debtor was not obligated under section 365(d)(3) to satisfy the lien. However, when judgment was sought from the landlord on the lien, the landlord's costs and loss were incurred postpetition, and the debtor was required to pay those fees. See also *In re BH S&B Holdings LLC*, 61 C.B.C.2d 662, 401 B.R. 96 (Bankr. S.D.N.Y. 2009) (in which the court used the same analysis, but reached a different conclusion based upon New York, rather than Arizona, mechanic's lien law).

(n51)Footnote 43c. See P 3.02 *infra* for a discussion of *Nostas Associates/Products v. Constich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996), which advocated the deferral of the assumption-rejection election until the prospects of a chapter 11 confirmation became clear.

(n52)Footnote 43d. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994).

(n53)Footnote 43e. According to the legislative history, the added language to section 363(e) was intended to "clarify that the lessor's interest is subject to 'adequate protection.'" 140 Cong. Rec. H10,769 (Oct. 4, 1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n54)Footnote 43f. See *In re Ernst Home Ctr., Inc.*, 209 B.R. 955 (Bankr. W.D. Wash. 1997), in which the debtor argued that the 1994 Amendments to section 363(e) of the Code demonstrated that real property lessors were not entitled to adequate protection. The amendment added to section 363(e) language providing that "This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362)." The debtor argued that inasmuch as this language did not cover unexpired leases of real property, the lessors thereunder were not entitled to adequate protection. The court, in rejecting this argument, found that the 1994 Amendments relating to personal property leases addressed specific concerns of personal property lessors and had no bearing on the rights of real property lessors. 209 B.R. at 965. The court held that lessors under unexpired leases of real property had the right under the Code to apply for adequate protection, stating: "The right to receive timely payments under Section 365(d)(3) would certainly be a hollow right if the debtor had no possibility of ever making those payments and the landlord was required to wait until the debtor's default before I could enforce that right." 209 B.R. at 965-66. The court in *In re P.J. Clarke's Rest. Corp.*, 265 B.R. 392 (Bankr. S.D.N.Y. 2001), held that a landlord under a below-market real estate lease was not entitled to adequate protection payments in excess of the rent reserved in the lease. The landlord was not entitled to compensation for lost opportunity costs. 265 B.R. at 406-07, discussing *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988). Thus, the court did not hold that a landlord was not entitled to obtain relief from the automatic stay if a debtor/tenant could not provide adequate protection, only that adequate protection was to be measured by the provisions of the lease. See also *In re Mr. Gatti's*, 164 B.R. 929, 946 (Bankr. W.D. Tex. 1994) (the enactment of section 365(d)(3) abrogated any argument against the entitlement of a landlord to adequate protection); *In re MS Freight Distribution*, 172 B.R. 976, 980 (Bankr. W.D. Wash. 1994) (landlord's right to be kept current on postpetition obligations is entitled to adequate protection).

(n55)Footnote 44. See *Rutland Indus. Dev. Corp. v. Kors, Inc. (In re Kors, Inc.)*, 5 C.B.C.2d 872, 13 B.R. 683 (Bankr. D. Vt. 1981); see also *In re Griggsby*, 404 B.R. 83 (Bankr. S.D.N.Y. 2009).

(n56)Footnote 45. *In re Great Scott Food Market, Inc.*, (Bankr. D.R.I. 1979).

(n57)Footnote 46. See *In re Fontainebleau Hotel Corp.*, 515 F.2d 913, 916 (5th Cir. 1975).

(n58)Footnote 47. In each of *In re W.T. Grant Co.*, Arrangement No. 75 B 1735 (S.D.N.Y., filed October 1975), and *In re J.M. Fields, Inc., Food Fair, Inc.*, Arrangement Nos. 78 B 1764-73 (S.D.N.Y., filed October 1978), both of which were filed under the former Bankruptcy Act, the debtor in possession operated a substantial number of retail stores and sought to assign the leases of stores no longer useful in the company's operations. In each case, the court permitted the debtor in possession to retain the leaseholds of the stores slated for disposition as long as use and occupancy payments were being made and until the debtor in possession advised the court that its efforts to market a particular leasehold had been unsuccessful.

(n59)Footnote 48. See note 47 *supra*.

(n60)Footnote 49. *In re Rocchio*, 125 B.R. 345 (Bankr. D. R.I. 1991); *Rutland Indus. Dev. Corp. v. Kors, Inc. (In re Kors, Inc.)*, 5 C.B.C.2d 872, 13 B.R. 683 (Bankr. D. Vt. 1981); *Second & E St., N.E., Assocs. v. Aries Enter., Ltd. (In re Aries Enter., Ltd.)*, 1 C.B.C.2d 1069, 3 B.R. 472 (Bankr. D.D.C. 1980); *In re Future Growth Enter., Inc.*, 14

C.B.C.2d 1410, 61 B.R. 469 (Bankr. E.D. Pa. 1986) .

(n61)Footnote 50. *In re GSVC Rest. Corp.*, 1 *C.B.C.2d* 727, 3 *B.R.* 491 (*Bankr. S.D.N.Y.*), *aff'd*, 1 *C.B.C.2d* 991, 10 *B.R.* 300 (*S.D.N.Y.* 1980) .

(n62)Footnote 50a. *See In re Ernst Home Ctr., Inc.*, 209 *B.R.* 955 (*Bankr. W.D. Wash.* 1997) , in which the landlord group failed to demonstrate administrative insolvency.

(n63)Footnote 50b. *In re Eclair Bakery, Ltd.*, 255 *B.R.* 121 (*Bankr. S.D.N.Y.* 2000) .

(n64)Footnote 51. *Executive Square Office Bldg. v. O'Connor & Assocs.*, 9 *B.C.D.* 35 (*Bankr. N.D. Fla.* 1981) . For a discussion of the procedural steps available to a landlord in seeking to terminate a lease, *see* P 3.01[3][b][iii] *infra*.

(n65)Footnote 51a. *In re Turner*, 326 *B.R.* 563 (*Bankr. W.D. Pa.* 2005) .

(n66)Footnote 52. *E.g.*, *Midwest Holding #7, LLC v. Anderson*, 59 *C.B.C.2d* 1191, 387 *B.R.* 892 (*N.D. Ga.* 2008) , *aff'd*, *In re Tanner Family, LLC*, 556 *F.3d* 1194, 61 *C.B.C.2d* 127 (11th Cir. 2009) (fee paid for early termination of lease was paid "for or on account of an antecedent debt," and not avoidable because debt had arisen at time when nonresidential real estate lease was signed); *In re Burch*, 401 *B.R.* 153 (*Bankr. E.D. Pa.* 2008) ; *First Nat'l Bank v. Fidelity Am. Mortgage Co. (In re Fidelity Am. Mortgage Co.)*, 9 *B.C.D.* 22 (*Bankr. E.D. Pa.* 1982) ; *In re Chuck Wagon Bar-B-Que, Inc.*, 7 *B.R.* 92 (*Bankr. D.D.C.* 1980) ; *Omni Int'l, Ltd. v. Mimi's of Atlanta, Inc. (In re Mimi's of Atlanta, Inc.)*, 2 *C.B.C.2d* 805, 5 *B.R.* 623 (*Bankr. N.D. Ga.* 1980) , *aff'd*, 11 *B.R.* 710 (*N.D. Ga.* 1981) .

(n67)Footnote 53. 11 *U.S.C.* § 541.

(n68)Footnote 54. 11 *U.S.C.* § 365(c)(3).

(n69)Footnote 55. 11 *U.S.C.* § 541(b)(2). Section 362(b)(10), which also was added by the 1984 Amendments, renders the section 362(a) automatic stay inapplicable to an act by the lessor of a debtor under a nonresidential real estate lease to obtain possession of the leased premises if the stated term of the lease has expired before the commencement or during the pendency of the debtor-tenant's case. *Erickson v. Polk*, 921 *F.2d* 200 (8th Cir. 1990) . The court in *In re West Pine Constr. Co.*, 80 *B.R.* 315 (*Bankr. E.D. Pa.* 1987) , held that section 362(b)(10) applies to leases that are terminated by reason of a tenant default as well as to leases that have reached their scheduled expiration date. 80 *B.R.* 315, 319 .

(n70)Footnote 55a. 11 *U.S.C.* § 362(b)(10). Some courts have held that section 362(b)(10) applies both to leases that have terminated by the passage of the stated end date in the lease as well as leases that have terminated because of a default followed by an accelerated termination. *In re Policy Realty Corp.*, 42 *C.B.C.2d* 876, 242 *B.R.* 121 (*S.D. N.Y.* 1999) , *aff'd*, 2000 U.S. App. LEXIS 8846 (2d Cir. May 2, 2000) ; *In re Southcoast Express, Inc.*, 337 *B.R.* 739 (*Bankr. D. Mass.* 2006) .

(n71)Footnote 55b. *See, e.g.*, 11 *U.S.C.* § 362(k) (providing for actual and punitive damages in the case of an individual injured by any willful violation of the automatic stay).

(n72)Footnote 56. *Robinson v. Chicago Hous. Auth.*, 54 *F.3d* 316 (7th Cir. 1995) ; *In re Griggsby*, 404 *B.R.* 83 (*Bankr. S.D.N.Y.* 2009) ; *In re Southcoast Express, Inc.*, 337 *B.R.* 739 (*Bankr. D. Mass.* 2006) ; *In re DiCamillo*, 206 *B.R.* 64 (*Bankr. D.N.J.* 1997) ; *In re Joker Enters.*, 35 *C.B.C.* 2d (MB) 195 (*Bankr. S.D.N.Y.* 1995) ; *EBG Midtown S. Corp. v. McLaren/Hart Env't Eng' Corp. (In re Sanshoe Worldwide Corp.)*, 139 *B.R.* 585 (*S.D.N.Y.* 1992) ; *In re Williams*, 201 *B.R.* 948, 952 (*Bankr. N.D. Ill.* 1996) ; *In re Telephonics, Inc.*, 85 *B.R.* 312, 316 (*Bankr. E.D. Pa.* 1988) ; *In re Camera*, 26 *B.R.* 587 (*Bankr. S.D.N.Y.* 1983) ; *Executive Square Office Bldg. v. O'Connor & Assocs.*, 9 *B.C.D.* 35 (*Bankr. N.D. Fla.* 1981) ; *In re R. R. S.*, 7 *B.R.* 870 (*Bankr. M.D. Fla.* 1980) ; *In re Final Touch Boutique, Inc.*, 6 *B.R.*

803 (Bankr. S.D. Fla. 1980) ; *In re Hospitality Associates, Inc.*, 6 B.R. 778 (Bankr. D. Or. 1980) ; *In re Richards Pontiac, Inc.*, 6 B.R. 773 (Bankr. E.D.N.Y. 1980) ; *In re GSVC Rest. Corp.*, 1 C.B.C.2d 727, 3 B.R. 491 (Bankr. S.D.N.Y. 1980) , *aff'd*, 10 B.R. 300, 1 C.B.C.2d 991 (S.D.N.Y. 1980) ; *Omni Int'l, Ltd. v. Mimi's of Atlanta, Inc. (In re Mimi's of Atlanta, Inc.)*, 2 C.B.C.2d 805, 5 B.R. 623 (Bankr. N.D. Ga. 1980) , *aff'd*, 11 B.R. 710 (N.D. Ga. 1981) ; cf. *Butner v. U.S.*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979). *Contra In re Land Mgmt., Inc.*, 14 B.R. 607 (Bankr. D.P.R. 1981) (lease that was "technically terminated" could be assumed through application of equitable power of the court).

(n73)Footnote 57. *In re GSVC Rest. Corp.*, 1 C.B.C.2d 727, 3 B.R. 491 (Bankr. S.D.N.Y. 1980) , *aff'd*, 1 C.B.C.2d 991, 10 B.R. 300 (S.D.N.Y. 1980) .

(n74)Footnote 58. *In re Richards Pontiac, Inc.* 6 B.R. 773 (Bankr. E.D.N.Y. 1980) . If the warrant of eviction has not been executed, the tenant's trustee may seek a state court order vacating the warrant. If successful, the trustee may thereafter assume the lease under section 365(a) of the Code. *In re W.A.S. Food Serv. Corp.*, 12 C.B.C.2d 1371, 49 B.R. 969 (Bankr. S.D.N.Y. 1985) ; *In re Onio's Italian Rest. Corp.*, 42 B.R. 319 (Bankr. S.D.N.Y. 1984) .

(n75)Footnote 58a. See, e.g., *In re Joker Enters.*, 35 C.B.C. 2d (MB) 195 (Bankr. S.D.N.Y. 1995) ; *In re Issa Corp.*, 142 B.R. 75 (Bankr. S.D.N.Y. 1992) ; and cases cited in note 58 *supra*; see also *In re Reinhardt*, 209 B.R. 183 (Bankr. S.D.N.Y. 1997) (describing New York practice and related bankruptcy issues).

(n76)Footnote 58b. 46 C.B.C.2d 1357, 265 B.R. 392 (Bankr. S.D.N.Y. 2001) .

(n77)Footnote 59. *In re R. R. S., Inc.*, 7 B.R. 870 (Bankr. M.D. Fla. 1980) .

(n78)Footnote 60. *Executive Square Office Bldg. v. O'Connor & Assocs.*, 19 B.R. 143 (Bankr. N.D. Fla. 1981) ; see also *In re Truffles, Inc.*, 30 B.R. 666 (Bankr. M.D. Fla. 1983) . Examples of refusals to permit lease terminations based upon a "scintilla" of interest remaining in the debtor-tenant under state law are provided in *In re Diamond Head, Inc.*, 51 B.R. 309 (Bankr. D.C. 1985) , and in *Lebanon Hous. Auth. v. Shannon (In re Shannon)*, 54 B.R. 219 (Bankr. M.D. Tenn. 1985) . One court, however, refused to prevent a lease termination because, among other reasons, the debtor-tenant did not have the wherewithal to exercise whatever redemption rights it may have had. *In re Norwood Aviation, Inc.*, 47 B.R. 155 (Bankr. D. Mass. 1985) , *aff'd*, 63 B.R. 68 (1986) . The court in *In re Studebaker's of Ft. Lauderdale, Ltd.*, 73 B.R. 217 (Bankr. N.D. Fla. 1987) , refused to find any leasehold or other property interest to restore following a valid state law prepetition lease termination and vacation of possession.

(n79)Footnote 61. *Omni Int'l, Ltd. v. Mimi's of Atlanta, Inc. (In re Mimi's of Atlanta, Inc.)*, 2 C.B.C.2d 805, 5 B.R. 623 (Bankr. N.D. Ga. 1980) , *aff'd*, 11 B.R. 710 (N.D. Ga. 1981) .

(n80)Footnote 62. *In re Tenfield, Inc.*, 12 B.R. 12, 13 (Bankr. E.D. Va. 1981) ; see also *In re Nasir*, 217 B.R. 995 (Bankr. E.D. Va. 1997) (warrant of eviction issued prepetition and mere possessory interest of tenant constituted cause for relief from stay).

(n81)Footnote 62a. *In re T.A.C. Group, Inc.*, 294 B.R. 199 (Bankr. D. Mass. 2003) . The court determined that the lease provision concerning the tenant's removal of goods from the premises outside the ordinary course, which entitled the landlord to immediate termination, was not triggered by a going out of business sale on the premises. 294 B.R. at 202-03 .

(n82)Footnote 63. 10 B.R. 585 (Bankr. N.D.N.Y. 1981) .

(n83)Footnote 63a. Other examples of a bankruptcy court's interpreting state anti-forfeiture provisions are provided by *In re Windmill Farms, Inc.*, 841 F.2d 1467 (9th Cir. 1988) (remand to determine whether state law contained any anti-forfeiture provisions notwithstanding the prepetition determination of the lease), and *In re Waterkist Corp.*, 775 F.2d 1089 (9th Cir. 1985) (determining that the state court would consider the equities of the case in order to avoid a

forfeiture notwithstanding the termination of the lease in accordance with state law).

(n84)Footnote 64. 4A Collier on Bankruptcy, P 70.44[3] notes 9, 10 (Matthew Bender 14th ed. 1978); *see also* 3 Collier on Bankruptcy, P 365.07 (Matthew Bender 15th Ed. Revised).

(n85)Footnote 65. 4A Collier on Bankruptcy, P 70.44[3] n.13 (Matthew Bender 14th ed. 1978).

(n86)Footnote 66. *Speare v. Consol. Assets Corp. (In re Speare)*, 360 F.2d 882 (2d Cir. 1966) ; *In re Fleetwood Motel Corp.*, 335 F.2d 857 (3d Cir. 1964) .

(n87)Footnote 67. *Queens Blvd. Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974) .

(n88)Footnote 68. 4 B.R. 730 (Bankr. S.D.N.Y. 1980) .

(n89)Footnote 69. 4 B.R. 730, 734 .

(n90)Footnote 70. 100 U.S. 578, 25 L. Ed. 618 (1880) .

(n91)Footnote 71. *In re Bronx-Westchester Mack Corp.*, 4 B.R. 730, 734 (Bankr. S.D.N.Y. 1980) . A similar holding was rendered in *In re Gordon Car & Truck Rental, Inc.*, 59 B.R. 956 (Bankr. N.D.N.Y. 1985) , in which the court found enforceable a prepetition insolvency default clause in a license agreement but held that the licensor's postdefault course of dealing constituted a waiver. *See In re Telephonics, Inc.*, 85 B.R. 312, 317-18 (Bankr. E.D. Pa. 1988) ; *cf. In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982) , and additional cases cited at P 4.01[1] note 1 *infra* , with respect to the bankruptcy court's power to recharacterize a mortgage or executory contract in order to effect a result under the Bankruptcy Code. *See also In re J.F. Hink & Son*, 815 F.2d 1314 (9th Cir. 1987) (waiver by assignee of lease to assert rights under section 365(f)(3)). *But cf. In re FCX, Inc.*, 853 F.2d 1149 (4th Cir. 1988) , *cert. denied*, 489 U.S. 1011, 109 S. Ct. 1118, 103 L. Ed. 2d 181 (1989) (debtor's rights in property are established by state law and are not altered by Bankruptcy Code proceeding).

(n92)Footnote 72. 1 C.B.C.2d 727, 3 B.R. 491 (Bankr. S.D.N.Y. 1980) , *aff'd*, 1 C.B.C.2d 991, 10 B.R. 300 (S.D.N.Y. 1980) .

(n93)Footnote 73. 1 C.B.C.2d 727, 730, 3 B.R. 491, 494 .

(n94)Footnote 74. 10 B.R. 300, 306, 1 C.B.C.2d 991, 993 . A debtor-tenant under a residential lease subject to the New York City rent control laws was found to have a post-termination possessory interest entitled to the protections of the automatic stay in 332-4 W. 47th st. Assocs., L.P. (*In re Muniz*), 1999 U.S. Dist. LEXIS 4060 (S.D.N.Y. 1999) . The court in *In re P.J. Clarke's Rest. Corp.*, 265 B.R. 392, 398-99 (Bankr. S.D.N.Y. 2001) , held that a debtor/tenant continues to hold an interest in a lease that had been declared terminated by a state court inasmuch as the state court decision was on appeal and could be overturned.

(n95)Footnote 74a. Under this theory, the bankruptcy court would look within the four corners of the lease to evaluate the propriety of a prepetition termination and, if it finds the termination to have been in violation of the lease, nullify the termination rather than simply leave the tenant with a damages remedy for wrongful termination. *In re T.A.C. Group, Inc.*, 294 B.R. 199 (Bankr. D. Mass. 2003) , discussed note 62a *supra*.

(n96)Footnote 75. In *In re National Shoes, Inc.*, 20 B.R. 51 (Bankr. S.D.N.Y. 1982) , the court reinstated a lease properly terminated under state law prior to the filing of the petition in view of the adverse consequences to the debtor and a potential windfall to the landlord. *See also* cases cited at P 3.01[3][a] note 58 *supra* . The issue is discussed in detail in *In re Telephonics, Inc.*, 85 B.R. 312 (Bankr. E.D. Pa. 1988) .

(n97)Footnote 75a. *See In re Family Showtime Theatres, Inc.*, 72 B.R. 38 (E.D.N.Y.) , *aff'd without op.*, 819 F.2d 1130 (2d Cir. 1987) (postdefault acceptance of rent with nonwaiver letter preserves landlord's rights).

(n98)Footnote 75b. *See, e.g., In re St. Casimir Development Corp.*, 358 B.R. 24 (S.D.N.Y. 2007) (permitting debtor's assumption of partnership agreement where notice of termination of interest was not served exactly in accordance with agreement).

(n99)Footnote 76. 11 U.S.C. § 365(a).

(n100)Footnote 77. 11 U.S.C. § 502(b)(6); *see P 3.03[2] infra*.

(n101)Footnote 78. 11 U.S.C. § 503(b)(7).

(n102)Footnote 78a. *Id.*

(n103)Footnote 78b. *Id.*

(n104)Footnote 78c. 11 U.S.C. § 503(b)(7), added by Pub. L. No. 109-8, § 445 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n105)Footnote 78d. *See, e.g., Nostas Assocs. v. Costich (In re Klein Sleep Prods. Inc.)*, 78 F.3d 18, 24 (2d. Cir. 1996) . *In re City Stores Co.*, 21 B.R. 809 (Bankr. S.D.N.Y. 1982) .

(n106)Footnote 78e. *See, e.g., In re Merry-Go-Round Enters., Inc.*, 180 F.3d 149, 158 (3d Cir. 1999) ; *Nostas Assocs. v. Costich (In re Klein Sleep Prods. Inc.)*, 78 F.3d 18, 29 (2d. Cir. 1996) ; *In re City Stores Co.*, 21 B.R. 809 (Bankr. S.D.N.Y. 1982) .

(n107)Footnote 79. 11 U.S.C. § 503(b)(7).

(n108)Footnote 80. 11 U.S.C. § 365(b)(1).

(n109)Footnote 81. 11 U.S.C. § 365(b)(2). The term "custodian" is defined at 11 U.S.C. § 101(11). The language of section 365(b)(2)(D) had engendered holdings to the effect that nonmonetary defaults under leases and executory contracts need not be cured as a condition to assumption. *See In re GP Express Airlines*, 200 B.R. 222, 233 (Bankr. D. Neb. 1996) ; *In re Claremont Acquisition Corp.*, 186 B.R. 977 (C.D. Cal. 1995) , *aff'd*, 113 F.3d 1029 (9th Cir. 1997) . It appears that section 365(b)(2)(D) was originally intended to apply to penalty rate provisions relating to nonmonetary defaults themselves. *See P 3.01[5][b][iii] infra*. This interpretation was confirmed by an amendment to the section under the 2005 Act which inserted the word "penalty" before the word "provision." Pub. L. No. 109-8, § 328, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n110)Footnote 82. 11 U.S.C. § 365(b)(3); *see P 3.01[6] infra*.

(n111)Footnote 83. 11 U.S.C. § 365(c). *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) , held that the debtor's Washington, D.C., airport facility lease could not be assumed and assigned absent approval of the lessee by the FAA as required by the Washington Airport Act. The court stated that the section 365(c) exception was not limited to relationships in the nature of personal services. 700 F.2d 935, 943, 8 C.B.C.2d 522, 530 . *Braniff* was followed in *In re Nitec Paper Corp.*, 11 C.B.C.2d 959, 43 B.R. 492 (S.D.N.Y. 1984) . *See also In re Catron*, 158 B.R. 629 (E.D. Va. 1993) , *aff'd*, 25 F.3d 1038 (1994) (debtor general partner could not assume partnership agreement because of provisions of Uniform Partnership Act that prohibit person from becoming member of a partnership without the consent of all partners). *But see In re Fulton Air Service, Inc.*, 34 B.R. 568 (Bankr. N.D. Ga. 1983) . *In re Federated Dep't Stores, Inc.*, 24 C.B.C.2d 1311, 126 B.R. 516 (Bankr. S.D. Ohio 1990) , holds, in the context of a proposed assignment of a shopping center lease, that the provisions of the Texas Code prohibiting subletting without landlord consent is not the type of "applicable law" that is enforceable under section 365(c); *accord In re Lil' Things*, (Bankr. N.D. Texas, May 21, 1998) ; *cf. In re Compass Van & Storage Corp.*, 65 B.R. 1007 (Bankr. E.D.N.Y. 1986) (agency contract with national van line is not a personal service contract under section 365(c)); *In re Alltech Plastics, Inc.*, 71 B.R. 686

(*Bankr. W.D. Tenn. 1987*) (patent license agreement is personal in nature and not assignable). Section 365(c)(2) also renders nonassumable a contract to make a loan or other debt financing or financial accommodations to or for the benefit of a debtor. Authority is divided concerning whether a tenant's trustee may assume a lease under which the landlord is obligated to expend funds to improve or repair the leased premises. *In re Postle Enterprises, Inc.*, 48 B.R. 721 (*Bankr. D. Ariz. 1985*) (section 365(c) applicable); *In re United Press Int'l, Inc.*, 55 B.R. 63 (*Bankr. D.C. 1985*) (section 365(c) inapplicable). A percentage rent lease has been held not to constitute an agreement for financial accommodation for the benefit of the debtor-tenant. *In re Peaches Records & Tapes, Inc.*, 51 B.R. 583 (B.A.P. 9th Cir. 1985). It appears that the "financial accommodation" exception in section 365(c)(2) will be narrowly read as applicable solely to actual loan, line of credit and guaranty transactions. *In re Wills Travel Serv., Inc.*, 72 B.R. 380, 382 (*Bankr. M.D. Fla. 1987*); *In re Adana Mortgage Bankers, Inc.*, 12 B.R. 977 (*Bankr. N.D. Ga. 1980*).

(n112)Footnote 84. 11 U.S.C. § 365(d)(4). The legislative history makes clear that the amendment was intended "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected." See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-354 (Matthew Bender 15th Ed. Revised).

(n113)Footnote 85. 11 U.S.C. § 365(d)(1).

It appears that residential real estate leases seldom come into "play" as a disposable asset in Bankruptcy Code cases. These leases usually relate to the sole residence of individual debtors, and may be viewed as a type of exempt property. *But see In re Bonita Glen II*, 152 B.R. 751 (*Bankr. S.D. Cal. 1993*) (ground lease for land on which debtor later built apartment building was a lease of residential real property).

(n114)Footnote 86. 11 U.S.C. § 365(d)(2).

(n115)Footnote 87. *Id.*

(n116)Footnote 88. See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499, 9 C.B.C.2d 1219, 1232-33 (1984).

(n117)Footnote 89. 11 U.S.C. § 365(b)(1).

(n118)Footnote 90. 11 U.S.C. § 365(b)(1).

(n119)Footnote 91. 11 U.S.C. §§ 365(g) and 502(g).

(n120)Footnote 92. 11 U.S.C. § 502(g).

(n121)Footnote 93. *In re Lane Foods, Inc.*, 213 F. Supp. 133 (S.D.N.Y. 1963); cf. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219 (1984).

(n122)Footnote 94. 11 U.S.C. § 365(d)(3); see P 3.01[3][i][B] *infra*.

(n123)Footnote 94a. 11 U.S.C. § 365(d)(3). There is a similar provision in the Bankruptcy Code relating to leases of personal property, which was added by the Bankruptcy Reform Act of 1994. See 11 U.S.C. § 365(d)(10).

(n124)Footnote 95. See 4A Collier on Bankruptcy, P 70.44[4] (Matthew Bender 14th ed. 1978); 3 Collier on Bankruptcy, P 365.04[7][a] (Matthew Bender 15th Ed. Revised); cf. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219, (1984).

(n125)Footnote 96. *Philadelphia Co. v. Dipple*, 312 U.S. 168, 61 S. Ct. 538, 85 L. Ed. 651 (1941).

(n126)Footnote 97. *Rutland Indus. Dev. Corp. v. Kors, Inc. (In re Kors, Inc.)*, 5 C.B.C.2d 872, 13 B.R. 683

(Bankr. D. Vt. 1981) ; see P 3.01[3][i][B] *infra*.

(n127)Footnote 98. Cf. *In re Leon's Casuals Co., Inc.*, 122 B.R. 768 (Bankr. S.D. Ala. 1990) ; *In re City Stores Co.*, 21 B.R. 809 (Bankr. S.D.N.Y. 1982) ; *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499, 9 C.B.C.2d 1219, 1232-33 (1984) .

(n128)Footnote 99. 11 U.S.C. § 108(b).

(n129)Footnote 100. See P 3.01[2][a] *supra*.

(n130)Footnote 101. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 11 C.B.C.2d 1 (7th Cir.) , cert. denied, 469 U.S. 982, 105 S. Ct. 386, 83 L. Ed. 2d 321 (1984) ; *In re Round Hill Travel, Inc.*, (Bankr. D. Nev. 1985) . Under section 365(d)(3), the debtor-tenant under a nonresidential real estate lease must timely perform the obligations provided for in the lease arising after the date of entry of the order for relief. Pursuant to the same section, the court may grant a grace period with respect to obligations that arise within 60 days of the order for relief, but such grace period may not extend beyond such 60-day period. The 60-day grace period provided for in section 108(b) automatically extends the time for performance of prepetition breaches that have not ripened into uncurable defaults under the terms of the lease. By contrast, the 60-day grace period provided for in section 365(d)(3) may be granted only by the court upon timely motion by the trustee of the debtor-tenant, and relates solely to lease obligations arising after entry of the order of relief (which is the date of the filing of a voluntary petition (section 301)). *In re Future Growth Enter., Inc.*, 14 C.B.C.2d 1410, 1412-13, 61 B.R. 469, 471 (Bankr. E.D. Pa. 1986) .

(n131)Footnote 101a. Cf. *In re Dunes Casino Hotel*, 63 B.R. 939 (D.N.J. 1986) . However, the trustee of a debtor-tenant cannot circumvent the assumption conditions specified in section 365(b) by purporting to reinstate the lease under section 1124. *In re Offices & Serv. of White Plains Plaza, Inc.* 58 B.R. 441 (Bankr. S.D.N.Y. 1986) .

(n132)Footnote 102. *Id.*

(n133)Footnote 103. See cases cited in note 56 *supra*.

(n134)Footnote 103e. Pub. L. No. 98-353 (1984), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n135)Footnote 103f. Pub. L. No. 109-8, § 404, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n136)Footnote 103f.1. Sen. Rep. No. 98-65, 98th Cong. 1st Sess. 36-38 (1983).

(n137)Footnote 103f.2. 130 Cong. Rec. S8894-95 (daily ed. June 29, 1984).

(n138)Footnote 103g. 11 U.S.C. § 365(a).

(n139)Footnote 103h. See *Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 29 C.B.C.2d 1341 (2d Cir. 1993) (assumption motion is a summary proceeding; sole question for court in considering motion is whether debtor satisfied business judgment standard); *In re 611 Sixth Avenue Corp.*, 191 B.R. 295 (Bankr. S.D.N.Y. 1996) .

(n140)Footnote 103i. *In re Southwest Aircraft Services, Inc.*, 831 F.2d 848 (9th Cir. 1987) , cert. denied, 487 U.S. 1206, 108 S. Ct. 2848, 101 L. Ed. 2d 885 (1988) ; *In re Wedtech Corp.*, 72 B.R. 464 (Bankr. S.D.N.Y. 1987) ; *In re Victoria Station, Inc.*, 16 C.B.C.2d 481, 69 B.R. 110 (B.A.P. 9th Cir. 1986) , *aff'd*, *Turgeon v. Victoria Station, Inc.*, 840 F.2d 682, 18 C.B.C.2d 458 (9th Cir. 1988) (motion made when served by mail); *In re By-Rite Distrib., Inc.*, 14 C.B.C.2d 460, 55 B.R. 740 (D. Utah 1985) ; *In re National Paragon Corp.*, 74 B.R. 180 (E.D. Pa. 1987) ; *In re Musikahn Corp.*, 57 B.R. 938 (Bankr. E.D.N.Y. 1986) ; *In re House of Emeralds, Inc.*, 14 C.B.C.2d 52, 57 B.R. 31

(Bankr. D. Hawaii 1985) ; *In re Chandel Enterprises, Inc.* 64 B.R. 607 (Bankr. C.D. Cal. 1986) ; *In re Burns Fabricating Co.*, 61 B.R. 955 (Bankr. E.D. Mich. 1986) (dictum); *In re Re-Trac Corp.*, 14 C.B.C.2d 782, 59 B.R. 251 (Bankr. D. Minn. 1986) (dictum); *In re Bon Ton Restaurant & Pastry Shop, Inc.*, 13 C.B.C.2d 592, 52 B.R. 850 (Bankr. N.D. Ill. 1985) ; *In re Unit Portions of Del., Inc.*, 13 C.B.C.2d 706, 53 B.R. 83 (Bankr. E.D.N.Y. 1985) .

(n141)Footnote 103j. *In re Communications Co. of Am.*, 65 B.R. 580 (Bankr. M.D. Fla. 1986) ; *In re House of Deals of Broward, Inc.*, 67 B.R. 23 (Bankr. E.D.N.Y. 1986) ; *In re Coastal Indus., Inc.*, 58 B.R. 48 (Bankr. D.N.J. 1986) ; *In re Alba Press, Inc.*, 55 B.R. 127 (Bankr. E.D.N.Y. 1985) ; *In re Flexipak, Inc.*, 49 B.R. 641 (Bankr. S.D.N.Y. 1985) ; *In re Las Margaritas, Inc.*, 54 B.R. 98 (Bankr. D. Nev. 1985) ; cf. *In re Butcher Shop & Deli of Miami, Inc.*, 45 B.R. 239 (Bankr. S.D. Fla. 1984) (former section 365(d)(1)).

(n142)Footnote 103j-1. See *Thompson-Mendez v. St. Charles at Olde Court P'ship, LLC* (*In re Thompson-Mendez*), 321 B.R. 814 (Bankr. D. Md. 2005) ; *In re Henderson*, 245 B.R. 449 (Bankr. S.D.N.Y. 2000) .

(n143)Footnote 103k. *In re Curio Shoppes, Inc.*, 13 C.B.C.2d 1012, 55 B.R. 148 (Bankr. D. Conn. 1985). *Contra In re Swiss Hot Dog Co.* 72 B.R. 569 (D. Colo. 1987) ; see *Magnolia Bluff Factory Shops L.P. v. Federated Food Courts, Inc.* (*In re Federated Food Courts, Inc.*), 222 B.R. 396 (Bankr. N.D. Ga. 1998) (60-day period may not be extended for excusable neglect). A variant of this approach is the redefinition by the court of the transaction as involving a residential real estate lease, thereby rendering section 365(d)(4) inapplicable. *In re Lippman*, 122 B.R. 206 (Bankr. S.D.N.Y. 1990) ; *In re Harrison*, 117 B.R. 570 (Bankr. C.D. Cal. 1990) (automobile repair facility under a lease, dealer agreement, automobile car agreement, warranty agreement and other agreements held outside scope of section 365(d)(4)); *In re Terrace Apartments, Ltd.*, 107 B.R. 382 (Bankr. N.D. Ga. 1989) (lease of entire residential apartment project); cf. *In re Gasoil, Inc.* 59 B.R. 804 (Bankr. N.D. Ohio 1986) (oil and gas lease is lease of real property under section 365(d)(4)).

(n144)Footnote 103l. *In re VMS Nat'l Props.*, 148 B.R. 942 (Bankr. C.D. 1992) ; *In re THW Enters.*, (Bankr. S.D.N.Y. 1988), 89 B.R. 351 ; *In re T.F.P. Res., Inc.*, 13 C.B.C.2d 1345, 56 B.R. 112 (Bankr. S.D.N.Y. 1985) . The adverse consequences of an unintended lease termination under section 365(d)(4) are illustrated in *Charter Asset Corp. v. Victory Markets, Inc.* (*In re Victory Markets, Inc.*), 221 B.R. 298 (B.A.P. 2d Cir. 1998) .

(n145)Footnote 103m. *In re Haute Cuisine, Inc.*, 57 B.R. 200 (Bankr. M.D. Fla. 1986) ; *In re Dulan*, 13 C.B.C.2d 737, 52 B.R. 739 (Bankr. C.D. Cal. 1985) .

(n146)Footnote 103n. 57 B.R. 200, 204 ; see *In re Car-Gill, Inc.*, 21 B.C.D. 766 (Bankr. E.D. Pa. 1991) (lessor stood by while debtor spent \$30,000 on leasehold improvements, and accepted rent payments); *In re Ranch House of Orange-Brevard, Inc.*, 78 B.R. 323 (Bankr. M.D. Fla. 1987) (lessor treated lease as valid until debtor sought to assign); *In re J. Woodson Hays, Inc.*, 69 B.R. 303 (Bankr. M.D. Fla. 1987) (lessor waived right to require formal assumption motion by debtor-tenant).

(n147)Footnote 103n.1. *In re George*, 177 F.3d 885 (9th Cir. 1999) .

(n148)Footnote 103o. *In re DCT, Inc.*, 283 B.R. 442 (Bankr. E.D. Mich. 2002) ; *In re Re-Trac Corp.*, 14 C.B.C.2d 782, 59 B.R. 251 (Bankr. D. Minn. 1986) ; *In re Spats Restaurant & Saloon*, 64 B.R. 442 (Bankr. D. Nev. 1986) ; *In re Chandel Enter., Inc.*, 64 B.R. 607 (Bankr. C.D. Cal. 1986) .

(n149)Footnote 103p. *In re Southwest Aircraft Services, Inc.*, 831 F.2d 848 (9th Cir. 1987) , cert. denied, 487 U.S. 1206, 108 S. Ct. 2848, 101 L. Ed. 2d 885 (1988) ; *In re Travel 2000, Inc.*, 264 B.R. 451 (Bankr. W.D. Mich. 2001) ; *In re Wedtech Corp.*, 72 B.R. 464 (Bankr. S.D.N.Y. 1987) .

(n150)Footnote 103p.1. See, e.g., *In re American Healthcare Mgmt., Inc.*, 900 F.2d 827, 22 C.B.C.2d 1740 (5th Cir. 1990) ; *In re Victoria Station, Inc.*, 875 F.2d 1380, 1385, 21 C.B.C.2d 483, 490 (9th Cir. 1989) ; *Chapman Inv. Assocs. v. American Healthcare Mgmt., Inc.*, 94 B.R. 420 (N.D. Tex. 1989) (further extensions may be granted); *Tigr*

Rest., Inc. v. Rouse S.I. Shopping Ctr., Inc., 79 B.R. 954, B.L.R. P 72,102 (E.D.N.Y. 1987) (same); *In re Coastal Indus., Inc.*, 58 B.R. 48 (Bankr. D.N.J. 1986) (further extension may not be granted).

(n151)Footnote 103p.2. The court in *In re Wedtech Corp.*, 72 B.R. 464 (Bankr. S.D.N.Y. 1987) found ample cause to extend the decision period for a real estate lease to provide time to consider whether the instrument should be characterized as a lease or a financing agreement. Cause to extend also was found in *In re Babylon L.P.*, 16 B.C.D. 445 (Bankr. S.D.N.Y. 1987), in which the decision to assume or reject depended upon the outcome of third party litigation concerning the permitted use of the premises. Cause to extend was also found in *In re THW Enters.*, 89 B.R. 351 (Bankr. S.D.N.Y. 1988) notwithstanding the debtor's mounting losses.

(n152)Footnote 103p.3. See, e.g., *Legacy, Ltd. v. Channel Home Ctrs., Inc. (In re Channel Home Ctrs., Inc.)*, 989 F.2d 682 (3d Cir.), cert. denied, 510 U.S. 865, 114 S. Ct. 184, 126 L.Ed.2d 143 (1993); *In re American Healthcare Mgmt., Inc.*, 900 F.2d 827, 22 C.B.C.2d 1740 (5th Cir. 1990); *In re Circle K Corp.*, 24 C.B.C.2d 917, 121 B.R. 257 (D. Ariz. 1990). Examples of such cases include *In re R.H. Macy & Co.*, Case No. 92-B-40477 (BRL) (Bankr. S.D.N.Y. March 20, 1992) and *In re Best Prods. Co., Inc.*, 91 B 1004 8-10053 (TLB) (Bankr. S.D.N.Y. Feb. 26, 1991). In *Net Realty Holding Trust v. R.H. Macy & Co., Inc. (In re R.H. Macy & Co., Inc.)*, 1992 U.S. Dist. LEXIS 16505 (S.D.N.Y. 1992), the court found an extension of the 60-day period to be appropriate, but directed that a specific date for the expiration of the extension be established in lieu of an open-ended extension.

(n153)Footnote 103q. See P 3.58 *infra*.

(n154)Footnote 103q.1. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-354 (Matthew Bender 15th Ed. Revised).

(n155)Footnote 103q.2. 348 B.R. 699 (Bankr. D.S.C. 2006). This published decision was rendered in the context of denying the debtor's motion for a stay pending appeal of an earlier decision ordering the rejection of the lease. That earlier decision, rendered on substantially the same grounds, is published at 362 B.R. 243.

(n156)Footnote 103q.3. 348 B.R. 699, 708-09 (citing legislative history).

(n157)Footnote 103q.4. 348 B.R. 699, 710.

(n158)Footnote 103r. 11 U.S.C. § 365(d)(4). The surrender requirement was continued in the statute, as amended by the 2005 Act.

(n159)Footnote 103s. *In re Criadores de Yabucoa, Inc.*, 75 B.R. 96 (Bankr. D.P.R. 1987) (immediate surrender ordered); *In re Adams*, 65 B.R. 646 (Bankr. E.D. Pa. 1986); *In re Communications Co. of Am.*, 65 B.R. 580 (Bankr. M.D. Fla. 1986); cf. *In re Grant Broad. of Philadelphia, Inc.*, 16 C.B.C.2d 1116, 71 B.R. 891 (Bankr. E.D. Pa. 1987). But see *In re Knight*, 3 C.B.C.2d 742, 8 B.R. 925 (Bankr. D. Md. 1981). It may be argued that rejection of a lease renders the leasehold no longer property of the estate and therefore outside the protections of the automatic stay under section 362(c)(1) of the Code. However, section 362(a)(3) proscribes acts to obtain possession of property from the estate as well as acts to obtain possession of property of the estate, and therefore the automatic stay may be deemed to protect a debtor-tenant's possessory interests even after a lease rejection if the postrejection surrender provision of section 365(d)(4) is not given effect. See *In re Boston Bus. Machs.*, 87 B.R. 867 (Bankr. E.D. Pa. 1988). But see *Cuffee v. Atlantic Bus. Cmty. Dev. Corp. (In re Atlantic Bus. & Cmty. Dev. Corp.)*, 901 F.2d 325 (7th Cir. 1995).

(n160)Footnote 103t. See, e.g., *Thinking Machs. v. Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.)*, 67 F.3d 1021 (3d Cir. 1995); *In re 1 Potato 2*, 182 B.R. 540 (Bankr. D. Minn. 1995); *Paul Harris Stores, Inc. v. Mabel L. Slater Realty Trust*, 148 B.R. 307 (S.D. Ind. 1992); *In re Four Star Pizza, Inc.*, 135 B.R. 498 (Bankr. W.D. Pa. 1992); *In re Federated Dep't Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991); *In re Revco D.S., Inc.*, 109 B.R. 264 (Bankr. N.D. Ohio 1989); see also *In re Jamesway Corp.*, 179 B.R. 33, 38 (S.D.N.Y. 1995) (authorizing rejection as of the date the bankruptcy court would have approved rejection but for delay caused by improper objection by landlord).

(n161)Footnote 103t.1. *In re Amber Stores, Inc.*, 193 B.R. 819, 826 (Bankr. N.D. Tex. 1996) .

(n162)Footnote 103u. See, e.g., *In re At Home Corp.*, 292 B.R. 195 (N.D. Cal. 2003) ; *In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992) ; *In re Carlisle Homes, Inc.*, 103 B.R. 524 (Bankr. D.N.J. 1988) .

(n163)Footnote 103u.1. *In re O'Neil Theatres*, 257 B.R. 806 (Bankr. E.D. La 2000) .

(n164)Footnote 103u.2. *In re BH S&B Holdings LLC*, 61 C.B.C.2d 662, 401 B.R. 96 (Bankr. S.D.N.Y. 2009) ; *In re Designer Doors, Inc.*, 389 B.R. 832 (Bankr. D. Ariz. 2008) ; *In re Pac-West Telecomm, Inc.*, 377 B.R. 119 (Bankr. D. Del 2007) .

(n165)Footnote 103v. *In re Wedtech Corp.*, 72 B.R. 464 (Bankr. S.D.N.Y. 1987) ; *In re Westview 74th St. Drug Corp.*, 14 C.B.C.2d 909, 59 B.R. 747 (Bankr. S.D.N.Y. 1986) ; *In re Musikahn Corp.*, 14 C.B.C.2d 314, 57 B.R. 942, 945 n.4 (Bankr. E.D.N.Y. 1986) .

(n166)Footnote 103w. *In re Tammey Jewels, Inc.*, 116 B.R. 292 (Bankr. M.D. Fla. 1990) . The *Tammey Jewels* court stated that in its view the proper remedy for a landlord that is not being paid in accordance with section 365(d)(3) is to seek an order directing that the debtor pay rent or to move for relief from the stay in order to evict the nonpaying tenant. 116 B.R. 292, 294 ; see also *In re Orvco, Inc.*, 95 B.R. 724, 728 (B.A.P. 9th Cir. 1989) and *In re Pacific-Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994) .

(n167)Footnote 103x. *In re Handy Andy Home Improvement Ctrs*, 144 F.3d 1125 (7th Cir. 1998) ; *Omni Partners, L.P. v. Pudgie's Dev. of N.Y., Inc. (In re Pudgie's Dev. of N.Y., Inc.)*, 239 B.R. 688, 692 (S.D.N.Y. 2000) ; *Towers v. Chickering & Gregory (In re Pacific-Atlantic Trading Co.)*, 27 F.3d 401 (9th Cir. 1994) .

(n168)Footnote 103y. *In re Longua*, 58 B.R. 503 (Bankr. W.D. Wis. 1986) ; cf. *In re TDC Devel. Corp.*, 73 B.R. 135 (Bankr. N.D. Tex. 1987) (prompt postfiling vacation of premises without express lease rejection does not affect debtor's section 365(d)(3) payment obligations for the 60-day period following entry of order for relief). *Contra Second Pennsylvania Real Estate Corp. v. Papercraft Corp. (In re Papercraft Corp.)*, 126 B.R. 926 (Bankr. W.D. Pa. 1991) ; *In re Cardinal Indus., Inc.*, 109 B.R. 738 (Bankr. E.D. Ohio 1989) .

(n169)Footnote 103z. *In re Food City, Inc.*, 20 C.B.C.2d 680, 95 B.R. 451 (Bankr. W.D. Tex. 1988) .

(n170)Footnote 104. *In re Handy Andy Home Improvement Ctrs*, 144 F.3d 1125 (7th Cir. 1998) ; *Omni Partners, L.P. v. Pudgie's Dev. of N.Y., Inc. (In re Pudgie's Dev. of N.Y., Inc.)*, 239 B.R. 688, 692 (S.D.N.Y. 2000) ; *Towers v. Chickering & Gregory (In re Pacific-Atlantic Trading Co.)*, 27 F.3d 401 (9th Cir. 1994) (overruling *In re Orvco, Inc.*, 95 B.R. 724 (B.A.P. 9th Cir. 1989) ; *In re Amber Stores, Inc.*, 35 C.B.C.2d 896, 904-05, 193 B.R. 819, 824 (Bankr. N.D. Tex. 1996) ; *In re Slim Life Weight Loss Ctrs. Corp.*, 33 C.B.C.2d 1182, 182 B.R. 701 (Bankr. D.N.J. 1995) ; *In re Worths Stores Corp.*, 135 B.R. 112 (Bankr. E.D. Mass. 1991) . The court in *Cukierman v. Uecker (In re Cukierman)*, 265 F.3d 846 (9th Cir. 2001) , held that payments under a real estate lease denominated as "further rent," but admittedly intended as a repayment of a debt from the tenant to the landlord, constituted postpetition, administrative expense obligations pursuant to section 365(d)(3). The provision in the lease for payment of landlord's attorney's fees for enforcement was deemed not to give rise to administrative expense status because the fees were incurred after the rejection of the lease. The landlord's request for administrative expense status for interest on the debtor/tenant's unpaid obligations arising in the postpetition period was denied on the grounds that the landlord's claim for interest was based on the applicable state statute and was not an obligation arising under the lease.

(n171)Footnote 104a. *In re Bryant Universal Roofing, Inc.*, 218 B.R. 948, 953 (Bankr. D. Ariz. 1998) ; *In re Rare Coin Galleries, Inc.*, 72 B.R. 415 (D. Mass. 1987) ; cf. *In re Sullivan Machinery Co.*, 79 B.R. 523 (Bankr. D. Conn. 1987) . *In re Orvco, Inc.*, 95 B.R. 724 (B.A.P. 9th Cir. 1989) , holds that section 365(d)(3) payments have administrative priority status *pro rata* with all other regular administrative claims and that payments on account of post-rejection possession are to reflect the reasonable value of the premises to the estate. The court in *In re Four Star*

Pizza, Inc., 135 B.R. 498 (Bankr. W.D. Pa. 1992) , stated that the section 365(d)(3) claim is to be paid immediately unless substantial doubt exists as to the availability of funds to pay all administrative costs. 135 B.R. 498, 500 ; see *In re Bryant Universal Roofing, Inc.* 218 B.R. 948 (Bankr. D. Ariz. 1998) (current payments not mandated under section 365(d)(3)).

(n172)Footnote 104b. See *In re Bryant Universal Roofing, Inc.* 218 B.R. 948 (Bankr. D. Ariz. 1998) (current payments not mandated under section 365(d)(3)). *In re Amber's Stores*, 193 B.R. 819, 826 (Bankr. N.D. Tex. 1996) , *In re Dieckhaus Stationers of King of Prussia, Inc.*, 73 B.R. 969 (Bankr. E.D. Pa. 1987) , and *In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992) , hold that the section 365(d)(3) claim does not have "superpriority" status over other administrative claims. See also *In re Tandem Group*, 15 C.B.C.2d 170, 61 B.R. 738 (Bankr. S.D. Cal. 1986) .

(n173)Footnote 104c. *In re Pyxsys Corp.*, 288 B.R. 309 (Bankr. D. Mass. 2003) ; *In re Tel-Central Communs.*, 212 B.R. 342, 349 (Bankr. W.D. Mo. 1997) ; *In re Almac's Inc.*, 31 C.B.C.2d 51, 167 B.R. 4 (Bankr. D.R.I. 1994) ; *In re Child World, Inc.*, 161 B.R. 571 (S.D.N.Y. 1993) . Contra, *In re Brennick*, 178 B.R. 305, 308 (Bankr. D. Mass. 1995) (disgorgement not required).

(n174)Footnote 104d. See, e.g., *In re C.Q., LLC*, 343 B.R. 915 (Bankr. D. Wis. 2005) . *In re New Almacs, Inc.*, 196 B.R. 244 (Bankr. N.D.N.Y. 1996) ; *In re Leisure Time Sports*, 189 B.R. 511 (Bankr. S.D. Cal. 1995) ; *In re Rare Coin Galleries of Am., Inc.*, 72 B.R. 415, 416 (Bankr. D. Mass. 1987) ; *In re Telesphere Communications*, 148 B.R. 525 (Bankr. N.D. Ill. 1992) .

(n175)Footnote 104d.1. *Omni Partners, L.P. v. Pudgie's Dev. of N.Y., Inc. (In re Pudgie's Dev. of N.Y., Inc.)*, 239 B.R. 688, 695 (S.D.N.Y. 2000) . But see *In re C.Q., LLC*, 343 B.R. 915 (Bankr. D. Wis. 2005) (requiring immediate payment notwithstanding possible administrative insolvency).

(n176)Footnote 104e. J. Fruchter, To Bind or Not to Bind--Bankruptcy Code § 365(d)(3): Statutory Minefield, 68 Am. Bankr. L.J. 437 (1994); see *In re Van Vleet*, 383 B.R. 782 (Bankr. D. Colo. 2008) .

(n177)Footnote 104e.1. See, e.g., *In re Rothman*, 2007 Bankr. LEXIS 2651 (Bankr. E.D.N.Y. Aug. 2, 2007) ; *In re Ames Dep't Stores*, 306 B.R. 43 (Bankr. S.D.N.Y. 2004) (citing cases).

(n178)Footnote 104f. *In re Handy Andy Home Improvement Ctrs.*, 144 F.3d 1125, 1127 (7th Cir. 1998) ; *In re Dunn Indus., LLC*, 320 B.R. 86 (Bankr. D. Md. 2005) ; *In re Trak Auto Corp.*, 277 B.R. 655, 663 (Bankr. E.D. Va. 2002) , *aff'd*, 2003 U.S. Dist. LEXIS 6029 (E.D. Va. 2003) ; *In re McCrory Corp.* 210 B.R. 934 (S.D.N.Y. 1997) ; *In re Child World, Inc.*, 161 B.R. 571 (Bankr. S.D.N.Y. 1993) , *aff'd*, 1994 U.S. Dist. LEXIS 21364 (S.D.N.Y. 1994) .

(n179)Footnote 104g. *In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 211 (3d Cir. 2001) ("an obligation arises under a lease for purposes of § 365(d)(3) when the legally enforceable duty to perform arises under that lease"); *In re R.H. Macy & Co., Inc.*, 152 B.R. 869, 873 (Bankr. S.D.N.Y. 1993) ; see also *In re Cukierman*, 265 F.3d 846 (9th Cir. 2001) (section 365(d)(3) required debtor to pay rental obligations coming due postpetition under lease notwithstanding that the payments in fact represented amounts required to retire prepetition promissory notes).

(n180)Footnote 104h. *Koenig Sporting Goods Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 43 C.B.C.2d 1229 (6th Cir. 2000) ; *In re Goody's Family Clothing, Inc.*, 60 C.B.C.2d 837, 392 B.R. 604 (Bankr. D. Del. 2008) , *aff'd*, 401 B.R. 656 (D. Del. 2009) .

(n181)Footnote 104i. 203 F.3d 986, 989 (6th Cir. 2000) .

(n182)Footnote 104j. *HA-LO Indus. v. CenterPoint Props. Trust*, 342 F.3d 794 (7th Cir. 2003) .

(n183)Footnote 104k. *Id.*

(n184)Footnote 104l. *In re Winn-Dixie Stores, Inc.*, 333 B.R. 870 (Bankr. D. Fla. 2005) .

(n185)Footnote 104m. 333 B.R. 870, 873 .

(n186)Footnote 104j. *See Equitable Life Assur. Soc'y v. Petrie Retail, Inc. (In re Petrie Retail, Inc.)*, 233 B.R. 256 (S.D.N.Y. 1999) ; *In re Kmart Corp.*, 286 B.R. 345 (Bankr. N.D. Ill. 2002) . *See generally* John C. Murray, *Percentage Rent Provisions in Shopping Center Leases: A Changing World*, 35 *Real Prop., Prob. & Tr. J.* 731, 779-85 (2001).

(n187)Footnote 104l. *Urban Retail Props. v. Loews Cineplex Entm't Corp.*, 2002 U.S. Dist. LEXIS 6186, (S.D.N.Y. 2002) .

(n188)Footnote 104m. *See* P 3.01[2][b] *supra*.

(n189)Footnote 105. *See* P 3.01[3][b][i] *supra*.

(n190)Footnote 106. *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.) , *aff'd*, 681 F.2d 102 (2d Cir. 1982) ; *In re GHR Energy Corp.*, 66 B.R. 54 (Bankr. S.D. Tex. 1986) ; *In re The Lionel Corp.*, 23 B.R. 224 (Bankr. S.D.N.Y. 1982) ; *1535 Chestnut Corp. v. Horn & Hardart Baking Co. (In re Horn & Hardart Baking Co.)*, 19 B.R. 597 (Bankr. E.D. Pa. 1982) ; *cf. In re Beker Indus. Corp.*, 64 B.R. 890 (Bankr. S.D.N.Y. 1986) .

(n191)Footnote 107. *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.) , *aff'd*, 681 F.2d 102 (2d Cir. 1982) .

(n192)Footnote 108. *Id.*; *see In re The Lionel Corp.*, 23 B.R. 224 (Bankr. S.D.N.Y. 1982) .

(n193)Footnote 109. *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.) , *aff'd*, 681 F.2d 102 (2d Cir. 1982) .

(n194)Footnote 110. *In re The Lionel Corp.*, 23 B.R. 224 (Bankr. S.D.N.Y. 1982) .

(n195)Footnote 111. *See* cases cited in note 106 *supra*. As set forth in note 85 *supra*, the likelihood of a residential real estate lease coming into "play," or of the trustee becoming involved with this aspect of debtor's assets, is highly remote.

(n196)Footnote 111a. *See In re Burger Boys, Inc.*, 94 F.3d 755 (2d Cir. 1996) (noting that the factors discussed in the *Theatre Holding* decision, 681 F.2d 102 , are still relevant to a bankruptcy court's decision on a debtor's motion for extension of time to assume or reject a nonresidential lease under section 365(d)(4)); *In re Winn-Dixie Stores, Inc.*, 345 B.R. 402, 406 (Bankr. S.D. Fla. 2006) (finding that in light of debtor's payment of post-petition obligations and possibility of assumption, landlord could not compel termination of lease under section 362(d) but was limited to filing motion to compel assumption or rejection).

(n197)Footnote 112. *See* P 3.01[2] *supra*; *In re Inn at Longshore, Inc.*, (Bankr. D. Conn. 1983) . *Contra In re Attorneys Office Mgmt., Inc.*, 29 B.R. 96 (Bankr. C.D. Cal. 1983) (section 362(d) inapplicable--landlord's remedies limited to section 365(d)(2)).

(n198)Footnote 113. *Id.*

(n199)Footnote 114. *See* P 3.01[2] *supra*.

(n200)Footnote 115. *See* P 2.06[1] *supra*; note 112 *supra*.

(n201)Footnote 116. *See* P 3.01[5] *infra*.

(n202)Footnote 117. *See also In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) ; *see also In re Fleming Companies, Inc.*, 2007 U.S. App. LEXIS 19927 (3d Cir. Aug. 22, 2007) (prohibiting assignment of supply agreement where use by supplier of specific facility location was materially and economically significant to the contract counterparty).

(n203)Footnote 118. *See P 3.01[3][b][ii] supra.*

(n204)Footnote 119. Additional steps that may be taken by any creditor, including a landlord, to bring a debtor or its property outside the protections of the Bankruptcy Code are a motion to dismiss the case under a bad faith filing theory (e.g., *Little Creek Dev. Co. v. Commonwealth Mrtg. Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068, 13 C.B.C.2d 1231 (5th Cir. 1986) ; *In re Winshall Settlor's Trust*, 758 F.2d 1136, 12 C.B.C.2d 605 (6th Cir. 1985) ; *Cinema Serv. Corp. v. Edbee Corp.*, 774 F.2d 584, 13 C.B.C.2d 1032 (3d Cir. 1985) ; *In re Brandywine Assocs., Ltd.*, 85 B.R. 626 (Bankr. M.D. Fla. 1988) ; *In re Mildevco, Inc.*, 40 B.R.191 (Bankr. S.D. Fla. 1984) ; *see text accompanying P 2.06[1] note 23a supra.* The landlord may also file a motion for abstention under *section 305(a) of the Code*, 11 U.S.C. § 305(a) (e.g., *In re Sun World Broadcasters, Inc.*, 2 C.B.C.2d 899, 5 B.R. 719 (Bankr. M.D. Fla. 1980)) .

(n205)Footnote 120. Multiple proceedings were employed to the landlord's advantage in *In re Inn at Longshore, Inc.*, (Bankr. D. Conn. 1983), .

(n206)Footnote 121. *See P 3.01[2][b] supra.*

(n207)Footnote 122. *See P 3.01[2][b] supra.*

(n208)Footnote 123. *See P 3.51 infra.*

(n209)Footnote 124. 4A Collier on Bankruptcy, P 70.44 [3] notes 9-10, 12 (Matthew Bender 14th ed. 1978); *see also 3 Collier on Bankruptcy*, P 365.07 (Matthew Bender 15th Ed. Revised).

(n210)Footnote 125. 4A Collier on Bankruptcy, P 70.44 [3] n.13 (Matthew Bender 14th ed. 1978).

(n211)Footnote 126. *E.g., In re Delta Motor Hotel of Syracuse, Inc.*, 10 B.R. 585, 598-600 (Bankr. N.D.N.Y. 1981)

(n212)Footnote 127. *In re Kistner*, 25 B.R. 262 (Bankr. S.D. Ohio 1982) , holds that an administrative claim for use and occupancy charges may be subject to equitable subordination under 11 U.S.C. § 510(c). The court in *In re Anchorage Boat Sales, Inc.*, 29 B.R. 275 (Bankr. E.D.N.Y. 1983) found a waiver of use and occupancy charges.

(n213)Footnote 128. *See P 3.01[3][a] supra.*

(n214)Footnote 128a. *See In re Perretta*, 7 B.R. 103 (Bankr. N.D. Ill. 1980) (lessor waived right to adequate assurance of prompt cure by permitting accrual of prepetition rental arrearages for 44 months).

(n215)Footnote 128b. *See, e.g., In re St. Casimir Development Corp.*, 358 B.R. 24 (S.D.N.Y. 2007) (permitting debtor's assumption of partnership agreement where notice of termination of interest was not served exactly in accordance with agreement)

(n216)Footnote 129. *See P 3.01[3][a] supra.*

(n217)Footnote 130. *See P 3.02[1] infra.*

(n218)Footnote 131. *See P 2.03[2] supra.*

(n219)Footnote 132. *See P 2.01[4], [5] supra*. If the agreement being considered for rejection is an unexpired lease of real property under which the debtor is lessor, the trustee of the debtor may weigh the benefits of eliminating its affirmative obligations under the lease against:

(1) the loss of rental that may be suffered under the lessee's right to offset therefrom its damages resulting from the lessor's nonperformance of its affirmative obligations (*see P 2.01[4] supra*),

(2) the possibility that the lessee will elect to remain in possession for the balance of the term and perhaps any renewal terms, so that the lessor will not have clear title to the premises in any event,

(3) the potentially massive damage claim that may be allowed to a lessee under a long-term lease if it elects to treat the lease as terminated, and

(4) the possibility of commencing negotiations with the lessee to effect a settlement.

The parameters of a settlement with the lessee could include such items as increasing the rental, liquidating the damage claim, or arranging for the lessee's purchase of the debtor's interest in the property.

(n220)Footnote 133. *Cf. In re Lafayette Radio Elec. Corp.*, 4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981) .

(n221)Footnote 134. *In re Belize Airways, Ltd.*, 5 B.R. 152 (Bankr. S.D. Fla. 1980) . Section 365(1) of the Code, added by the 1984 Amendments, permits a landlord in the case of a section 365 lease assignment by the tenant's trustee to require "a deposit or other security for the performance of the debtor's obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant." The floor statement of Senator Dole, accompanying the 1984 Amendments, included an observation that section 365(1) "... permits the landlord to get his usual, reasonable security deposit from an assignee tenant." 130 Cong. Rec. S8895 (June 29, 1984).

(n222)Footnote 135. *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.) , *aff'd*, 681 F.2d 102 (2d Cir. 1982) .

(n223)Footnote 136. *See In re Arctic Enter., Inc.*, 16 B.R. 153 (Bankr. D. Minn. 1981) ; *cf. In re U.L. Radio Corp.*, 6 C.B.C.2d 430, 19 B.R. 537 (Bankr. S.D.N.Y. 1982) ; *In re Lafayette Radio Elec. Corp.*, 4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981) .

(n224)Footnote 137. 11 U.S.C. § 365(b)(1). The Second Circuit Court of Appeals views a motion to assume as a summary proceeding reviewing the trustee's decision to assume or reject, and that it is not to be used to adjudicate tangential issues such as the existence of a default. *Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 29 C.B.C.2d 1341 (2d Cir. 1993) . The summary proceeding may be joined with a related adversary proceeding. 4 F.3d 1095, 1099, 29 C.B.C.2d 1341, 1348 ; *see also In re 611 Sixth Ave. Corp.*, 191 B.R. 295 (Bankr. S.D.N.Y. 1996) . If the lease provides for interest on delinquent rental installments, and for attorneys' fees incurred in the enforcement of the lease, and such provisions are enforceable under applicable state law, interest on prepetition rent, and such fees, must be paid as part of the cure required for assumption. *Andrew v. KMR Corp. (In re Bullock)*, 17 B.R. 438 (B.A.P. 9th Cir. 1982) ; *In re M. Fine Lumber Co., Inc.*, 59 C.B.C.2d 636, 383 B.R. 565 (Bankr. E.D.N.Y. 2008) ; *In re Bab Enter., Inc.*, 100 B.R. 982 (Bankr. W.D. Tenn. 1989) (attorneys' fees--U.S. trustee may raise issue of reasonableness); *In re Westworld Cmty. Healthcare, Inc.*, 21 C.B.C.2d 587, 95 B.R. 730 (Bankr. C.D. Cal. 1989) ; *cf. In re Foreign Crating, Inc.*, 55 B.R. 53 (Bankr. E.D.N.Y. 1985) ; *In re J.W. Mays, Inc.*, 30 B.R. 769 (Bankr. S.D.N.Y. 1983) . The tenant's trustee must assume the lease and cure outstanding defaults as a condition to the exercise of a renewal option. *In re Cook United, Inc.*, 53 B.R. 342 (Bankr. N.D. Ohio 1985) . *Contra Coleman Oil Co. v. Circle K Corp. (In re Circle K Corp.)*, 127 F.3d 904 (9th Cir. 1997) (debtor may renew without assumption of lease); *In re Revco D.S., Inc.*, 111 B.R. 626 (Bankr. N.D. Ohio 1989) . Section 362(a) of the Code does not toll the running of the option exercise period. *In re Crabb*, 12 C.B.C.2d 704, 48 B.R. 165 (Bankr. D. Mass. 1985) .

(n225)Footnote 137a. *In re United Airlines, Inc.*, 368 F.3d 720, 726, 51 C.B.C.2d 1924 (7th Cir. 2004) (holding that debtor was not required to protect counterparty to contract for unreasonable risk of a future default where the debtor had never before defaulted under the contract).

(n226)Footnote 138. 11 U.S.C. § 365(f)(2)(B). Because adequate assurance of future performance is not required for a lease that is only being assumed and for which there has not been a prepetition or postpetition default, in appropriate situations, a debtor may wish to consider the benefits of a strategy of curing all defaults prior to the petition date in order to avoid the need to demonstrate adequate assurance as a condition to assumption.

(n227)Footnote 139. 6 C.B.C.2d 843, 20 B.R. 454 (Bankr. D. Mass. 1982) .

(n228)Footnote 140. 6 C.B.C.2d 843, 846-48, 20 B.R. 454, 457-59 (emphasis in original) (footnotes omitted). Adequate assurance of prompt cure of prepetition defaults has been held to permit cure over a three year period after the assignment of a beer distributorship contract. *In re Coors, Inc.*, 27 B.R. 918 (Bankr. N.D. Miss. 1983) (citing *Berkshire*). A proposed cure period of five years, substantially equivalent to the remaining lease term, was held not to constitute a prompt cure. *In re R/P International Technologies, Inc.*, (Bankr. S.D. Ohio 1985) (citing *Berkshire*); accord *In re Gold Standard at Penn., Inc.*, 75 B.R. 669 (Bankr. E.D. Pa. 1987) . A 29-month cure period was found unacceptable in *In re Embers 86th Street Inc.*, 184 B.R. 892 (Bankr. S.D.N.Y. 1995) , where the court also was not persuaded that the cure would be effected. *In re Whitsett*, 163 B.R. 752, 755-56 (Bankr. E.D. Pa. 1994) held a two-year cure period to be acceptable where the lessor also had other protections.

(n229)Footnote 141. *In re DBSI, Inc.*, 405 B.R. 698 (Bankr. D. Del. 2009) ; *In re Natco Indus., Inc.*, 54 B.R. 436 (Bankr. S.D.N.Y. 1985) ; *In re Lafayette Radio Elect. Corp.*, 4 C.B.C.2d 220, 226-27, 9 B.R. 993 (Bankr. E.D.N.Y. 1981) ; *In re Luce Indus., Inc.*, 3 C.B.C.2d 574, 579-83, 8 B.R. 100, 104-08 (Bankr. S.D.N.Y. 1980) , rev'd, 4 C.B.C.2d 355, 14 B.R. 529 (S.D.N.Y. 1981) ; *In re Sapolin Paints, Inc.*, 2 C.B.C.2d 854, 5 B.R. 412 (Bankr. E.D.N.Y. 1980) ; Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 Minn. L. Rev. 341, 354-58 (1980). The reinstatement provisions of section 1124 cannot be used to circumvent the section 365(b) assumption requirements for real estate leases. *In re Offices & Serv. of White Plains Plaza, Inc.* 58 B.R. 441 (Bankr. S.D.N.Y. 1986) .

(n230)Footnote 142. *In re Luce Indus.*, 3 C.B.C.2d 574, 583, 8 B.R. 100, 107 (Bankr. E.D.N.Y. 1980) , and authorities cited therein.

(n231)Footnote 143. Murphy, *Creditors' Rights in Bankruptcy* § 9.10 at 9-11 (1980).

(n232)Footnote 144. Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, Part II, 93d Cong., 1st Sess. 152-53 (1973) (emphasis supplied) [hereinafter Commission Report].

(n233)Footnote 145. H.R. Doc. No. 93-137, Part II, 93d Cong., 1st Sess. 156-57 (1973).

(n234)Footnote 145a. See, e.g., *Cinicola v. Scharffenberger*, 248 F.3d 110 (3d Cir. 2001) (applying UCC section 2-609(1) to employment agreement).

(n235)Footnote 146. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977).

(n236)Footnote 147. H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 348 (1977).

(n237)Footnote 148. H.R. Doc. No. 93-137, Part II, 93d Cong., 1st Sess., 156-57 (1973).

(n238)Footnote 149. *In re Sapolin Paints, Inc.*, 2 C.B.C.2d 854, 5 B.R. 412 (Bankr. E.D.N.Y. 1980) .

(n239)Footnote 150. 4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981) .

(n240)Footnote 151. 6 C.B.C.2d 843, 20 B.R. 454 (Bankr. D. Mass. 1982) ; see P 3.02[5][a] *supra*.

(n241)Footnote 152. 6 C.B.C.2d 843, 848, 20 B.R. 454, 459 (Bankr. D. Mass. 1982) .

(n242)Footnote 152a. Similarly, in *In re World Skating Ctr. Inc.*, 100 B.R. 147 (Bankr. D. Conn. 1989) , the court denied the debtor's motion to assume a lease in a nonassignment context. The court stated that:

Adequate assurance requires a foundation that is nonspeculative and sufficiently substantive so as to assure the landlord that it will receive the amount of the default. ... It necessarily follows from the foregoing that the record made in this proceeding will also not support a finding that the debtor, for the purposes of § 365(b)(1)(C), has provided adequate assurance of its future performance under the lease.

100 B.R. 147, 148-49 .

See also *In re Embers 86th Street, Inc.*, 184 B.R. 892, 902 (Bankr. S.D.N.Y. 1995) (projections were not sufficiently convincing to permit 29-month cure period).

(n243)Footnote 152b. *In re Grayhall Res., Inc.*, 63 B.R. 382 (Bankr. D. Colo. 1986) involved a mining lease with a 30-day cancellation clause in favor of the debtor-tenant. The court permitted assumption, despite the debtor's precarious financial condition, because the cancellation clause evidenced that the lessor did not rely upon an assured future income stream in entering into the transaction. Rejection of the lease would have given rise to a worthless section 502(b)(6) claim of the lessor. The court's reasoning appears equally applicable to a nonrecourse lease transaction.

(n244)Footnote 153. *E.g., Nostas Assocs. v. Costich (In re Klein Sleep Prods., Inc.)*, 78 F.3d 18, 24 (2d Cir. 1996) ; *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951) ; *In re Three A's Holdings, L.L.C.*, 364 B.R. 550 (Bankr. D. Del. 2007) .

(n245)Footnote 154. H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 348 (1977).

(n246)Footnote 155. See P 3.01[7] *infra*.

(n247)Footnote 156. *In re U.L. Radio Corp.*, 6 C.B.C.2d 430, 19 B.R. 537 (Bankr. S.D.N.Y. 1982) ; cf. *In re Bentley*, 26 B.R. 69 (Bankr. S.D.N.Y. 1982) ; *In re Lafayette Radio Elect. Corp.*, 4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981) ; *In re Pin Oaks Apt.*, 7 B.R. 364 (Bankr. S.D. Tex. 1980) ; *Kishi v. Greco (In re Greco)*, 1 C.B.C.2d 619 (Bankr. D. Hawaii 1980) ; *Reyco of Nevada v. Johns (In re Johns)*, 1 C.B.C.2d 174 (Bankr. D. Nev. 1979) ; cases cited in note 168 *infra*; Simpson, *Leases and the Bankruptcy Code: Tempering the Rigors of Strict Performance*, 38 Bus. Law. 61 (1982); cf. *In re Goldblatt Bros., Inc.*, 766 F.2d 1136, 13 C.B.C.2d 115 (7th Cir. 1985) (assumption of percentage rent lease permitted notwithstanding discontinuance of retail use of part of premises); *In re Vista VI, Inc.*, 35 B.R. 564 (Bankr. N.D. Ohio 1983) (lease requiring debtor in possession to conduct business under franchised name may be assumed with same business to be conducted under a different name); *In re Libson Shops, Inc.*, 24 B.R. 693 (Bankr. E.D. Mo. 1982) (going-out-of-business sale permitted notwithstanding prohibition in shopping center lease).

(n248)Footnote 157. 328 U.S. 123, 66 S. Ct. 947 (1946) .

(n249)Footnote 158. 335 F.2d 857 (3d Cir. 1964) .

(n250)Footnote 159. 335 F.2d 857, 862 .

(n251)Footnote 160. 459 F.2d 741 (4th Cir.) , cert. denied, 409 U.S. 957, 93 S. Ct. 288, 34 L. Ed. 2d 227 (1972)

(n252)Footnote 161. 459 F.2d 741, 745 .

(n253)Footnote 162. 503 F.2d 202 (2d Cir. 1974) .

(n254)Footnote 163. 654 F.2d 578 (9th Cir. 1981) .

(n255)Footnote 164. 654 F.2d 578, 586 .

(n256)Footnote 165. 654 F.2d 578, 590-91 .

(n257)Footnote 166. 6 C.B.C.2d 430, 19 B.R. 537 (Bankr. S.D.N.Y. 1982) .

(n258)Footnote 167. 6 C.B.C.2d 430, 439, 19 B.R. 537, 545 .

(n259)Footnote 168. The courts have permitted certain changes in use to permit lease assignments. *E.g.*, *In re Rickel Home Ctrs., Inc.*, 240 B.R. 826 (D. Del.1998) , dismissed as moot, 209 F.3d 291 (3d Cir. 2000) , cert. denied, 531 U.S. 873, 121 S. Ct. 175, 148 L. Ed. 2d. 120 (2000) (use clause modified from home improvement center to permit operation of a "Staples" store; alteration and assignment clauses also modified permanently, all such clauses characterized as anti-assignment provisions); *Double K Props., LLC v. Aaron Rents, Inc.*, 2003 U.S. Dist. LEXIS 11940 (W.D. Va. 2003) (notwithstanding terms of lease limiting right of renewal to named, original tenant, renewal right could be enforced by assignee of debtor); *In re Petersons, Ltd.*, 31 B.R. 524 (Bankr. S.D.N.Y. 1983) (lease authorizing high grade tobacco products store and prohibiting cut rate tobacco shop assigned to legitimate but discount operator); *In re Fifth Ave. Originals*, 32 B.R. 648 (Bankr. S.D.N.Y. 1983) (lease requiring use of store for sale of male and female clothing and shoes assigned to women's clothing operation); *In re Evelyn Byrnes, Inc.*, 9 C.B.C.2d 430, 32 B.R. 825 (Bankr. S.D.N.Y. 1983) (lease prescribing use for sale of fine women's clothing and accessories and conduct of high grade and reputable business assigned to seller of fine clothing at discount); *Magoon Estate, Ltd. v. Grudowski*, 8 C.B.C.2d 1064, 33 B.R. 154 (Bankr. D. Hawaii 1983) (lease prescribing use of store premises as a delicatessen may be assigned for use as a Japanese restaurant); cf. *In re Sun T.V. & Appliances, Inc.*, 234 B.R. 356, 370 (Bankr. D. Del. 1999) (shopping center lease use clause may be subject to "insubstantial modification"); *Reyco of Nevada v. Johns (In re Johns)*, 1 C.B.C.2d 174 (Bankr. D. Nev. 1979) (use restriction in shopping center lease not breached where, after filing petition, discotheque commenced once-weekly male striptease show); *In re Tech Hifi, Inc.*, 49 B.R. 876 (Bankr. D. Mass. 1985) (lease prescribing sale of consumer electronics assigned to leather goods retailer); *In re Joshua Slocum, Ltd.*, 99 B.R. 250 (Bankr. E.D. Pa. 1989) (change from company- owned outlet store to retail clothing store). But cf. *In re TSW Stores, Inc.*, 9 C.B.C.2d 793, 34 B.R. 299 (Bankr. S.D.N.Y. 1983) (modification of shopping center store lease denied when modification would have permitted introduction into shopping center of direct competitor of another tenant).

(n260)Footnote 169. 7 B.R. 364 (Bankr. S.D. Tex. 1980) .

(n261)Footnote 170. 7 B.R. 364, 372 .

(n262)Footnote 170a. Pub. L. No. 103-394 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n263)Footnote 170a-1. Pub. L. No. 103-394 (1994).

(n264)Footnote 170a-2. Section-by-Section Analysis of the Bankruptcy Reform Act of 1994, 5 U.S.C.C.A.N. 3357 (1994), reprinted in Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n265)Footnote 170a-3. *In re GP Express Airlines, Inc.*, 200 B.R. 222 (D. Neb. 1996) , held that section 365(b)(2)(D) is to be read in the disjunctive and eliminates the requirement for cure of all nonmonetary defaults as a condition to assumption. *In re Claremont Acquisition Corp.*, 113 F.3d 1029 (9th Cir. 1997) , holds that section 365(b)(2)(D) relates only to penalties clauses in nonmonetary default provisions. See also *In re New Breed Realty Enters., Inc.*, 278 B.R. 314, 325 (Bankr. E.D.N.Y. 2002) (where failure to close by date certain constituted a material

breach of contract for sale of stock in corporation containing time of the essence clause, default could not be cured under section 365(b)(2)(D), explicitly following *Claremont*; P 3.01[5] *infra* .

(n266)Footnote 170b. 113 F.3d 1029 (9th Cir. 1997) , *aff'g* 186 B.R. 977 (C.D. Cal 1995) .

(n267)Footnote 170c. 113 F.2d 1029, 1034 .

(n268)Footnote 170d. *Contra In re GP Express Airlines, Inc.*, 200 B.R. 222, 233-34 (Bankr. D. Neb. 1996) ; *cf.* *Casa Blanca Project Lenders, L.P. v. City Commerce Bank (In re Casa Blanca Project Lenders, L.P.)*, 196 B.R. 140 (B.A.P. 9th Cir. 1996) .

(n269)Footnote 170e. 11 U.S.C. § 365(b)(2)(D) (emphasis added), as amended by Pub. L. No. 109-8, § 328, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The legislative history of the revised provision clearly states that the change was intended to "clarify that [the statutory provision] applies to penalty provisions." H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-350 (Matthew Bender 15th Ed. Revised).

(n270)Footnote 170f. 11 U.S.C. § 365(b)(1)(A), as amended by Pub. L. No. 109-8, § 328 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n271)Footnote 170g. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b) p. 10-349 (Matthew Bender 15th Ed. Revised).

(n272)Footnote 171. H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 348-49 (1977).

(n273)Footnote 172. Simpson, *Leases and the Bankruptcy Code: Tempering the Rigors of Strict Performance*, 38 *Bus. Law.* 61, 74 (1982); *In re Tech Hifi, Inc.*, 49 B.R. 876 (Bankr. D. Mass. 1985) .

(n274)Footnote 173. Simpson, *note 172 supra*, at 74-75 .

(n275)Footnote 174. Simpson, *note 172 supra*, at 76-77 .

(n276)Footnote 175. S. Rep. No. 98-65, 98th Cong., 1st Sess. 41 (1983); *cf.* *Double K Props., LLC v. Aaron Rents, Inc.*, 2003 U.S. Dist. LEXIS 11940 (W.D. Va. 2003) (lease limiting right of renewal to named, original tenant was an unenforceable *de facto* anti-assignment clause); *In re Federated Dep't Stores, Inc.*, Case No. 1-90-00130, Slip Opinion (Bankr. W.D. Ohio October 9, 1991), holding that a "nameplate provision" in a shopping center reciprocal operating agreement constituted an unenforceable *de facto*- anti-assignment clause.

(n277)Footnote 176. 130 Cong. Rec. S8895 (June 29, 1984), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(c) (Matthew Bender 15th Ed. Revised). For a case applying section 365(d)(3) and refusing to permit a proposed assignment of a shopping center lease on the ground that the proposed new tenant would disrupt the tenant mix at the shopping center, *see In re Federated Dep't Stores, Inc.*, 135 B.R. 941 (Bankr. S.D. Ohio 1991) . The court in *In re Joshua Slocum, Ltd.*, 922 F.2d 1081 (3d Cir. 1990) , held that the bankruptcy court could not excise a gross sales "kick-out" clause from a lease in order to foster an assignment. *See* text accompanying note 176a *infra*. In *In re Martin Paint Stores, Inc.*, 199 B.R. 258 (Bankr. S.D.N.Y. 1996) , the court held that a tenant with an exclusivity provision in its lease did not have standing to object to the assignment of a debtor's lease to a party that would use the premises for a competing business.

(n278)Footnote 176a. *Trak Auto Corp. v. West Town Ctr. LLC (In re Trak Auto Corp.)*, 367 F.3d 237, 245 (4th Cir. 2004) (citing specific statement of Senator Hatch quoted above relating to operations under a specified trade name).

(n279)Footnote 176b. 922 F.2d 1081, 24 C.B.C.2d 581 (3d Cir. 1990) . This case also deals with the question of what constitutes a "shopping center" under the Code. *See* P 3.06[7] *infra*.

(n280)Footnote 176c. 922 F.2d at 1090-92, 24 C.B.C.2d at 591-94 .

(n281)Footnote 176c. Trak Auto Corp. v. West Town Ctr. LLC (In re Trak Auto Corp.), 367 F.3d 237, 52 C.B.C.2d 1009 (4th Cir. 2004) .

(n282)Footnote 176d. 367 F.3d 237, 239 .

(n283)Footnote 176e. 367 F.3d 237, 244 (citation omitted).

(n284)Footnote 176f. 367 F.3d 237, 244-45 .

(n285)Footnote 176g. One pair of commentators has sought to reconcile this decision with other decisions that refused to enforce a *de facto* anti-assignment clause by interpreting *Trak Auto* as enforcing for the benefit of landlords anti-assignment clauses that were merely economically unattractive to the debtor based on present market conditions, as distinguished from cases such *In re Rickel Home Centers*, *infra*, where the enforcement of the anti-assignment clause would have made an assignment impossible by reason of the obsolescence of the restricted use. See P. Holleman & M. Ellis, *Solvent Shopping Center Tenants: Reexamination in Light of In re Trak Auto Corp.: Part I*, ABI Journal, Dec. 2004/Jan. 2005, at 14. In *In re Rickel Home Centers*, 240 B.R. 826, 830 (D. Del. 1998) , *appeal dismissed*, 209 F.3d 291 (3d Cir. 2000) , the court refused to enforce clause that restricted use of premises to a "home improvement store" by finding that that such use had "either become obsolete or is struggling to remain in existence as a result of the advent of warehouse type home-improvement stores like Home Depot."

(n286)Footnote 177. 11 U.S.C. §§ 108(b), 363(1), 365(a), (b), (e), (f) and 541(c).

(n287)Footnote 178. 11 U.S.C. § 365(d)(4), amended by Pub. L. No. 109-8, § 404 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. P. 10(a) (Matthew Bender 15th Ed. Revised).

(n288)Footnote 178a. *Id.*

(n289)Footnote 178b. The legislative history makes clear that the amendment was intended "to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected." See H.R. Rep. No. 109-031, 109th Cong., 1st Sess. (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(b), at p. 10-354 (Matthew Bender 15th Ed. Revised).

(n290)Footnote 178. In each of *In re W.T. Grant Co.*, Arrangement No. 75 B 1735 (S.D.N.Y., filed October 1975), and *In re J.M. Fields, Inc.*, Food Fair, Inc., Arrangement Nos. 78 B 1764-73 (S.D.N.Y., filed October 1978), both of which were filed under the former Bankruptcy Act, the debtor in possession operated a substantial number of retail stores and sought to assign the leases of stores no longer useful in the company's operations. In each case, the court permitted the debtor in possession to retain the leaseholds of the stores slated for disposition as long as use and occupancy payments were being made and until the debtor in possession advised the court that its efforts to market a particular leasehold had been unsuccessful.

(n291)Footnote 179. *In re J.M. Fields, Inc.*, Food Fair, Inc., Arrangement Nos. 78 B 1764-73 (S.D.N.Y., filed October 1978).

(n292)Footnote 180. Telephone conversation with David B. Simpson, Esq., a member of the firm of Stein, Simpson & Rosen, co-counsel to the debtors and debtors in possession in the *Food Fair* proceedings.

(n293)Footnote 181. See P 3.02[2] *infra*.

(n294)Footnote 182. See P 3.52 *infra*.

(n295)Footnote 183. *In re City Stores Co.*, 21 B.R. 809 (Bankr. S.D.N.Y. 1982) .

(n296)Footnote 184. 11 U.S.C. § 503(b)(7), added by Pub. L. No. 109-8, § 445, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The new section also provides that any claim for remaining sums due for the balance of the term of the assumed lease is a claim under section 502(b)(6). This provision and its genesis is discussed further at *P 3.01[5] infra*.

(n297)Footnote 185. *In re Lafayette Radio Elec. Corp.*, 4 C.B.C.2d 220, 9 B.R. 993 (Bankr. E.D.N.Y. 1981), provides an example of a successful subleasing program.

(n298)Footnote 186. *See P 3.01[7][a] supra*.

(n299)Footnote 186a. If the premises are subject to a lease that prohibits going out of business or liquidation sales, the inventory nevertheless may be liquidated at the premises pursuant to the overriding policy in favor of maximizing value for the estate. *In re Ames Dep't Stores, Inc.*, 136 B.R. 357 (Bankr. S.D.N.Y. 1992).

(n300)Footnote 186b. An example of such an assignment and assumption agreement is included as a form at the end of this chapter. *See P 3.55 infra*.

(n301)Footnote 186c. For example, in certain situations it would be necessary to examine environmental reports concerning the premise or the correspondence file with the landlord.

(n302)Footnote 187. *See P 3.53 infra*.

(n303)Footnote 188. This procedure was upheld in *In re Joshua Slocum, Ltd.*, 19 B.C.D. 313 (Bankr. E.D. Pa. 1989).

(n304)Footnote 188a. The recent trend in court decisions is to apply section 363(m) to such transactions where the effect of a reversal or modification on appeal would be to effect the validity of the sale itself, because, for example, the assignee had taken possession and commenced substantial renovations. *See, e.g., L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs.)*, 209 F.3d 291, 305 (3d Cir. 2000) (court noted that any revocation of lease assignment would adversely affect the sale itself because assignee had taken possession and had substantially remodeled the premises for a different use); *Development Co. of Am. v. Adamson Co. (In re Adamson Co.)*, 159 F.3d 896, 898 (4th Cir. 1998). *See also Krebs Chrysler-Plymouth, Inc. v. Valley Motors, Inc.*, 141 F.3d 490, 497 (3d Cir. 1998) (in the context of a sale of a franchise agreement, section 363(m) governs the sale of the franchises, "whereas "section 365 applies to the particular mechanics of conveyance").

(n305)Footnote 188b. This was the effect of the decision in *Rickel*, note 198a *supra*, where the failure of the landlord to obtain a stay pending appeal was implicitly questioned in the court's decision to dismiss the landlord's appeal as moot. *Rickel*, 209 F.3d 291, 304 ("[g]iven the policies underlying section 363(m) and the series of cases that emphasize the importance of securing a stay, we are perplexed by LRSC's failure even to request a stay").

(n306)Footnote 189. *See In re Chateaugay Corp.*, 10 F. 3d 944, 952-53 (2d Cir. 1993); *Abel v. Shugrue (In re Ionosphere Clubs)*, 184 B.R. 648 (S.D.N.Y. 1995); *In re Perona Bros., Inc.*, 186 B.R. 833 (D.N.J. 1995); *In re Stadium Management Corp.*, 895 F.2d 845 (1st Cir. 1990); *In re Exennium*, 715 F. 2d 1401, 1404 (9th Cir. 1983).

(n307)Footnote 190. *See P 3.54 infra*.

(n308)Footnote 191. *See P 3.55 infra*.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.02

P 3.02 The Demise of the "Pick-Off Agreement."

Under the Bankruptcy Code prior to enactment of the 1984 Amendments, most courts viewed the postpetition possession of leased real property by a Bankruptcy Code trustee (of a debtor-tenant) as governed by the doctrine of "use and occupation."ⁿ¹ The use and occupation doctrine provided that: (1) after the filing of a Bankruptcy Code petition by or against a tenant, the tenant's trustee could remain in possession of the leased premises not as a tenant under the lease but pursuant to its statutory right and obligation to use and occupy the premises for the benefit of the debtor's estate; (2) the tenant's lease did not govern the relationship between the landlord and the trustee unless the trustee "assumed" the lease with the permission of the court in the Bankruptcy Code proceedings; (3) the tenant's lease was therefore "in limbo," and not effective, unless so assumed; (4) if assumed, the lease was deemed retroactively to have been in effect as of the date of filing of the tenant's Bankruptcy Code petition; (5) if rejected by the trustee with the permission of the court, the lease was deemed to have been breached as of the time immediately prior to the filing of the petition; and (6) the trustee was obligated to pay to the landlord until the lease was assumed or rejected, on a current basis, charges for use and occupation in an amount equal to the value of the premises to the trustee.ⁿ² The trustee's obligation for use and occupation charges constituted an "administrative priority" obligation of the estate.ⁿ³

In the case of full use of the premises, the amount of use and occupation charges payable by the trustee was presumed to equal the lease rental.ⁿ⁴ A lesser use, such as storage, would result in use and occupation payments keyed to the value of warehouse space; maintenance of vacant space would result in no charges being paid to the landlord.ⁿ⁵

The traditional concept of use and occupation charges, tied as it was to actual use and possession, was formulated without consideration of the possibility that a trustee might vacate possession of a property, refuse to surrender possession of the property to the landlord and refuse to reject the lease, refuse to pay use and occupation charges because the property was vacant, and hold the lease out for assignment. If the lease were eventually assigned, the landlord would be made whole by the cure of the outstanding defaults. If, however, the lease were ultimately rejected, as a result of the failure of the assignment effort, the landlord would be left with a claim for breach of contract damages, but without an administrative claim for use and occupation charges inasmuch as there was no use and occupation of the premises and hence no value of the property to the estate.

The courts' response to this dilemma under the former Bankruptcy Act was to point to the landlords' ability to petition the court, even in the absence of an express statutory provision therefor, for an order directing the trustee to assume or reject a lease by a specified time.ⁿ⁶ This procedure was expressly recognized in *section 365(d)(2) of the Code* as in

effect before to the 1984 Amendments. The obtaining of such an order did not result in the landlord's receiving use and occupation payments for vacant property under the traditional rules, and merely served to accelerate the day on which the landlord could be able to cut its loss. Moreover, under the former Act, and under the Code as in effect prior to enactment of the 1984 Amendments, the employment of this procedure as the sole remedy in this context required the landlord to incur the expense of retaining counsel, perhaps in a jurisdiction far from the location of the property. Although there had been limited judicial recognition of the inequities of applying traditional use and occupation concepts under the Bankruptcy Code,ⁿ⁷ the traditional rules had not been generally revised to take into account the new rights and powers of trustees under *section 365 of the Code*, or to ascribe value to vacant property that may be the subject of a lease assignment for the benefit of the estate.

Before enactment of the 1984 Amendments, rather than incur the expense of hiring counsel, and in order to avoid the delays and uncertainties of litigation, many landlords preferred to obtain prompt surrender of the property in exchange for a release of the estate's liability on the lease. Thus, the trustee or its real estate consultant would negotiate a "pick-off agreement," in which the landlord released certain liabilities and the trustee agreed to move promptly in court for authority to reject the lease. The liabilities that were released varied with the bargaining power and skill of the parties, but generally related to all or part of (1) prepetition rent, (2) postpetition use and occupation charges and (3) damages arising out of the rejection of the lease.

The enactment in the 1984 Amendments of a new section 365(d)(3), requiring the trustee to timely perform all postpetition obligations of the debtor-tenant under nonresidential real estate leases, appears to have eliminated the concept of postpetition use and occupation charges with respect to nonresidential leased properties of Bankruptcy Code debtors, and therefore to have removed from the trustee's arsenal the weapon of nonpayment of such charges in the case of vacant premises.^{n7a} The enactment in the 1984 Amendments of section 365(d)(4), requiring the trustee of a debtor-tenant to suffer an automatic rejection of the debtor's nonresidential real estate leases that are not rejected or assumed within 60 days after the entry of the order for relief (with a right of the trustee to obtain from the court an extension of the 60-day period for cause on application made within the period), were intended to deny to the trustee the leverage of delay which was inherent in the section 365(d)(2) procedure under the Code prior to the 1984 Amendments. Even if the trustee obtains an extension of the time for rejection or assumption, it is required under the Code to continue to timely perform the debtor's lease obligations, thereby giving the landlord the benefit of its original bargain. Finally, the debtor's leverage has been further reduced by the 2005 Act which amended section 365(d)(4) to provide that the time for rejection or assumption could not be extended beyond 210 days following the order for relief without the prior written consent of the landlord. Accordingly, the 1984 Amendments, as further amended under the 2005 Act, should reduce the pressure felt by landlords to enter into "pick-off agreements" in order to obtain a prompt release of their properties from the Bankruptcy Code cases of their tenants.

It should be noted, however, that some court decisions have called into question the foregoing understanding of the obligations of a debtor-tenant under subsections 365(d)(3) and (d)(4). For example, the Court of Appeals for the Second Circuit, in *Nostas Associates v. Constich (In re Klein Sleep Products, Inc.)*,ⁿ⁸ has advocated the use of delay in the assumption-rejection process as a means of protecting against ill-considered lease assumptions and engendering renegotiation of long term leases. The holding of *Klein Sleep* was that (1) the section 502(b)(6) limitation on the allowable claim of a landlord arising out of the rejection of a nonresidential real estate leaseⁿ⁹ did not apply to the rejection of such a lease after it had been duly assumed by the debtor in possession in a chapter 11 case, and (2) the landlord's claim was entitled to administrative priority status. Although the court determined that the Code compelled the result reflected in its holding, it expressed concern that the decision would give to landlords the "lion's share" of any chapter 11 estate upon its liquidation and rejection of previously assumed leases.ⁿ¹⁰ The court sought to address this issue by advocating delay in the assumption of long-term nonresidential real estate leases:

Under the rule we adopt, bankruptcy courts will rarely find that assuming liability for all future rent under a long-term lease is in the best interests of the estate—including the interest of the general creditors—unless the rental terms are highly advantageous. They will therefore block assumption of such

leases except in unusual cases The uncertainty engendered by such an approach would give the bankruptcy court significant leverage over both tenant and landlord, and might well lead to a renegotiation of the long-term lease. The tenant who wishes to retain control over the premises has an interest--arising out of fear that the court will force rejection of the original lease--in renegotiating the lease, though perhaps for a shorter term. The landlord also has an interest in renegotiating the lease to escape the limbo between assumption and rejection. In such circumstances the landlord might well prefer to recover some guaranteed amount of future rent, as an administrative expense, under a new contract rather than risk having the lease rejected and the recovery limited to a fractional share of one year's worth of future rent, as an unsecured claim, under the pre-existing contract. [footnote omitted] None of this is before us today. But we do note that the rule that we enunciate may not be quite as rigid as it looks. It may well operate, like so many other default rules in contract law, only as a backdrop against which the parties--here the landlord and tenant--can renegotiate to reach a satisfactory middle solution.ⁿ¹¹

It is clear that the Second Circuit's *dictum* advocates the reinstitution of a form of pick-off agreement. The court was openly directing that, notwithstanding the provisions of *section 365(d)(4) of the Code*, landlords be denied the benefits of timely assumption or rejection of nonresidential real estate leases in favor of the forced renegotiation of existing lease transactions.

Section 365(a) of the Code provides for the approval by the bankruptcy court of all rejections and assumptions of executory contracts and unexpired leases. It has long been understood that the assumption of a contract or lease by a trustee or debtor in possession gives rise to an administrative level claim in the event of a post-assumption breach of such contract or lease.ⁿ¹² Accordingly, the courts carefully consider the merits of applications for assumption authority, including the prospects for a successful reorganization. In the case of nonresidential real estate leases, *section 365(d)(4)* directs that assumption and direction decisions be made relatively soon after the commencement of a case under the Code. However, the *Klein Sleep* decision appeared to direct that the determinations mandated under *section 365(a)* not be made until near the conclusion of each chapter 11 case. Although it may be argued that this directive applies only to nonresidential real estate leases, in view of the substantial magnitude of lease rejection damages in relation to damages arising from the rejection of other types of agreements, it appears that the holding was intended to apply to any type of agreement the breach of which would give rise to a significant damage claim.

The *Klein Sleep* court did recognize that *section 365(d)(3) of the Code* ameliorates the impact of its decision by providing landlords with an administrative priority claim for the rent reserved in a lease pending the rejection or assumption thereof.ⁿ¹³ However, the court expressed its reading of *section 365(d)(3)* by stating that "the landlord is entitled to recover as an administrative expense the rent due while the debtor and the bankruptcy court debate whether to assume the lease."ⁿ¹⁴ *Section 365(d)(3)* provides for the "timely" performance by the trustee of all of the obligations of the debtor under any unexpired lease of nonresidential real property. The court's reference to this section appears to contemplate only that a landlord's postpetition claim is to receive administrative status and does not reflect the statutory requirement that postpetition lease rentals be paid on a current basis. The requirement for payment of postpetition rental on a current basis would soften the impact of the *Klein Sleep dictum*. The deferral of payment until funding of administrative priority claims, together with the deferral of the assumption-rejection decision, would to a substantial extent relegate landlords to the posture prevailing before the enactment of the 1984 Amendments.

The effect of the *Klein Sleep* decision should be substantially reduced by the amendments to *section 365(d)(4)* pursuant to the 2005 Act that have the effect of requiring written landlord consent to extend the rejection/assumption period beyond 210 days. Moreover, the concerns of the Court in that and other cases regarding the potential prejudice to other creditors that could arise from a premature assumption decisions appear to have been ameliorated to a great extent by the concurrent amendment to *section 503(b)* that has the effect of limiting the administrative claim of a landlord with respect to a lease that is assumed, but then rejected, to an amount equal to all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises.ⁿ¹⁵

Some circumstances remain in which a landlord and trustee of a debtor-tenant will derive benefits from a pick-off agreement. Examples include (1) a case in which a landlord has a pressing need to recapture the leased premises prior to expiration of the initial period; (2) a below-market lease under which continued payments will not materially deplete the estate and with respect to which there are reasonable prospects for assignment and attendant payment of consideration to the estate; and (3) situations in which rental and other obligations occur, by the terms of the lease, at lengthy intervals, thereby mitigating some of the benefits of section 365(d)(3) in jurisdictions that follow the "billing date" method of determining the timing of a postpetition obligation.ⁿ¹⁶

Accordingly, furnished at the end of this chapter is a specimen of an application and order for a "pick-off transaction" with a form of agreement attached to the application.ⁿ¹⁷ This agreement provides not only for a release of all liabilities of the estate in connection with the lease, but for a substantial payment by the landlord for the rejection of the lease.

FOOTNOTES:

(n1)Footnote 1. *See* P 3.01[2][b] *supra*.

(n2)Footnote 2. *E.g.*, *Philadelphia Co. v. Dipple*, 312 U.S. 168, 61 S. Ct. 538, 85 L. Ed. 651 (1941) ; *120 Wall Assocs. v. Schilling*, 266 F.2d 548 (2d Cir. 1959) , *aff'g In re North Atl. & Gulf S.S. Co.*, 166 F. Supp. 29 (S.D.N.Y. 1958) ; *In re Lane Foods, Inc.*, 213 F. Supp. 133 (S.D.N.Y. 1963) (Weinfeld, J.); 11 U.S.C §§ 365(g), 502(g).

(n3)Footnote 3. 11 U.S.C. § 503(b).

(n4)Footnote 4. Cases cited in note 2 *supra*; *Theatre Holding Corp. v. Mauro*, 17 B.R. 430 (S.D.N.Y.) , *aff'd*, 681 F.2d 102 (2d Cir. 1982) .

(n5)Footnote 5. *120 Wall Assocs. v. Schilling*, 266 F.2d 548 (2d Cir. 1959) , *aff'g In re North Atl. & Gulf S.S. Co.*, 166 F. Supp. 29 (S.D.N.Y. 1958) .

(n6)Footnote 6. *American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A.*, 280 F.2d 119, 124-26 (2d Cir. 1960) .

(n7)Footnote 7. *In re Fred Sanders Co.*, 7 C.B.C.2d 421, 22 B.R. 902 (Bankr. E.D. Mich. 1982) . The *Sanders* ruling, requiring payment at the contract rate until assumption or rejection, has been followed in *In re GHR Energy Corp.*, 41 B.R. 668 (Bankr. D. Mass. 1984) (oil storage tanks).

(n8)Footnote 7a. *Towers v. Chickering & Gregory (In re Pacific-Atlantic Trading Co.)*, 27 F.3d 401, 403-405 (9th Cir. 1994) ; *In re S & F Concession, Inc.*, 55 B.R. 689 (Bankr. E.D. Pa. 1985) . It should be noted, however, that there may be an issue as to the measurement of the trustee's payment obligations if a lease is rejected under section 365(d)(4) or 365(a) and the trustee nevertheless fails promptly to surrender possession of the premises. *See In re Longua*, 58 B.R. 503 (Bankr. W.D. Wis. 1986) (trustee must continue to pay an amount equal to lease rental); *In re Western Monetary Consultants*, 19 B.C.D. 646 (Bankr. D. Colo. 1989) (trustee to pay use and occupation charges).

(n9)Footnote 8. 78 F.3d 18 (2d Cir. 1996) . *See generally* Comment, *The Klein Sleep Decision: Section 502(b)(6) Lease Damages Cap as the Rule, Not the Exception*, 4 Am. Bankr. Inst. L. Rev. 557 (1996).

(n10)Footnote 9. *See* P 3.03[2] *infra*.

(n11)Footnote 10. 78 F.3d 18, 29 (2d Cir. 1996) .

(n12)Footnote 11. 78 F.3d 18, 29-30 (2d Cir. 1996) . The Ninth Circuit Court of Appeals has also created a mechanism under which the election to assume or reject a nonresidential real property lease may be deferred. In the circumstance in which the time to extend or renew a lease occurs during the postpetition period but prior to the time when the debtor is prepared to elect assumption or rejection, the court has held that the lease may be extended by the

debtor without (a) curing any outstanding defaults under the lease notwithstanding the requirement of the lease that there be no outstanding defaults as a condition of extension, and (b) electing to assume or reject. The court found that requiring cure of outstanding defaults would be tantamount to an early assumption, which would create an undesirable administrative liability of the estate and potentially impair its ability to reorganize. *In re The Circle K Corp.*, 127 F.3d 904, 38 C.B.C.2d 1445 (9th Cir. 1997) .

(n13)Footnote 12. See *In re Italian Cook Oil Corp.*, 190 F.2d 994, 996 (3d Cir. 1951) ; *Continental Energy Assocs. Ltd. Pshp. v. Hazelton Fuel Mgmt. Co. (In re Continental Energy Assocs. Ltd. Pshp.)*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) . But see *Memphis-Shelby County Airport Auth. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 783 F.2d 1283, 1286, 14 C.B.C.2d 453, 455 (5th Cir. 1986) .

(n14)Footnote 13. 78 F.3d 18 (2d Cir. 1996) .

(n15)Footnote 14. 78 F.3d 18, 30 n.7 .

(n16)Footnote 15. 11 U.S.C. § 503(b)(7). Pub. L. No. 109-8, § 445, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The limitation is applicable to cases commenced on or after October 17, 2005. The administrative claim arising from the rejection is not subject to setoff or rejection for any reason whatsoever except for sums actually received from an entity other than the debtor. Any claim for remaining sums due for the balance of the term of the assumed lease is a claim under section 502(b)(6). *Id.*

(n17)Footnote 16. See P 3.01[3][b][I][B] *supra*; see also, e.g., *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001) .

(n18)Footnote 17. See P 3.56 *infra*.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

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P 3.03 Rejection of Leases

[1] Rejection Standards

It appears to be generally accepted that a trustee may reject a lease that is deemed burdensome and that the determination of whether a lease is burdensome is a matter of the trustee's business judgment.ⁿ¹ If a landlord seeks to oppose a proposed lease rejection by a tenant's trustee, the landlord will be required to demonstrate that the rejection will be of no benefit to the general creditors of the estate and would be prejudicial to the landlord's interests.ⁿ² It is very difficult for a nondebtor party to resist a proposed rejection of a lease inasmuch as denial of rejection will compel the trustee to retain and ultimately assume a relatively long-term obligation that it perceives to be harmful to the financial position of the estate. In sum, a landlord will be able successfully to oppose a lease rejection only in the rare instances in which the rejection would confer no demonstrable benefit to the estate. Rejection is effected only upon approval of the court under *section 365(a) of the Code* and not by a unilateral notice of surrender from the debtor to the landlord.ⁿ³ A motion to reject a lease will be made under *Bankruptcy Rules 6006(a)* and *9014*. A specimen of a motion for the rejection of a lease is provided at the end of this chapter.ⁿ⁴

[2] Computation of Damages

Under the Bankruptcy Code, a landlord's claim for damages arising out of the termination of a lease is computed by determining the amount of damages provided for under applicable state law and applying the ceiling on that amount in accordance with *section 502(b)(6) of the Code*.ⁿ⁵ The ceiling has been held to be applicable even if the estate is solvent or otherwise has sufficient funds to pay in full the claims of all creditors, including landlords, without giving effect to *section 502(b)(6)*.^{n5a} Although it may appear that there should be no federal law impact on the computation of damages pursuant to applicable state law, the bankruptcy courts have found it necessary to construe lease damage clauses in the context of a lease rejection effected under federal bankruptcy law.^{n5b}

Many commercial leases contain two damage provisions, each of which is effective upon the breach and termination of the lease. The first provision, sometimes referred to as a liquidated damage covenant, typically provides for damages in an amount equal to the excess of the rent reserved in the lease for the balance of the term above the fair rental value of the premises over the same period, discounted to present value at a specified discount rate. The second type of clause, sometimes referred to as a survival covenant, recognizes the termination of the lease and provides for the payment of damages in an amount equal to the excess of the rents reserved in the lease above the rents actually collected by the landlord upon reletting. Under a survival covenant, the landlord may commence successive monthly lawsuits to recover

the deficiency computed in accordance with the covenant, or may file one lawsuit for the aggregate deficiency upon the expiration of the lease term.ⁿ⁶ Under both the liquidated damage and survival covenants, the landlord is ordinarily entitled to deduct from the credit to the tenant the reasonable costs of renovation required for reletting, brokerage commissions, attorneys' fees incurred with respect to reletting and similar reasonable costs.ⁿ⁷

Although it is not possible to point to specific language in the cases, a review of the precedents indicates that bankruptcy courts are more favorably disposed towards landlord claims under liquidated damage covenants than towards claims under survival covenants.ⁿ⁸ Under a liquidated damage covenant, the landlord must show that the rent reserved in the lease exceeds the fair rental value of the premises, and must overcome the presumption that the two amounts are the same.ⁿ⁹ The landlord and the trustee may present the testimony of their appraisers and other experts, and the court is required to make findings of fact as to the fair rental value of the premises.ⁿ¹⁰ The fair rental value of the premises for the balance of the lease term may take into account anticipated market appreciation and inflationary pressures which may result in greater value in the later years of the lease.

Under a survival covenant, on the other hand, the measure of damages does not depend upon a rental value appraisal but instead relates to the actual reletting receipts, if any, of the landlord measured against the lease rental. The damages appear to be computed on a month-by-month basis, so that a deficiency incurred during one month cannot be erased by a surplus in a subsequent month.ⁿ¹¹ Thus, this manner of computation may be perceived as providing a higher recovery for a landlord under a rejected lease. As indicated above, landlord claims under survival covenants have received a less than warm reception from the courts.

In one case, a landlord sought to recover for the actual loss of rental during a two-and-three-quarter-month period after a debtor had vacated the premises and rejected the lease but before the space was relet to another tenant. The lease to the new tenant was, in the aggregate, more favorable than the debtor's lease, even taking into account the loss of rental for the two-and-three-quarter-month period. The court held that the landlord was not entitled to recover under the survival covenant for the unpaid rental because the survival covenant was set forth in the section of the lease dealing with payment defaults and the separate bankruptcy default provision did not refer to the survival covenant.ⁿ¹² The court concluded that the landlord could not apply the survival covenant to a bankruptcy-related breach and that the landlord's alternative claim under the liquidated damages standard would yield no recovery in view of the beneficial reletting of the premises.ⁿ¹³ In a subsequent case in which the bankruptcy default clause in the lease referred to the survival covenant, the court held that the landlord could under the survival covenant recover an amount equal to the rent reserved under the lease for the applicable three-year limitation period under section 353 of the former Bankruptcy Act, less the rentals received from a new tenant during that period (plus an amount for reletting commissions and repairs to the premises).ⁿ¹⁴ However, another court has expressed the view that enforcement of an admittedly applicable survival covenant in the context of a bankruptcy case may be inconsistent with the rehabilitative purpose of the bankruptcy law if the landlord can wait until the expiration of a long-term lease and then seek to recover the aggregate rental deficiency.ⁿ¹⁵ In other words, employment of a survival covenant and recovery at the end of the lease term are inconsistent with the effort to liquidate and discharge claims in the context of the bankruptcy case, and to confirm a plan and close the case without a material contingent liability hanging over the rehabilitated enterprise.

As noted above, repairs to the premises effected by the landlord are an allowable item of damages. There are four different categories of repairs, each of which is given different treatment in bankruptcy cases. First, repairs, renovations and remodelling are required to put the premises in condition for reletting. The cost of this work is includable in the computation of damages arising out of the rejection of the lease.ⁿ¹⁶ Accordingly, this item is allowed as part of the general unsecured damage claim of the landlord under *section 502(g) of the Code* and is subject to the limitation provided for in section 502(b)(6). However, it has been held that the unamortized portion of a construction allowance does not constitute "rent reserved" within the meaning of the section; accordingly, the amount was not allowable as a claim even though the lease required that such unamortized amount be paid to the lessor if the lease was terminated prior to the end of the amortization period.^{n16a}

Second, there are repairs and renovations that relate to the reletting of the premises but which are so extensive as to enhance the value of the premises above the value in effect as of the date of the original letting. Such repairs and renovations are not to be charged against the former tenant's estate to the extent of the excess appreciation.ⁿ¹⁷

Third, there are repairs required to be made by the tenant under a net lease that the tenant has failed to perform before the filing of its Bankruptcy Code petition. The cost of such repairs is allowable as an item of unpaid "rent" in the damage claim.ⁿ¹⁸

Fourth, repairs are necessitated by an act or omission of the trustee following the filing of the tenant's petition. The cost of these repairs has been held to be chargeable against the estate as an expense of administration, and are to be computed without regard to the limitation on damages set forth in section 502(b)(6).ⁿ¹⁹

The holdings in respect of the last category of repairs are based on the theory that the failure to effect repairs took place during the postpetition period and such failure should accordingly be charged against the estate. In the case of infliction of damage to the premises during the postpetition period, it seems proper to charge the estate with the consequences of affirmative and wrongful acts.ⁿ²⁰ However, when the financially troubled debtor neglected its repair obligations before the filing of its petition, continues to neglect the same obligations after the filing and ultimately rejects the lease, it is questionable whether the failure of performance should give rise to an administrative claim. As discussed earlier, the filing of a tenant's bankruptcy petition places the lease into suspension pending action by the trustee to assume or reject the lease.ⁿ²¹ If the lease is ultimately assumed, any defaults relating to the failure to repair will have to be cured.ⁿ²² If the lease is ultimately rejected, the rejection is deemed to have occurred immediately prior to the date of entry of the order for relief.ⁿ²³ Thus, even though the rejection occurred during the period of administration of the estate, the Bankruptcy Code expressly provides that the breach is deemed to have occurred earlier, so the damage claim will be a general unsecured claim rather than a claim having priority as an expense of administration. If the trustee is in possession of the premises before the rejection of the lease under its authority under the Bankruptcy Code to protect and preserve the assets of the estate,ⁿ²⁴ and not as the tenant under the lease, and if the lease is deemed rejected before the commencement of the proceedings under the Code, then how may the estate be charged with breach of a lease obligation that was not binding on the trustee *ab initio*? Indeed, how may the estate be administratively charged with a breach of a particular covenant in the lease--the covenant to repair--when it is not administratively charged with a breach of the entire lease by means of rejection?

It may be argued, on the other hand, that section 502(g), in providing that a claim for rejection damages shall be treated as a prepetition claim, does not speak to a breach of a particular lease covenant and deals only with a rejection of the entire lease. It may be further argued that section 502(b)(6) by its terms limits only claims arising from the termination of a lease, and likewise does not limit any claims arising out of the breach of a particular lease covenant prior to termination. However, both of these arguments assume the existence during the bankruptcy case of a lease that is capable of being breached. As demonstrated earlier, this assumption is incorrect.ⁿ²⁵

This issue frequently arises in the context of a claim by a real property lessor against the estate of a debtor tenant asserting a right to administrative priority for costs incurred in the postpetition period for remediation of environmental contamination caused by the debtor during the prepetition period.^{n25a} The fact pattern in these cases typically involves the creation by the debtor of an environmental hazard during the prepetition period, such as the accumulation and failure to dispose of barrels containing hazardous materials, or the spillage of such materials and the failure to remediate the resulting environmental damage.^{n25b} After the filing of the debtor's petition under the Code, the lease will be rejected, and the lessor of the affected premises will be faced with the prospect of paying for the cost of remediation.^{n25c} The lessor will seek administrative priority status for the remediation costs.

The courts that have granted administrative priority status to such claims have based their holding on the Supreme Court's decision in *Midlantic National Bank v. New Jersey Department of Environmental Protection*,^{n25d} which held that a trustee may not abandon property in contravention of a statute designed to protect public health where such

abandonment would give rise to a threat of identifiable and imminent harm.^{n25e} Under 28 U.S.C. § 959(b), a trustee is required to manage and operate the property in its possession in accordance with applicable state law as if it were the owner or possessor thereof. Accordingly, these courts hold that (1) the trustee may not abandon the leased property; (2) the trustee is obligated under section 959(b) to operate the property in accordance with state law, and is therefore required to remediate existing environmental hazards as an administrative obligation of the estate; and (3) a claim of a real property lessor for the costs of such remediation is therefore an administrative claim.^{n25f}

In large part, the cases that refuse to accord administrative priority status to lessors' claims for postpetition remediation costs relating to prepetition contamination do so under a factual determination that there is no threat of imminent harm to the public, and that abandonment of the asset therefore would be permitted under *Midlantic*.^{n25g}

It is clear, however, that the creation of an environmentally hazardous condition during the course of operations in the postpetition period gives rise to an administrative claim by a lessor of the debtor.^{n25h} There is also precedent indicating that the lessor may also receive administrative priority treatment for a claim arising out of the postpetition negligence of a debtor in possession or trustee resulting in environmental damage,ⁿ²⁵ⁱ but it is less clear whether the negligence theory will apply to a passive failure during the postpetition period to remedy a condition created in the prepetition period.^{n25j}

The import of the foregoing with respect to the allowance of administrative priority claims for lessors relating to prepetition lease breaches by debtor-tenants continuing into the postpetition period should not be limited to environmental law cases. The *Midlantic* holding, together with the dictates of 28 U.S.C. § 959(b), may demonstrate that a lessor of real property will have an administrative priority claim for the costs of curing a prepetition default by a debtor-lessee involving any lease provision that affects public health or safety, requires compliance with local law, and involves an imminent threat to safety or health. Although this formulation may appear to encompass a very limited range of cases, it is probably not uncommon to find that lessees of industrial and perhaps commercial property who are experiencing financial difficulties will defer maintenance, repairs and replacements to the leased premises, in some instances to the extent that hazardous conditions and violations of local law will result.

The above-described cases involving claims for administrative priority treatment by lessors responsible for remediation of prepetition environmental hazards, and the cases involving fact patterns described in the immediately preceding paragraph, appear to entail a judicially created limitation on the generally understood consequences of a lease rejection. As discussed above, it is generally the case that a lessor's claim for damages arising from the existence of uncured prepetition lease defaults will constitute a general unsecured claim. These prepetition defaults will remain uncured in the context of a rejection of the lease, rather than being cured in the context of an assumption of the lease.^{n25k} The effect of the *Midlantic* prohibition against abandonment in conjunction with the requirements of 28 U.S.C. § 959(b) is not to proscribe the rejection of a lease by the trustee of a debtor-lessee, but to select a discrete obligation of the debtor under the lease (such as compliance with law, or maintenance of the premises in good order and repair) and to create the same financial consequence to the estate and its creditors as if the lease had been assumed and the provision thereafter breached--that is, administrative priority status for the claim arising from such breach.^{n25l} However, in the absence of these special circumstances, the claim of a real property lessor against the estate of a debtor-tenant arising from the existence of a prepetition lease default that remains uncured in the postpetition period is a general unsecured claim.

The preceding conclusions should not be affected by section 365(d)(3), enacted as part of the 1984 Amendments, which provides that the trustee shall timely perform all of the debtor's obligations under a nonresidential real estate lease arising from and after the entry of the order for relief until rejection or assumption. This section should not be read to require the trustee to cure a continuing prepetition lease default of the debtor, but only to perform new obligations, and not to create new defaults, arising from and after the entry of the order for relief.^{n25m} If the trustee's passive neglect of the leased premises is causing a diminution in value of the property, the landlord should commence a proceeding in the bankruptcy court seeking adequate protection in the form of compensation for the depreciation of the property or affirmative action on the part of the trustee to repair the damage to the property. This action by the landlord may be

accompanied by a proceeding to obtain modification of the automatic stay to permit the termination of the lease on the basis of the prepetition breach of the material obligation of the debtor to maintain the premises in good order and repair, if such is the case.ⁿ²⁶ The landlord could also file a motion pursuant to section 365(d)(2) seeking an order directing the trustee to assume or reject a lease by a specified time, on the grounds that the delay in the decision was causing unreasonable prejudice to the landlord. If, however, the debtor in possession or trustee during the period of the case affirmatively acts to damage the property, the landlord's claim, allowable as an expense of administration, would be based on several theories, including (1) an implied covenant on the part of the trustee not to commit waste, (2) a theory of intentional tort, (3) a lack of adequate protection, (4) the powers of the bankruptcy court as a court of equity to provide an adequate remedy for wrongful conduct and (5) the provisions of section 365(d)(3) requiring the trustee to perform the postpetition obligations provided for in the lease.

Many commercial leases provide for the payment of a fixed rental and obligate the tenant to pay additional sums for taxes, operating costs, utilities, special services and the like. In a lease properly drafted from the landlord's viewpoint, these charges will be denominated as additional rental and the failure of their payment will have the same default consequences as nonpayment of fixed rental. Moreover, many commercial leases will grant the landlord a self-help right to perform the obligations of the tenant and to recover the cost of such performance from the tenant. Again in this instance, a properly drafted landlord's lease will provide that the tenant's reimbursement obligations constitute additional rent. If a lease provides for additional charges to be paid by a tenant, but does not characterize such charges as additional rent, a question arises whether such charges may be included in the computation of rent under section 502(b)(6), which establishes a rejection damage limitation based on "the rent reserved" in the lease. It was held under the former Bankruptcy Act that a landlord may include in its rejection damage claim unpaid charges and self-help costs not denominated as rent under a lease.^{n26a} Under this holding, the statutory limitation on the damage recovery should likewise be construed to include lease charges not denominated as rent (thereby increasing the amount of the limitation), for otherwise the expanded scope of recovery would be immediately circumscribed by the narrower limitation. However, one court has held under the Bankruptcy Code that attorney's fees provided for under a lease do not constitute "rent reserved" for the following reasons: (1) the fees were not labeled as rent or additional rent; (2) the fees were not related to the value of the property; and (3) the fees did not constitute a fixed, periodic charge.^{n26b} Therefore, the court held that such fees could not be included as part of the allowable claim under section 502(b)(6). A similar result was obtained in a case where a bankruptcy court held that damages arising from the tenant's breach of a repair and maintenance covenant did not constitute rent under the same three-part test.^{n26c}

Section 502(b)(6) is also implicated in the computation of claims arising under guarantees of real estate leases. The issue is whether the limitations provided for in section 502(b)(6) on the allowed amount of a claim against a debtor-lessee also apply to and limit the allowed amount of a claim against a guarantor of the lessee's obligations under the lease. The fact patterns generally encountered are (1) a solvent guarantor is not a debtor in a Bankruptcy Code case and a lessee is such a debtor; (2) both the guarantor and the lessee are debtors in Bankruptcy Code cases; and (3) the guarantor, but not the lessee, is a debtor in a Bankruptcy Code case.

The issue described above cannot be resolved by reference to the language of section 502(b)(6). This section limits "the claim of a lessor for damages resulting from the termination of a lease of real property." This language does not clearly distinguish between the claim against a debtor-lessee for such damages and the claim against a guarantor of the lessee for recovery of the same damages. Although it may be argued that a claim against the guarantor is a claim under a guarantee rather than a claim resulting from the termination of a lease, and is therefore not subject to the section 502(b)(6) limitation, the courts have not regarded this argument as sufficiently persuasive in view of the close relationship between a guarantee and the obligations so guaranteed.ⁿ²⁷

In the case of a nonbankrupt guarantor and a lessee that is a debtor in a Bankruptcy Code case, it is clear that the section 502(b)(6) limitation does not apply to the claim of the lessor against the guarantor.^{n27a} The claim may not be asserted against the guarantor in bankruptcy court inasmuch as the guarantor is not a Bankruptcy Code debtor. The claim is governed under applicable nonbankruptcy law. Furthermore, most properly drafted guarantees will provide that the

obligation of the guarantor thereunder is not affected or impaired by the insolvency or bankruptcy of the lessee. Indeed, one of the very purposes of the guarantee is to assure the guaranteed party (the lessor) of the benefit of its bargain in case the principal obligor (the lessee) is not willing or is unable to perform its financial obligations, including in the event of a bankruptcy case. It should be noted, however, that if the guarantor seeks to assert a claim in subrogation against the lessee in the lessee's Bankruptcy Code case, the section 502(b)(6) limitation should be held to limit the amount of the allowed claim of the guarantor. The subrogated guarantor stands in the shoes of the lessor of the Bankruptcy Code debtor; the claim of the lessor of the Bankruptcy Code debtor clearly is limited under the terms of section 502(b)(6).

The result changes when both the guarantor and the lessee are Bankruptcy Code debtors. The cases are consistent in holding that the allowed claim against the debtor-guarantor in such debtor's case will be limited by the formula prescribed in section 502(b)(6).^{n27b} The rationale for this rule is that a lessor's claim for damages arising out of the rejection of a real estate lease may in some instances be so large as to overwhelm the claims of other unsecured creditors, and that this problem will obtain in the Bankruptcy Code case of the guarantor as well as in the Bankruptcy Code case of the debtor-lessee.^{n27c}

A somewhat more difficult issue arises in the context of the Bankruptcy Code case of the guarantor and the absence of a Bankruptcy Code filing involving the lessee. If the issue is viewed as involving only the limitation of large lessor damage claims, then the policy considerations underlying the section 502(b)(6) limitations should apply to the claim in the guarantor's case.^{n27d} However, it also may be argued that the limitation on a direct claim of the lessor against a bankrupt lessee is appropriate because the lessor will recover the leased premises after rejection of the lease and, therefore, will have the opportunity to mitigate the effects of the lessee's bankruptcy. In the case of a claim against a guarantor of a lessee, the guarantor, although subrogated to the claim of the lessor, will not be entitled to recover the leased premises from the defaulting lessee, and therefore should be accorded full state law damage recovery rights. One approach, accepted by some courts, is to resolve the issue on a case-by-case basis under equitable principles. Application of equitable principles in this context means that the court will evaluate the effect of an unlimited lessor's claim on the distribution to other creditors of the estate. If the estate is solvent, and other creditors are to be made whole without application of the section 502(b)(6) limitation, then the limitation may be held not to apply.^{n27e}

[3] Preparation of Proofs of Claim

Proofs of claim relating to leases under which the debtor is the tenant will cover one or more of the following categories:

- (1) general unsecured claims for amounts dueⁿ²⁸ prior to the earlier of the date of filing of the petition or the date of repossession or surrender of the premises;^{n28a}
- (2) claims for unpaid obligations arising under section 365(d)(3), in the case of a nonresidential lease, and otherwise for use and occupation of the premises after the filing of the petition;ⁿ²⁹ and
- (3) general unsecured claims for damages arising out of the rejection of the lease.ⁿ³⁰

In addition to proofs of claim for the categories listed above, a request for payment of an administrative expense may be made under *section 503(a) of the Code* if a lease is rejected after being assumed. As a result of the 2005 Act, a landlord has an administrative expense claim in an amount equal to all monetary obligations for the two-year period following rejection or actual turnover of the property if the rejected lease had been previously assumed in the case.^{n30a}

These claims may be combined within one proof of claim document. In some instances, however, the claims described in (1) and (2) above will have to be filed before a "bar date" specified on notice to creditors in the case, but the lease may be rejected after that date. In these circumstances, a second proof of claim for rejection damages will be filed or the

necessary steps will be taken to amend the first proof of claim. Under Bankruptcy Rule 3002(c)(4), a claim arising from the rejection of an "executory contract or unexpired lease of the debtor" is to be filed within the time as the court may direct. It should also be noted that in chapter 7 and 13 cases, nonrejection proofs of claim must be filed within 90 days after the date first set for the meeting of creditors under section 341(a), but in chapter 11 cases the bar date for filing is to be fixed by the court.

Section 502(b)(6) of the Code provides for allowance of a landlord's claim for damages resulting from the "termination" of a lease of real property except to the extent that 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 (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates[.]" The principal issue relating to the computation of the damage limitation under this section is whether the phrase "15 percent of the remaining term of the lease" means 15 percent of the rent reserved under a lease for the remainder of the term (the "Rental Computation"), or an amount equal to the rent reserved under such lease for the next ensuing 15 percent of the remaining term (the "Term Computation"). Under the Rental Computation, the aggregate amount of the rent reserved under the lease is multiplied by 15 percent, with the result to constitute a part of the computation of the section 506(b)(6) allowable claim limitation. Under the Term Computation, the limitation is calculated by determining the next ensuing period of time representing 15 percent of the remaining lease term, and ascertaining the rent that would have been payable under the lease during such period.^{n30a-1} The importance of this distinction is demonstrated by the following example described by one court:

A chapter 11 debtor rejects a lease with 10 years remaining under the lease. Each of the first 5 years of the remaining lease term requires rental of \$80,000 per year, and each of the last 5 years of the remaining lease term requires a rental of \$120,000 a year. If the § 502(b)(6)(A) damage cap is calculated as a function of time, 15% of the remaining lease term would be 1.5 years (10 years multiplied by .15), which would make the lessor's rejection damages \$120,000 (1.5 years multiplied by \$80,000 a year for that period of time). If the damage cap is calculated as a function of rent, the lessor would be entitled to \$150,000 in damages (\$1 million multiplied by 15%).^{n30b}

The two approaches will yield the same result with respect to leases that provide for a fixed and unchanging rental obligation throughout the term. However, the issue arises with respect to leases that provide for escalating rentals, inasmuch as 15 percent of the aggregate remaining lease rental will be greater than the rental payable under the next ensuing 15 percent of the remaining term of such lease. Moreover, the difficulty is compounded when a lease contains escalation provisions relating to increases in a landlord's operating expenses, real estate taxes or other extrinsic and variable factors rather than a fixed and determinable escalation of base rent.

A lease providing for a fixed and determinable escalation of base rent may have the same present value as a lease with a base rent that is constant throughout the term, with the escalating lease calling for a lower monthly rental payment at the outset and a higher monthly rental payment towards the end of the term. Although the two leases may be identical for valuation purposes on a present value basis, an escalating lease may be more desirable to a tenant that needs to expend front-end funds for space renovation and move-in costs, and may also serve as a marketing tool for the landlord seeking a tenant for the space. However, if the tenant under such a lease becomes a Bankruptcy Code debtor and rejects the lease prior to the occurrence of the last escalation date, application of the Term Computation would result in a greater limitation on the landlord's allowable claim.

Indeed, the prospect of employment of the Term Computation should result in landlords requiring higher front-end rentals than later on during the lease term in the case of tenants with questionable financial statements. Inasmuch as such tenants may be more likely to become Bankruptcy Code debtors during the early part of a lease term, application of the Term Computation to a landlord's claim for damages arising out of a lease rejection occurring early in the term of such a lease will result in a higher allowable claim amount than would application of the Rental Computation to the

rejection of the same lease. Of course, a landlord's insistence on charging a financially-pressed prospective tenant an enhanced rental at the outset of a lease term may cause the tenant to go elsewhere for space, or exacerbate the tenant's financial problems and contribute to the causes of the tenant's bankruptcy and subsequent rejection of the lease.

Although the foregoing discussion leads to the conclusion that use of the Rental Computation rather than the Term Computation better reflects the financial attributes of escalating leases and results in a more equitable application of section 502(b)(6) among the various possible fact patterns, the language of section 502(b)(6) does not dictate that use of the Rental Computation is the correct result. The statute speaks in terms of rent reserved for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of a lease. This language does not instruct a court as to which one-year or three-year period during the term of a lease is being addressed. Presumably, Congress did not choose to let the courts select any one-year or three-year period they felt to be best, but meant to refer to the period next following the date of the lease rejection. If the references to the one-year and three-year periods are references to the periods next following the date of rejection, then the period constituting 15 percent of the remaining term--which is to be measured against the prescribed one-year and three-year periods--should also be read to refer to a period beginning with the same starting date as the one and three year periods. Thus the period measured as 15 percent of the remaining term appears to be the period next following the date of rejection. It should also be noted that section 502(b)(6) speaks in terms of the rent reserved by "such lease" for 15 percent of the remaining term of the lease, and not 15 percent of the rent reserved by such lease for the remaining term. The thrust of this language appears to point to a computation of rental payable during a specified period, rather than to a percentage of the rental payable over the entire remaining term.

Finally, it appears that the use in section 502(b)(6) of the term "without acceleration" is meaningful only in the context of the Term Computation, inasmuch as these words instruct courts to deal with the separate installment payments provided for in a lease rather than with the aggregate amount of the rental provided for over the life of the lease. Under the Term Computation, the installments of rental coming due during the respective periods of time specified in section 502(b)(6) are the only amounts relevant to the computations called for under the section. On the other hand, under the Rental Computation, the proper measurement is of (15 percent of) the aggregate amount of the rental payable throughout the remaining term of the lease, which of course is equal to the total rental payable during such period on an accelerated basis. Thus the use of the term "without acceleration" appears to be consistent with the Term Computation rather than the Rental Computation.^{n30c}

Counsel for the landlord will of course desire to maximize the amount of the section 502(b)(6) limitation. Accordingly, if the lease so provides, the term "rent" will include all charges payable under the lease denominated as rent, including charges for taxes, electricity, insurance premiums, maintenance costs and the like. If the lease does not denominate such charges as rent, they nevertheless should be included in the claim as though they constituted "rent."ⁿ³¹ In any event, in computing rent for a given period of time, allowance should be made for escalation clauses commonly found in real estate leases. For example, in computing the amount of rent payable during the ensuing 15% of the term, counsel should estimate escalations that may occur under cost-of-living (consumer price index) clauses, operating expense escalation clauses, tax escalation clauses, labor rate escalation clauses and the like. The damage claim will be based upon the measure of damages computed in accordance with state law, limited, however, as provided in section 502(b)(6). A form of proof of claim with respect to a rejected lease of real property is set forth at the end of Chapter 2.ⁿ³² This form, prepared for the holder of an assignment of leases, may easily be adapted for a direct claim by a landlord.

[4] Rejection of Leases by Trustees of Debtor-Lessors

Discussed elsewhere in this book is the effect upon a leasehold mortgagee or a sublessee of the rejection of a real estate lease by the trustee of a debtor-lessor.ⁿ³³ Under section 365(h), the lessee under such a rejected lease may elect to treat the lease as terminated if the rejection "... amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee ..." or to retain its rights under the lease for the balance of the current term and for any renewal or extension option periods exercisable by the lessee under nonbankruptcy law.ⁿ³⁴ If a lessee under a rejected lease elects to remain in possession, the

debtor-lessor is relieved from the performance of its affirmative obligations under the lease. The sole recourse of a lessee in possession with respect to the breach of the lessor's affirmative obligations is to offset the lessee's resulting damages from succeeding installments of rent.

If the premises involved in a lease rejection by the trustee for a debtor-lessor are residential premises subject to local governmental requirements with respect to repairs, heating, hot water, illumination and the like, and the rejection would purport to free the debtor-lessor from the lease-related obligations to comply with such governmental requirements, the court must consider the effect of 28 U.S.C. § 959(b) upon the trustee's right to free the debtor from these requirements. 28 U.S.C. § 959(b) provides that:

Except as provided in section 1166 of title 11 [with respect to railroad reorganization], a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

Under Section 959(b) (or its predecessor, 28 U.S.C. § 124), trustees have been held subject to a variety of local, state and federal laws pertaining to real estate, including federal rent control, municipal rent control, state housing laws, and zoning laws.ⁿ³⁵ Although it is not entirely clear that a trustee who has rejected a lease, particularly a net lease, is "managing and operating" the leased premises, it may be argued that a trustee for a debtor-lessor who proposes to discontinue provision of, for example, elevator service, heat, hot water, maintenance or repairs, would violate state or local laws relating to health and safety, fire prevention, nuisance and similar matters.

In this connection, it should be noted that section 362(b)(4) exempts from the automatic stay created by section 362(a) certain actions by a governmental unit to enforce its police or regulatory power. The section 362(b)(4) exemption is narrowly interpreted so as to apply only to postpetition enforcement of pre-petition violations of local law.ⁿ³⁶ Proceedings under authority of 28 U.S.C. § 959(b), however (unlike actions coming under the section 362(b)(4) exemption), are directed to postpetition violations of local law and may be brought by private citizens.ⁿ³⁷ Nevertheless, one court has held that a chapter 11 trustee of a debtor-lessor could reject five residential leases relating to one building and was not obligated to comply with the local governmental requirements concerning health and safety if the lessees elected to remain in possession.ⁿ³⁸ The court determined that (1) the specific provisions of section 365(h) governed the general provisions of 28 U.S.C. § 959(b); (2) the local requirements could not override the Bankruptcy Code's policy favoring the elimination of burdensome contractual obligations for the benefit of an estate and its creditors; (3) the tenants had the option to relocate; and (4) under local law, the tenants could engage in a rent strike to protect their interests.ⁿ³⁹

A similar and even more difficult issue is whether a trustee for a debtor-lessor may free itself of local rent control requirements through the mechanism of a lease rejection. These requirements deal not only with ceilings upon rental charges but with obligations to provide renewal leases, subletting rights and other matters fundamental to the landlord-tenant relationship. It has been held that a trustee for a debtor-lessor could not escape residential rent control limitations through the use of section 365(h) because: (1) the provisions of 28 U.S.C. § 959(b) require the application of local rent control laws to the conduct of business by the trustee for a debtor-lessor; (2) section 362(b)(4) evidences a policy favoring enforcement of local rent control regulations; and (3) the statutory tenants involved in the case held possession under the rent control laws and not under leases.ⁿ⁴⁰

FOOTNOTES:

(n1)Footnote 1. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219 (1984). *In re Orion Pictures Corp.*, 4 F.3d 1095, 29 C.B.C.2d 1341 (2d Cir. 1993); see 3 *Collier on Bankruptcy*, P 365.03 (Matthew Bender 15th Ed. Revised).

Detailed discussion of the standards to be satisfied by a trustee to obtain approval of the rejection of a lease is beyond the scope of this book. See 3 *Collier on Bankruptcy*, P 365.03 (Matthew Bender 15th Ed. Revised). In *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219 (1984), the Supreme Court set forth the standards for rejection of a collective bargaining agreement. The rejection of collective bargaining agreements is now governed by section 1113 of the Code, enacted in the 1984 Amendments. However, the *Bildisco* opinion contains an extensive discussion of the law governing rejection of executory contracts in Bankruptcy Code cases and therefore remains an important source for reference.

(n2)Footnote 2. *Control Data Corp. v. Zellman (In re Minges)*, 602 F.2d 38, 20 C.B.C. 955 (2d Cir. 1979); *In re Petur U.S.A. Instr. Co.*, 35 B.R. 561 (Bankr. W.D. Wash. 1983). There is a conflict among cases concerning whether the court, in the context of an executory contract rejection motion, should consider only the benefits of the rejection for the estate's general creditors or also consider the adverse consequences of the proposed rejection to the nondebtor party. *In re Federated Dep't Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991); *In re Prime Motor Inns*, 124 B.R. 378, 383 (Bankr. S.D. Fla. 1991); *In re H.M. Bowness, Inc.*, 89 B.R. 238 (Bankr. M.D. Fla. 1988); see *Infosystems Tech., Inc. v. Logical Software, Inc.*, B.L.R. P 71,899 1987 U.S. Dist. LEXIS 6285 (D. Mass. 1987) and cases cited therein. A court may for the purpose of protecting third party rights recognize a rejection but regard the lease as merely breached and not terminated. *Eastover Bank for Sav. v. Sowashee Venture (In re of Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir. 1994); *In re Storage Tech. Corp.*, 55 B.R. 479, B.L.R. P 70,757 (Bankr. D. Colo. 1985). *Contra Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077 (9th Cir. 1989). Another view of lease rejection is that the lease reverts to the debtor and that rejection means only that the estate has elected not to assume the obligation. *In re Miller*, 103 B.R. 353 (Bankr. D.D.C. 1989).

(n3)Footnote 3. *Thinking Machs. v. Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.)*, 67 F.3d 1021, 1025 (1st Cir. 1995); *In re Revco D.S., Inc.*, 109 B.R. 264 (Bankr. N.D. Ohio 1989). A minority of courts have found that issuance of an order approving rejection may be a condition subsequent, relating back to an earlier date. See *Constant L.P. v. Jamesway Corp. (In re Jamesway Corp.)* 179 B.R. 33 (S.D.N.Y. 1995); *In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992); *In re 1 Potato 2, Inc.*, 58 B.R. 752, 755-56, 14 C.B.C.2d 534, 538-40 (Bankr. D. Minn. 1986).

(n4)Footnote 4. See P 3.57 *infra*.

(n5)Footnote 5. *Wall St. Plaza, LLC v. JSJF Corp. (In re JSJF Corp.)*, 344 B.R. 94 (B.A.P. 9th Cir. 2006) (under structure of section 502(b)(6), damages arising from rejection of lease are first determined under state law and cap applies to limit that claim to a function of "rent reserved" whether or not the damages themselves constitute rent); *In re Goldblatt Bros., Inc.*, 66 B.R. 337 (Bankr. N.D. Ill. 1986); cf. *C.D. Stimson Co. v. Porter (In re Save-Rite Drug Stores)*, 195 F.2d 410, 413 (10th Cir. 1952) (damages arising from lease termination computed according to state law but limited by provisions of former Bankruptcy Act). If a real estate lease is assumed by the tenant's trustee in a chapter 11 proceeding and rejected after conversion to chapter 7, the section 502(b)(6) limitation is partly inapplicable, and the damage claim will be treated as an expense of administration ranking junior only to the chapter 7 administration expenses. *Giant Eagle, Inc. v. Phar-Mor, Inc.*, 528 F.3d 455, 59 C.B.C.2d 1030 (6th Cir. 2008). Before the 2005 Act, it appeared that the entire amount of damages arising from the rejection of the lease would be treated as an expense of administration. See, e.g., *Nostas Assocs. v. Costich (In re Klein Sleep Prods, Inc.)*, 78 F.3d 18 (2d Cir. 1996). However, the 2005 Act added a new provision, section 503(b)(7), which essentially provides that if a lease is assumed by the debtor during the case, but later rejected, the damages arising from such breach are entitled to administrative priority in an amount equal to the all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises, with any claim for remaining sums due for the balance of the term being subject to the cap under section 502(b)(6).

(n6)Footnote 5a. *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003); *In re Farley, Inc.*, 146 BR 739 (Bankr. N.D. Ill. 1992); *In re Federated Dep't Stores, Inc.*, 131 B.R. 808, 816 (S.D. Ohio 1991). *Contra In re Danrik, Ltd.*, 92 B.R. 964 (Bankr. N.D. Ga. 1988). However, it has been held that a case may be dismissed as being filed in bad faith where the only reason for the filing of the bankruptcy petition was to take advantage of the cap under 502(b)(6).

In re Liberate Techs., 52 C.B.C.2d 1451, 314 B.R. 206 (Bankr. N.D. Cal. 2004) .

(n7)Footnote 5b. *Unsecured Creditors' Comm. of Highland Superstores v. Strobeck Real Estate (In re Highland Superstores, Inc.)*, 154 F.3d 573, 40 C.B.C.2d 1038 (6th Cir. 1998) ; *In re Ames Dep't Stores, Inc.*, 209 B.R. 627 (S.D.N.Y. 1997) .

(n8)Footnote 6. *In re D.H. Overmyer Co.*, 10 C.B.C.2d 17, 25 (Bankr. S.D.N.Y. 1976) .

(n9)Footnote 7. *In re Parkview-Gem, Inc.*, 465 F. Supp. 629 (W.D. Mo. 1979) ; *In re Fernandes Supermarkets, Inc.*, 1 B.R. 249 (Bankr. D. Mass. 1979) .

(n10)Footnote 8. *In re Ames Dep't Stores, Inc.*, 209 B.R. 627, 630-31 (S.D.N.Y. 1997) ; *D.H. Overmyer Co. (Ohio) v. Irving Trust Co.*, 60 B.R. 391 (S.D.N.Y. 1986) ; *In re City Stores Co.*, 23 B.R. 201, 203 (Bankr. S.D.N.Y. 1982) ; *In re D.H. Overmyer Co.*, 10 C.B.C. 17, 25-26 (Bankr. S.D.N.Y. 1976) ; see *C.D. Stimson Co. v. Porter (In re Save-Rite Drug Stores)*, 195 F.2d 410, 413 (10th Cir. 1952) ; *In re W.T. Grant Co.*, 13 B.R. 198 (Bankr. S.D.N.Y. 1981) , *aff'd*, 36 B.R. 939 (S.D.N.Y. 1984) .

(n11)Footnote 9. *In re Ames Dep't Stores, Inc.*, 209 B.R. 627, 630 n.5 (S.D.N.Y. 1997) ; *D.H. Overmyer Co. (Ohio) v. Irving Trust Co.*, 60 B.R. 391 (S.D.N.Y. 1986) . *C.D. Stimson Co. v. Porter (In re Save-Rite Drug Stores)*, 195 F.2d 410, 413 (10th Cir. 1952) ; *In re D.H. Overmyer Co.*, 10 C.B.C.2d 17, 25 (Bankr. S.D.N.Y. 1976) .

(n12)Footnote 10. See *In re Fernandes Supermarkets, Inc.*, 1 B.R. 249 (Bankr. D. Mass. 1979) .

(n13)Footnote 11. *In re City Stores Co.*, 23 B.R. 201, 203 (Bankr. S.D.N.Y. 1982) .

(n14)Footnote 12. *In re W.T. Grant Co.*, 13 B.R. 198 (Bankr. S.D.N.Y. 1981) , *aff'd*, 36 B.R. 939 (S.D.N.Y. 1984) .

(n15)Footnote 13. 13 B.R. 198, 201-02 .

(n16)Footnote 14. *In re City Stores Co.*, 23 B.R. 201 (Bankr. S.D.N.Y. 1982) .

(n17)Footnote 15. *In re D.H. Overmyer Co.*, 10 C.B.C.2d 17 (Bankr. S.D.N.Y. 1976) ; cf. *In re Bus Stop, Inc.*, 1 C.B.C.2d 828, 3 B.R. 26 (Bankr. S.D. Fla. 1980) (section 502(b)(6) limitation applicable even where landlord obtained prepetition judgment for greater sum).

(n18)Footnote 16. *In re Parkview-Gem, Inc.*, 465 F. Supp. 629 (W.D. Mo. 1979) ; *In re Fernandes Supermarkets, Inc.*, 1 B.R. 249 (Bankr. D. Mass. 1979) .

(n19)Footnote 16a. *In re Gantos*, 181 B.R. 903 (Bankr. W.D. Mich. 1995) .

(n20)Footnote 17. *In re Parkview-Gem, Inc.*, 465 F. Supp. 629 (W.D. Mo. 1979) ; *In re Fernandes Supermarkets, Inc.*, 1 B.R. 249 (Bankr. D. Mass. 1979) .

(n21)Footnote 18. *Picker v. Irving Trust Co. (In re United Cigar Stores Co.)*, 86 F.2d 629 (2d Cir. 1936) , *cert. denied*, 300 U.S. 679, 57 S. Ct. 671, 81 L. Ed. 883 (1937) ; *In re Atlantic Container Corp.*, 26 C.B.C.2d 597, 612, 133 B.R. 980, 992 (Bankr. N.D. Ill. 1991) .

(n22)Footnote 19. *In re Atlantic Container Corp.*, 26 C.B.C.2d 597, 133 B.R. 980 (Bankr. N.D. Ill. 1991) ; *In re Circle K Corp.*, 137 B.R. 346, 351 (Bankr. D. Ariz. 1992) ; *In re Transport Clearings-Midwest, Inc.*, 41 B.R. 528 (Bankr. W.D. Mo. 1984) ; *In re International Coins & Currency, Inc.*, 6 C.B.C.2d 309, 18 B.R. 335 (Bankr. D. Vt. 1982) ; *In re Standard Furniture Co.*, 2 C.B.C.2d 274, 3 B.R. 527 (Bankr. S.D. Cal. 1980) (clean-up costs); *In re D.H. Overmyer Co. (Texas)*, 12 B.R. 777 (Bankr. S.D.N.Y. 1981) , *aff'd*, 30 B.R. 823 (S.D.N.Y. 1983) . *Contra In re Cardinal Exp. Corp.*, 30 B.R. 682 (Bankr. E.D.N.Y. 1983) ; cf. *In re United Trucking Serv., Inc.*, 851 F.2d 159, 19 C.B.C.2d 542

(6th Cir. 1988) (equipment lease).

(n23)Footnote 20. *In re International Coins & Currency, Inc.*, 6 C.B.C.2d 309, 18 B.R. 335 (Bankr. D. Vt. 1982) .

(n24)Footnote 21. *See* P 3.01[3][b][i] *supra*.

(n25)Footnote 22. 11 U.S.C. § 365(b)(1).

(n26)Footnote 23. 11 U.S.C. §§ 365(g), 502(g).

(n27)Footnote 24. *See* P 3.01[3][b][i] *supra*.

(n28)Footnote 25. *See* P 3.01[3][b][i] *supra*. If the lease is assumed, then it is deemed to have been in effect since the filing of the petition. If, however, the lease is rejected, then it is deemed never to have been in effect since the filing of the petition. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219 (1984). *Contra In re Atlantic Container Corp.*, 26 C.B.C.2d 597, 605-10, 133 B.R. 980, 987-91 (Bankr. N.D. Ill. 1991) .

(n29)Footnote 25a. *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988) ; *In re Kent Holland Die Casting & Plating, Inc.*, 24 C.B.C.2d 1620, 125 B.R. 493 (Bankr., W.D.Mich. 1991) ; *In re Mahoney-Troast Constr. Co., Inc.*, 189 B.R. 57 (Bankr. D.N.J. 1995) ; *In re McCrory Corp.*, 188 B.R. 763 (Bankr. S.D.N.Y. 1995) ; *see* P 6.05[2] *infra*; *see also In re Great N. Forest Prods., Inc.*, 26 C.B.C.2d 411, 135 B.R. 46 (Bankr. W.D. Mich. 1991)

(n30)Footnote 25b. *See In re Kent Holland Die Casting & Plating, Inc.*, 125 B.R. 493, 496-97 (Bankr. W.D. Mich. 1991) .

(n31)Footnote 25c. 124 B.R. 493, 497 . *See generally* P 6.05 *infra* for a discussion of liability of landowners under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended (CERCLA).

(n32)Footnote 25d. 474 U.S. 494, 106 S. Ct. 755, 88 L. Ed. 2d 859, 13 C.B.C.2d 1355 (1986) , *reh'g denied*, 475 U.S. 1090, 106 S. Ct. 1482, 89 L. Ed. 2d 736 (1986) .

(n33)Footnote 25e. 474 U.S. 494, 507 n.9, 106 S. Ct. 755, 762 n.9, 88 L. Ed. 2d 859 .

(n34)Footnote 25f. *In re Great Northern Forest Products, Inc.*, 135 B.R. 46, 61-62 (Bankr. W.D. Mich. 1991) (actual costs must be incurred); *see In re McCrory Corp.*, 188 B.R. 763, 765-66 (Bankr. S.D.N.Y. 1995) (*dictum*). This holding appears to necessitate a relatively expansive view of allowable administrative claims beyond those that arise from expenditures that directly benefit the estate. *See In re Kent Holland Die Casting & Plating, Inc.*, 125 B.R. 493, 502-03 (Bankr. W.D. Mich. 1991) (discussing allowance of administrative claims in context of breach of an assumed lease); *see also* P 6.05[2] *infra*. An indirect benefit may be found in the financial benefits to the estate resulting from the failure to expend the funds required to comply with nonbankruptcy law. *In re Kent Holland Die Casting & Plating, Inc.*, 125 B.R. 493, 502 (Bankr. W.D. Mich. 1991) , citing, among other cases, *In re United Trucking Serv.*, 851 F.2d 159 (6th Cir. 1988) , holding that the continuation during the postpetition period of the debtor's prepetition failure to maintain leased equipment in good order and repair gave rise to an administrative priority claim for the lessor to the extent allocated to the damage caused in the postpetition period. The savings to the estate resulting from the failure to make the necessary repairs constituted a postpetition benefit to the estate. 851 F.2d 159, 162 .

(n35)Footnote 25g. *In re Mahoney-Troast Constr. Co.*, 189 B.R. 57 (Bankr. D.N.J. 1995) ; *In re McCrory Corp.*, 188 B.R. 763 (Bankr. S.D.N.Y. 1995) ; *see also In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988) .

(n36)Footnote 25h. *In re Great N. Forest Prods., Inc.*, 26 C.B.C.2d 411, 429, 135 B.R. 46, 62 (Bankr. W.D. Mich. 1991) ; *In re Kent Holland Die Casting & Plating, Inc.*, 24 C.B.C.2d 1620, 1631, 125 B.R. 493, 503 (Bankr. W.D. Mich. 1991) .

(n37)Footnote 25i. *In re Kent Holland Die Casting & Plating, Inc.*, 24 C.B.C.2d 1620, 1631-33, 125 B.R. 493, 503-04 (Bankr. W.D. Mich. 1991) .

(n38)Footnote 25j. *In re Kent Holland Die Casting & Plating, Inc.*, 24 C.B.C.2d 1620, 1631-33, 125 B.R. 493, 503-04 (Bankr. W.D. Mich. 1991) .

(n39)Footnote 25k. *See P 3.01[5] supra.*

(n40)Footnote 25l. *See note 5 supra.*

(n41)Footnote 25m. The court in *In re Atlantic Container Corp.*, 26 C.B.C.2d 597, 611, 133 B.R. 980, 991 , rejected this contention, stating:

However, § 365(d)(3) of the Bankruptcy Code requires that as a condition of continued use and occupancy of the property, a debtor-in-possession or trustee must perform all of the debtor's obligations under an unexpired lease until the lease is either assumed or rejected. Thus, the DIP and the Trustee in the instant case remained obligated to repair and maintain the Premises throughout the administrative period.

(Footnote omitted.) *But see In re Macy & Co., Inc.*, 170 B.R. 69 (Bankr. S.D.N.Y. 1994) (denying administrative expense priority for a landlord's claim for damages for postpetition breach of an operating covenant).

(n42)Footnote 26. *See P 3.01[3][b][iii] supra.*

(n43)Footnote 26a. *Picker v. Irving Trust Co. (In re United Cigar Stores Co.)*, 86 F.2d 629 (2d Cir. 1936) , cert. denied, 300 U.S. 679, 57 S. Ct. 671, 81 L. Ed. 883 (1937) .

(n44)Footnote 26b. *In re Pacific Arts Publ'g, Inc.*, 198 B.R. 319 (Bankr. C.D. Cal. 1996) (citing cases); *see also In re Rose's Stores, Inc.*, 179 B.R. 789 (Bankr. E.D.N.C. 1995) . For a synopsis of the case law addressing the scope of the term "rent reserved," particularly with respect to triple-net leases, *see In re McSheridan*, 33 C.B.C.2d 1300, 184 B.R. 91 (B.A.P. 9th Cir. 1995) . *But see In re South Lincoln Medical Group, P.C.*, 2008 Bankr. LEXIS 468 (Bankr. D. Neb. Feb. 21, 2008) .

(n45)Footnote 26c. *In re Foamex Int'l, Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007) (citing *In re McSheridan*, note 26b *supra*).

(n46)Footnote 27. *Hippodrome Bldg. Co. v. Irving Trust Co.*, 91 F.2d 753, 756 (2d Cir. 1937) .

(n47)Footnote 27a. *In re Modern Textile, Inc.*, 900 F.2d 1184 (8th Cir. 1990) ; *Bel-Ken Assocs. Ltd. v. Clark*, 83 B.R. 357 (D. Md. 1988) .

(n48)Footnote 27b. *Fisher v. Lee Bros. Value World, Inc. (In re Lee Bros. Value World, Inc.)*, 486 F.2d 1037 (9th Cir. 1973) ; *Hippodrome Bldg. Co. v. Irving Trust Co.*, 91 F.2d 753, 756 (2d Cir. 1937) ; *In re Arden*, 176 F.3d 1226 (9th Cir. 1999) ; *In re Ace Elec. Acquisition, L.L.C.*, 53 C.B.C.2d 963, 342 B.R. 831 (Bankr. M.D. Fla. 2005) ; *In re Henderson*, 297 B.R. 875 (Bankr. M.D. Fla. 2003) ; *In re Lindsey*, 199 B.R. 580 (E.D. Va. 1996) ; *In re Unishops*, 2 B.C.D. 1735 (Bankr. S.D.N.Y. 1977) .

(n49)Footnote 27c. *See note 27b supra.*

(n50)Footnote 27d. *In re Episode USA*, 37 C.B.C.2d 172, 202 B.R. 691, 695 (Bankr. S.D.N.Y. 1996) ("thrust of the § 502(b)(6) cap is not directed toward any particular debtor-entity; rather, it acts to limit the amount of damages the lessor may be allowed from bankruptcy estate assets" (citations omitted)).

(n51)Footnote 27e. *In re Danrik, Ltd.*, 92 B.R. 964 (Bankr. N.D. Ga. 1988) . *Contra In re Federated Dep't Stores, Inc.*, 131 B.R. 808, 816 (S.D. Ohio 1991) (applying cap notwithstanding solvency of debtor).

(n52)Footnote 28. *In re Vause*, 886 F.2d 794 (6th Cir. 1989) , holds that the reference in section 502(b)(6)(B) to rent that is "due" includes prepetition rent that has accrued to the date of the lessee's petition. Following *Vause*, *In re Gantos, Inc.*, 181 B.R. 903 (Bankr. W.D. Mich. 1995) , holds that prepetition rent, the payment of which was deferred under the lease until the end of the lease term, constituted prepetition unpaid rent under 502(b)(6)(B) and, therefore, was not subject to the damage limitations in section 502(b)(6).

(n53)Footnote 28a. 11 U.S.C. § 502(b)(6)(B). The question of when "surrender" occurs is discussed in *Picker v. Irving Trust Co. (In re United Cigar Stores Co.)*, 86 F.2d 629 (2d Cir. 1936) , *cert. denied*, 300 U.S. 679, 57 S. Ct. 671, 81 L. Ed. 883 (1937) (surrender of premises subject to subleases occurs when landlord is free to deal with the property and to collect rent from or seek to eject the subtenants), and in *Third Nat'l Bank v. Winner Corp.*, 29 B.R. 383 (M.D. Tenn. 1982) (surrender occurs upon actual physical surrender even if lease not yet rejected). The holding in *Winner* is correct in the sense that it maintains continuity between the administrative rent period, which terminates on surrender, and the commencement of the damage limitation period. However, it is doubtful that the landlord is "free to deal with the premises" under the *United Cigar* rule if the premises have been surrendered without a lease rejection. See *In re Iron-Oak Supply Corp.*, 31 C.B.C.2d 439, 169 B.R. 414 (Bankr. E.D. Cal. 1994) ; *see also* P 3.02[2] *supra*.

(n54)Footnote 29. *See* P 3.01[3][b][i] *supra*.

(n55)Footnote 30. 11 U.S.C. § 502(b)(6)(A).

(n56)Footnote 30a. 11 U.S.C. §§ 503(b)(7), 502(b)(6)(A).

(n57)Footnote 30a-1. *In re Ace Elec. Acquisition, L.L.C.*, 53 C.B.C.2d 963, 342 B.R. 831 (Bankr. M.D. Fla. 2005) ; *In re Gantos, Inc.*, 176 B.R. 793 (Bankr. W.D. Mich. 1995) ; *see also In re Today's Woman of Florida, Inc.*, 195 B.R. 506 (Bankr. M.D. Fla. 1996) ; *In re Financial News Network, Inc.*, 28 C.B.C.2d 384, 149 B.R. 348 (Bankr. S.D.N.Y. 1993) ; *In re Q-Masters, Inc.*, 135 B.R. 157 (Bankr. Fla. 1991) . *Contra In re Iron-Oak Supply Corp.*, 31 C.B.C.2d 439, 169 B.R. 414 (Bankr. E.D. Cal. 1994) ; *In re Allegheny Int'l, Inc.*, 136 B.R. 396 (Bankr. W.D. Pa. 1991) , *aff'd*, 145 B.R. 823 (W.D. Pa. 1992) . The court in *Unsecured Creditors' Comm. of Highland Superstores v. Strobeck Real Estate (In re Highland Superstores, Inc.)*, 154 F.3d 573, 577, 40 C.B.C.2d 1038, 1042 (6th Cir.) , appears to have employed the Rental Computation.

(n58)Footnote 30b. *In re Gantos*, 176 B.R. 793, 795 n.3 (Bankr. W.D. Mich. 1995) .

(n59)Footnote 30c. Not surprisingly, the case law in this area is sharply divided. The court in *In re Allegheny Int'l, Inc.*, 136 B.R. 396 (Bankr. W.D. Pa. 1991) , *aff'd*, 145 B.R. 823 (W.D. Pa. 1992) , held that the 15 percent computation related to the remaining term rather than the remaining rent, and noted that it would have to account for rent escalations if it were to calculate 15 percent of the remaining rent. 136 B.R. 396, 402 . The court in *In re Gantos*, 176 B.R. 793 (Bankr. W.D. Mich. 1995) , found section 502(b)(6) to be "not a model of clarity," but held that the "most natural" interpretation of the section was that "the 15% quantifier is a function of rent, not time." 176 B.R. 793, 796 . For other cases in this area, *see Unsecured Creditors' Comm. of Highland Superstores v. Strobeck Real Estate (In re Highland Superstores, Inc.)*, 154 F.3d 573, 577, 40 C.B.C.2d 1038, 1042 (6th Cir. 1998) ; *In re Today's Woman of Fla., Inc.*, 195 B.R. 506 (Bankr. M.D. Fla. 1996) ; *In re Financial News Network, Inc.*, 28 C.B.C.2d 384, 149 B.R. 348 (Bankr. S.D.N.Y. 1993) ; *In re Q-Masters, Inc.*, 135 B.R. 157 (Bankr. Fla. 1991) ; *In re Iron-Oak Supply Corp.*, 31 C.B.C.2d 439, 169 B.R. 414 (Bankr. E.D. Cal. 1994) .

(n60)Footnote 31. *See* text accompanying note 27 *supra*.

(n61)Footnote 32. *See* P 2.51 *supra*.

(n62)Footnote 33. *See P 2.01[4], [5] supra.*

(n63)Footnote 34. 11 U.S.C. § 365(h)(1); the court in *In re High Fliers, Ltd.*, (Bankr. S.D. Cal. Apr. 29, 1981) , denied to a sublessee that had not taken possession of the subleased premises the right to exercise the section 365(h) options upon the rejection of the sublease by the debtor-sublessor.

(n64)Footnote 35. *Cullen v. Bowles*, 148 F.2d 621 (2d Cir. 1945) ; *In re Kennise Diversified Corp.*, 9 C.B.C.2d 778, 34 B.R. 237 (Bankr. S.D.N.Y. 1983) ; *In re The Briarcliff*, 15 B.R. 864 (Bankr. D.N.J. 1981) ; *see In re IDH Realty, Inc.* 5 C.B.C.2d 1390, 16 B.R. 55 (Bankr. E.D.N.Y. 1981) .

(n65)Footnote 36. *In re IDH Realty, Inc.* 5 C.B.C.2d 1390, 16 B.R. 55 (Bankr. E.D.N.Y. 1981) .

(n66)Footnote 37. *Revere Copper & Brass, Inc.*, 8 C.B.C.2d 541, 29 B.R. 584 (Bankr. S.D.N.Y. 1983) , *aff'd*, 32 B.R. 725 (Bankr. S.D.N.Y. 1983) .

(n67)Footnote 38. *In re Stable Mews Assocs., Inc.*, 9 C.B.C.2d 976, 35 B.R. 603 (Bankr. S.D.N.Y. 1984) .

(n68)Footnote 39. *Id.*

(n69)Footnote 40. *Friarton Estates Corp. v. City of New York (In re Friarton Estates Corp.)*, 15 C.B.C.2d 779, 65 B.R. 586 (Bankr. S.D.N.Y. 1986) , in which the court rejected the holding of *In re Stable Mews Assocs., Inc.*, 9 C.B.C.2d 976, 35 B.R. 603 (Bankr. S.D.N.Y. 1984) . *Accord Saravia v. 1736 18th Street, N.W., L.P.*, 844 F.2d 823, 18 C.B.C.2d 832 (D.C. Cir. 1988) .

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.04

P 3.04 Security Deposits and Letters of Credit

[1] Security Deposits

A deposit by a tenant with its landlord of cash or other property under a lease provision creating a security interest in the landlord in such property to secure the tenant's performance under the lease should be analyzed, for Bankruptcy Code purposes, in the same manner as any other collateralized or secured obligation. Nothing in the landlord-tenant relationship inherently warrants different treatment of the security under the Code.

If on or within 90 days prior to the filing of the tenant's petition the landlord applies the security to a lease default, the trustee may put forward an argument that such application is voidable as a preferential transfer under section 547(b). The trustee would assert, especially if the lease rental had been accelerated, that (1) given the amount of the deposit (usually a few months' rent) in relation to the amount of the accelerated rental, the landlord is an undersecured creditor, and (2) application by the landlord of the security deposit against the tenant's antecedent debt constitutes a voidable preference under section 547(b) because the landlord is undersecured.ⁿ¹ The trustee's argument is without merit. The landlord, in applying the security deposit, has not received a transfer from the debtor, but has merely exercised its right to employ existing collateral to satisfy part of the tenant's defaulted obligation under the lease. The application of collateral has not diminished the debtor's estate because the collateral does not belong to the estate. The transfer that would be subject to section 547(b) attack would be the creation of the landlord's interest in the security deposit, and then only if such transfer occurred within the 90-day period provided for in section 547(b).ⁿ²

If a tenant under a real estate lease has filed a petition under the Code before the landlord has applied the tenant's security deposit to the payment of a prepetition default, the automatic stay set forth in *section 362(a) of the Code* will prohibit application of the security.ⁿ³ Under Bankruptcy *Rule 2015(a)(4)*, the trustee is required to notify a landlord holding a security deposit of the filing of a tenant's Bankruptcy Code case "as soon as possible after the commencement of the case." Section 362(a)(4) prohibits the landlord from enforcing any lien against property of the debtor or property of the estate. Section 362(a)(6) enjoins any act to collect a prepetition claim against the debtor. Inasmuch as security deposits will be deemed property of the estate in the form of cash collateral held by the landlord to secure the tenant's performance under the lease, section 362(a) is applicable to the security deposit and the landlord cannot effect a postpetition application of the funds absent a modification of the stay by the bankruptcy court. It would seem that the most likely grounds for relief from the stay in this scenario would be under section 362(d)(2) based on the landlord's assertion that the debtor does not have an equity in the security deposit (being that the amount of the landlord's claim

exceeds the deposit amount) and the security deposit is not necessary to an effective reorganization.^{n3a}

Similarly, application of the deposit to the amount in default may be construed as a violation of section 362(a)(6) as an act to collect a prepetition claim. Indeed, under section 542(a), the landlord may be obligated to turn the deposit over to the trustee if the landlord receives adequate protection for use of its security.ⁿ⁴ If the value of the real property equals or exceeds the capitalized rental under the lease, or if an alternative method of valuation otherwise demonstrates that the landlord will be adequately protected by its right ultimately to repossess the premises, it is possible that the court may deem the landlord adequately protected without any security deposit or other collateral in lieu thereof.ⁿ⁵ Indeed, if the landlord comes into court seeking a modification of the automatic stay so that it may apply the deposit to prepetition defaults, there is a fair likelihood that the trustee will respond with a motion for a turnover of the deposit under section 542(a). It is suggested that the landlord do nothing with the deposit after the filing of the lessee's petition except as otherwise required under section 542(a) and except as set forth in the next paragraph.ⁿ⁶

If the landlord files a proof of claim in respect of a prepetition lease default or for damages arising out of the rejection of a lease, or both, and there has been no turnover of the security deposit in the case, it appears that at the time of allowance of the claim the landlord may apply the deposit up to the full allowed amount of the claim.ⁿ⁷ The proof of claim should set forth the landlord's intention to apply the deposit when the claim is allowed in the case. Allowance of the claim without objection to the stated intention of the landlord-claimant to apply the security deposit upon allowance may be viewed as a waiver by the trustee of any rights to the deposit and of any right to enjoin such application under the automatic stay provisions of the Code. If a question arises as to the existence of such a waiver, the landlord should commence a contested matter seeking a modification of the stay to permit application of the deposit. As discussed above, such an application for modification of the automatic stay may be greeted with the trustee's motion for a turnover of the security deposit. However, the stage in the case in which claims are being allowed or objected to ordinarily occurs relatively late. If the trustee has not theretofore sought a turnover of the deposit under section 542(a), it is less likely that at this point the trustee will respond to the landlord's motion with a proceeding for turnover.

If application of the deposit is effected, and if the deposit is greater than the allowed amount of the claim, the excess should be turned over to the trustee.ⁿ⁸ Thus, even though the deposit is less than the full amount of the recovery that would be permitted for the landlord under state law, if the operation of *section 502(b)(6) of the Code* reduces the allowable amount of the recovery to an amount less than the deposit, the amount of the deposit in excess of the allowed claim must be surrendered. It should be noted, however, that if the distribution on account of general unsecured claims is less than 100 percent of the claim, the landlord with a security deposit may apply the deposit on a dollar-for-dollar basis on its allowed claim, even though other creditors in the same class will be receiving less than the full amount of their allowed claims. In other words, the security deposit is applied against the allowed claim, not against the amount of the actual recovery on the claim that would occur if there were no security deposit. These rules have been expressly discussed in the House Report and merit presentation here in full:

Paragraph (7) [section 502(b)(6)], derived from current law, limits the damages allowable to a landlord of the debtor. The history of this provision is set out at length in *Oldden v. Tonto Realty Co.*, 143 F.2d 916 (2d Cir. 1944). It is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate. 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 [as enacted, fifteen percent], not to exceed three years, after the earlier of the date of the filing of the petition and the date of surrender or repossession. The sliding scale formula is new, is designed to protect the long-term lessor, and is included as a replacement of the dual provisions in current law of a three-year test for reorganization cases and a one-year test for liquidation cases. This subsection does not apply to limit administrative expense claims for use of the leased premises to which the landlord is otherwise entitled.

This paragraph will not overrule *Oldden*, or the proposition for which it has been read to stand: to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate. Moreover, his allowed claim is for his total damages, as limited by this paragraph. By virtue of proposed 11 U.S.C. §§ 506(a) and 506(d), the claim will be divided into a secured portion and an unsecured portion in those cases in which the deposit that the landlord holds is less than his damages. As under *Oldden*, he will not be permitted to offset his actual damages against his security deposit and then claim for the balance under this paragraph. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph.ⁿ⁹

As discussed in the House Report, the portion of a landlord's damage claim that cannot be recovered through application of a security deposit will be treated as a separate, unsecured claim under *section 506(a) of the Code*. Of course, that portion of the claim will be paid the same percentage as other general unsecured claims, rather than the dollar-for-dollar application of the portion corresponding to the amount of the security deposit.

Some authority exists to the effect that security deposits must be applied against outstanding charges for use and occupation of leased premises during the period of case administration.ⁿ¹⁰ This position fails to recognize that administrative charges are separate obligations of the estate which are not lease rental paymentsⁿ¹¹ and that the security deposit does not secure the obligations of the estate arising by operation of the Bankruptcy Code. Mandatory application of security deposits to administrative charges would deprive landlords of the ability to apply such deposits to claims for prepetition rental obligations and for rejection damages, and accordingly would result in compulsory financing of administrative obligations of estates. If landlords are thus compelled to relinquish security for the benefit of other administrative creditors of the estate, they will be deprived of the benefits provided for under the *Oldden* case as confirmed in the House Report.

In certain instances, leases are written to provide that monies held by the landlord do not constitute a security deposit but are to be applied to the last few months' rent at the end of the term.ⁿ¹² This type of fund may be characterized as a debt owing from the landlord to the tenant to be applied in the future to an indebtedness to arise from the tenant to the landlord. Under this characterization, the rights of the landlord to apply the fund to a prepetition default or to a damage claim require an analysis of the setoff provisions of the Code.

Although the subject of setoff has been treated elsewhere,ⁿ¹³ it should be noted that a setoff effected by a landlord prior to the filing of the tenant's petition may be attacked by the trustee only (1) if the setoff occurred on or within 90 days before the filing of the petition and (2) to the extent that during the 90-day period there was a decrease in the amount of the deficiency as between the fund held by the landlord and the amount owed by the tenant to the landlord.ⁿ¹⁴ Such decrease (generally known as the "improvement in position" test) would occur if, for example, the tenant gave to the landlord during the 90-day period additional sums to be added to the fund being held by the landlord. In most landlord-tenant situations, an improvement in position of the type dealt with in the Code would not occur, so that there is no Bankruptcy Code limitation on the prepetition setoff of an advance rental deposit.

After the filing of the tenant's petition, section 362(a)(7) will enjoin the exercise of any setoff against any claim of the debtor. Accordingly, it would be necessary to seek a modification of the stay to effect the setoff. Thus, as in the case of a security deposit, prepetition action should be the better course of action from the landlord's viewpoint.ⁿ¹⁵

[2] Letters of Credit

A less often used, but (from the landlord's perspective) superior, alternative to a standard security deposit is that of a standby letter of credit to enhance the credit of a tenant under a real estate lease. The principal advantage of a standby letter of credit over a security deposit is that because of the "independence principal" discussed below, a landlord can usually draw on the letter of credit and obtain immediate possession and use of the funds notwithstanding the debtor-tenant's bankruptcy. Those funds are not property of the debtor's estate.^{n15a} In effect, the landlord has obtained

funds directly from the issuing financial institution and can therefore immediately apply such funds to mitigate losses arising from the tenant's default, without the delay, expense and uncertainty of seeking relief from the automatic stay or awaiting for a lengthy period of time the outcome of the bankruptcy case.

Until a recent decision of the Court of Appeals for the Fifth Circuit, it was reasonably well settled among practitioners that letters of credit were subject to the rule of *Oldden v. Tonto* discussed above. Several appellate courts that addressed the issue held that letters of credit were functionally equivalent to, and thus subject to the same limitations as, security deposits posted directly by the tenant for purposes of calculating the landlord's remaining claim against the debtor/tenant. Those decisions required the landlord to deduct the proceeds of the draw from the claim as capped under section 502(b)(6), rather than the gross claim determined before giving effect to the statutory cap.^{n15b} In the event that the proceeds exceeded the cap, the landlord was required to return the excess to the debtor.

However, a recent decision of a court of appeals suggests the possibility that a notable exception to the rule treating letters of credit similar to cash security deposits could arise in situations where the landlord does not file a proof of claim against the debtor, and thereby does not invoke the claim limitation provision of section 502(b)(6). This decision may be relevant in cases where the face amount of the letter of credit is sufficient to either cover the landlord's damages in full or is in an amount that exceeds the statutory cap. In *In re Stonebridge Technologies, Inc.*,^{n15c} the Court of Appeals for the Fifth Circuit recently declined to apply the statutory cap and permitted the landlord to retain all letter of credit proceeds because the landlord did not to file a proof of claim. In *Stonebridge*, prior to the petition date, the debtor had provided the landlord with a letter of credit in the amount of approximately \$1,400,000 and a security deposit in the amount of about \$100,000 as security for its performance of the lease.^{n15d} After the debtor filed for bankruptcy and decided to reject the lease, the landlord drew on the letter of credit for the full amount. The issuing bank subsequently sought relief from the stay to apply certain collateral (a certificate of deposit in the amount of \$1,250,000) against the debtor's reimbursement obligations. As a settlement of the bank's motion, the debtor permitted the bank to apply the collateral in exchange for the bank assigning it any rights against the landlord for improperly drawing on the letter of credit. Subsequently, the debtor, as assignee, brought an adversary proceeding against the landlord, alleging that the landlord improperly drew an amount in excess of the section 502(b)(6) cap and seeking return of the excess.

The bankruptcy court awarded damages to the debtor in an amount that was a function of the amount by which the letter of credit exceeded the claim that would have been allowed under section 502(b)(6).^{n15e} The district court affirmed. On appeal, the Court of Appeals for the Fifth Circuit reversed. The court first cited the fundamental "independence principal" in letter of credit law and emphasized that "[i]nsofar as letters of credit embody obligations between the issuer and beneficiary, such contractual rights and duties are entirely separate from the debtor's estate."^{n15f} Turning to the limitations of section 502(b)(6), the court held that, by its express terms, the statutory cap applied to limit claims against the estate only, and, therefore, because the landlord did not file a proof of claim in the case, the limitation did not apply:

By its terms, § 502(b) applies only to claims against the bankruptcy estate. *See, e.g., In re Ska! Design, Inc.*, 308 B.R. 777, 781 (Bankr. N.D. Tex. 2004) ("Section 502 deals only with allowance by a landlord of a claim, if presented, against the bankruptcy estate.") (quoting *In re Mr. Gatti's, Inc.*, 162 B.R. 1004 (Bankr. W.D. Tex. 1994) (emphasis added)). Claims under § 502(b) are not automatically assumed simply because the debtor assumes or rejects a lease under § 365, but rather must be formally filed against the estate in the bankruptcy court. *See In re National Gypsum Co.*, 208 F.3d 498, 505 (5th Cir. 2000) (finding that the "opportunity" to file a proof of claim arises only "subsequent to the debtor's decision on how to treat the contract or lease"); *In re Austin Dev. Co.*, 19 F.3d 1077, 1084 (5th Cir. 1994) (finding that assumption or rejection of a lease simply entitles lessor to then file a proof of claim). Stated simply, the claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all. *See In re Arden*, 176 F.3d 1226, 1229 (9th Cir. 1999) ([section 502(b)(6)] has two predicates: 'claim of a lessor' and 'damages resulting from the termination of a lease or real property.'"). Thus, the damages cap of § 502(b) does not apply to limit the beneficiary's entitlement to the proceeds

of the letter of credit unless and until the lessor makes a claim against the estate. We find, therefore, that further inquiry into the appropriate interpretation of § 502(b) is unnecessary in this case because [the landlord] did not file a claim against the estate.^{n15g}

Stonebridge suggests that letters of credit may provide another significant advantage to landlords over traditional security deposits. In addition to providing immediate access to funds, the case suggests that utilizing a letter of credit instead of a security deposit may provide landlords with an ability to avoid the limitation of section 502(b)(6) and the principals of *Oldden v. Tonto* so long as the landlord avoids filing a proof of claim in the bankruptcy case. Since *Stonebridge* is a very recent case, the impact of the decision is uncertain and it is not clear if other courts will seek to distinguish the particular facts of *Stonebridge*--involving alleged misrepresentations by the landlord to the bank--from cases where a trustee simply seeks turnover of excess amounts. It may be that *Stonebridge* signals a split in the circuits on the scope of section 502(b)(6) that may ultimately require resolution from the U.S. Supreme Court. One commentator has suggested that the impact of *Stonebridge* will be limited because the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure provide a mechanism for the debtor to file a proof of claim on behalf of a creditor.^{n15h} Under the reasoning of *Stonebridge*, such an action by the debtor may have changed the result.

In any event, from the landlord's perspective, letters of credit clearly have an advantage compared to security deposits because of the timing issue discussed above. Notwithstanding their superiority, this credit enhancement technique is not typically employed in ordinary, arms-length leasing transactions because it requires the payment of fees, and in some instances, the posting of security by the tenant for the benefit of the issuing bank. In this circumstance, a tenant with suspect credit is being asked to use some of its assets for purposes not directly related to the production of income. In addition, these transactions can be difficult to structure inasmuch as (1) the payments provided under the letter of credit must be tailored to unknown levels of rent defaults, and (2) may require periodic renewals of the letter of credit over the remaining term of the lease.

Nevertheless, letters of credit supporting tenant obligations are often used in structured finance transactions and have increasingly become more common in standard commercial leases because of the significant advantage discussed above relating to the landlord's ability to generally draw on the letter of credit without implicating the automatic stay. In addition, in the context of a workout transaction involving a tenant, a landlord, and, perhaps, other creditors with a stake in the continuation of the tenant's business at the leased location, a landlord may be able to successfully negotiate for a letter of credit as the price of its agreement to a lease modification and forbearance transaction. If the parties intend to have a letter of credit provide for payment to a landlord of an amount equal to the damages arising out of the rejection of a lease by the tenant-account party, it will be necessary to set forth a methodology for calculating the amount of such damages as of the time of rejection. The amount claimed will then be inserted in the form of draft to be presented by the beneficiary. The letter of credit will also provide for a maximum sum that can be drawn.

The transaction involving the issuance of a standby letter of credit as a tenant credit enhancement is a tripartite arrangement involving the tenant as the account party, the landlord as the beneficiary of the letter of credit, and an issuing bank. Under state law, this transaction contains three separate contracts.ⁿ¹⁶ First, there is the leasing transaction between the landlord and the tenant, which will include provisions dealing with the tenant's posting and maintenance of a standby letter of credit meeting specified criteria. Second, there is an agreement between the tenant (the account party) and the issuing bank providing for, among other things, the issuance of the letter of credit, the honoring of drafts presented against the credit, the payment of fees by the account party and the reimbursement obligations of the account party to the bank arising if the letter of credit is drawn upon. As discussed below, the reimbursement obligations of the account party may or may not be secured. Third, there is the contract between the issuing bank and the landlord, as the beneficiary under the letter of credit. This contract is generally set forth in the letter of credit itself, which contains the form of draft that may be signed and presented by the landlord upon the occurrence of a lease default described in the form of draft. The form of draft will typically require little more than a certification by the landlord that an event of default has occurred and will almost never require the issuing bank to verify whether a default has in fact occurred. A

false certification by the landlord could create a cause of action by the tenant against the landlord, but will not affect the validity of the draw as between the landlord and the bank.

[a] Claim Disallowance Under Section 502(b)(6)

A principal concern for an issuing bank in the letter of credit transaction described above is whether, in the context of a Bankruptcy Code filing by the tenant--account party, the bank's reimbursement claim against the estate will be subject to the claim allowance limitation set forth in *section 502(b)(6) of the Code*. This issue is to be distinguished from the issue, discussed previously, whether, for purposes of determining the allowed claim of the landlord in the tenant's bankruptcy case, the landlord is required to deduct the amount of the letter of credit drawing from the capped claim under 502(b)(6) for purposes of determining the landlord's remaining allowed claim. In that instance, it has been held that where the letter of credit is treated under the lease as a security deposit the proceeds are to be treated similarly to a standard security deposit and accordingly deducted from the claim, as capped.^{n16a} As noted, one court of appeals case has suggested a different result where the landlord has failed to file a proof of claim.^{n16b}

Section 502(b)(6) sets forth a formula that can effectively reduce the allowed amount of a landlord's claim arising from the rejection of a real estate lease to a sum that is less than the amount of the landlord's damages provided for under state law.ⁿ¹⁷ In the context of a third-party guarantee of a tenant's obligations under a real estate lease, as distinguished from a letter of credit, it has been held that a guarantor's reimbursement claim against a tenant-debtor under the Bankruptcy Code is subject to the same allowance limitations as is the direct claim of a landlord under section 502(b)(6).ⁿ¹⁸ The purpose of section 502(b)(6) is to limit the allowed amount of landlords' lease rejection claims in order to prevent such potentially large claims from overwhelming the claims of and distributions to other creditors of a debtor--tenant.ⁿ¹⁹ It appears that the application of the section 502(b)(6) limitation to reimbursement claims by lease guarantors is necessary to serve the same purpose.ⁿ²⁰

Although it may be argued that the application of the section 502(b)(6) limitation to reimbursement claims of issuing banks under letters of credit against account party-tenants is likewise necessary to fulfill the same purpose, it appears that the differences between letter of credit and guarantee transactions should yield a different conclusion--to wit, that issuing bank reimbursement claims arising out of lease rejections by debtor-tenants should not be subject to the section 502(b)(6) allowance limitation.

The legal attributes of a letter of credit transaction are established under applicable state law.ⁿ²¹ One of the principal attributes is generally referred to as the "independence principle," which is that an issuing bank's obligation to the beneficiary to honor draws on a letter of credit is entirely independent of the bank's arrangement with the account party and the terms of the arrangement between the account party and the beneficiary under the letter of credit.ⁿ²² In a standard standby letter of credit transaction, the bank is primarily liable to the landlord-beneficiary upon the default of the tenant-account party. All that is required to trigger the payment obligation of the bank to the beneficiary is the presentation by the beneficiary to the bank of the draft and any related documents specified in and conforming to the draw provisions of the letter of credit. Accordingly, except in instances of fraud by the beneficiary, the issuer is bound to honor the letter of credit even if the account party has valid defenses to the beneficiary's claim for payment.ⁿ²³ The risk of nonperformance of the underlying transaction by the account party shifts from the beneficiary to the issuing bank, including the risk of the bankruptcy of the account party.

The inquiry into the applicability of section 502(b)(6) to a reimbursement claim by a letter of credit bank against an account party-tenant that has filed a petition under the Code begins with the provisions of *section 502(e) of the Code*.ⁿ²⁴ Section 502(e) provides that:

(1) Notwithstanding subsections (a), (b) and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that--

(A) such creditor's claim against the estate is disallowed;

(B) such claim for reimbursement or contribution is contingent at the time of allowance or disallowance of such claim for reimbursement or contribution; or

(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

If section 502(e) applies to an issuing bank as "an entity that is liable with the debtor," then, under section 502(e)(a)(1), the bank's reimbursement claim against the account party, as a debtor rejecting a real estate lease under the Code, will be disallowed to the extent that the landlord's claim for rejection damages is disallowed under *section 502(b)(6) of the Code*. This reflects the policy that a "surety's claim for reimbursement or contribution is entitled to no better status than the claim of the creditor assured by such surety."²⁵

Section 502(e) should be read together with *section 509 of the Code* for a more complete understanding of the Code's treatment of the claims of codebtors. Section 509 provides:

(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that--

(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is--

(A) allowed under section 502 of this title;

(B) disallowed other than under section 502(e) of this title; or

(C) subordinated under section 510 of this title; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.²⁶

Sections 502(e) and 509 set forth the principal terms of the Code's scheme for allowance and disallowance of the claims of codebtors. These provisions recognize three remedies for codebtors against a primary obligor that is a debtor under the Code: reimbursement and contribution (section 502(e)), and subrogation (section 509). The legislative history accompanying section 502(e) describes this scheme explicitly:

Thus, the surety or codebtor has a choice; to the extent a claim for contribution or reimbursement would be advantageous, such as in the case where such a claim is secured, a surety or codebtor may opt

for reimbursement or contribution under Section 502(e). On the other hand, to the extent the claim for such surety or codebtor by way of subrogation is more advantageous, such as where such claim is secured, the surety may elect subrogation under section 509.

The section changes current law by making the election identical in all other respects. To the extent a creditor's claim is satisfied by a surety or codebtor, other creditors should benefit by the surety's inability to file a claim against the estate merely because such surety or codebtor has failed to pay such creditor's claim in full. On the other hand, to the extent the creditor's claim against the estate is otherwise disallowed, the surety or codebtor should not be entitled to increased rights by way of reimbursement or contribution, to the detriment of competing claims of other unsecured creditors, than would be realized by subrogation.ⁿ²⁷

Both sections 502(e) and 509(a) refer to a codebtor as an entity that is liable with the debtor on, or has secured the claim of, a creditor against the debtor. Thus cases that have interpreted this language in section 509 provide precedents for the interpretation of the same language in section 502(e), particularly because the two sections are part of one statutory scheme dealing with codebtors. The great majority of courts, in applying section 509(a), have held that an issuing bank is not "liable with the debtor" on the claim of a creditor.ⁿ²⁸ These cases, which generally result in the denial to an issuing bank of the remedy of subrogation, hold that an issuer of a letter of credit is not a codebtor, but rather a primary obligor under an absolute, independent, and separate obligation.

Letters of credit are governed by Article 5 of the Uniform Commercial Code ("UCC") and, to a lesser extent, by the Uniform Customs and Practice for Documentary Credits. Article 5 of the UCC was revised in 1995 by the American Law Institute and by the National Conference of Commissioners on Uniform State Laws.ⁿ²⁹ Thus, letters of credit are governed by a statutory scheme entirely separate from the laws of suretyship and guarantee. The Official Comment to Section 5-101 of revised Article 5 of the UCC includes the following comment relating to the distinction between the two areas:

A letter of credit is an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement. The objectives of the original and revised Article 5 are best achieved (1) by defining the peculiar characteristics of a letter of credit that distinguish it and the legal consequences of its use from other forms of assurance such as secondary guarantees, performance bonds, and insurance policies, and from ordinary contracts, fiduciary engagements, and escrow arrangement; and (2) by preserving flexibility through variation by agreement in order to respond to and accommodate developments in custom and usage that are not inconsistent with the essential definitions and substantive mandates of the statute.ⁿ³⁰

A second and important comment dealing with the distinction between letters of credit and guarantees is set forth in the Official Comment to revised section 5-103:

Many undertakings in commerce and contract are similar, but not identical to the letter of credit. Principal among those are "secondary," "accessory," or "suretyship" guarantees. Although the word "guarantee" is sometimes used to describe an independent obligation like that of the issuer of a letter of credit..., in the United States the word "guarantee" is more typically used to describe a suretyship transaction in which the "guarantor" is only secondarily liable and has the right to assert the underlying debtor's defenses. This article does not apply to secondary or accessory guarantees and it is important to recognize the distinction between letters of credit and these guarantees. This article does not apply to secondary or accessory guarantees and it is important to recognize the distinction between letters of credit and those guarantees. It is often a defense to a secondary or accessory guarantor's liability that the underlying debt has been discharged or that the debtor has other defenses to the underlying liability. In letter of credit law, on the other hand, the independence principle recognized throughout Article 5 states

that the issuer's liability is independent of the underlying obligation. That the beneficiary may have breached the underlying contract and thus have given a good defense on that contract to the applicant against the beneficiary is no defense for the issuer's refusal to honor. Only staunch recognition of this principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit. To that end, it is important that the law not carry into letter of credit transactions rules that properly apply only to secondary guarantees or to other forms of engagement.ⁿ³¹

Notwithstanding the abundantly clear presentation by the drafters of revised Article 5 of the differences between letters of credit and guarantees, the UCC does provide to letter of credit issuers the remedies of reimbursement and subrogation in the event that a letter of credit is honored.ⁿ³²

Under Section 5-108(1) of revised Article 5, an issuer that has honored a presentation is entitled to be reimbursed by the applicant (the account party) in immediately available funds not later than the date of the issuer's payment on the letter of credit. This provision is similar to its antecedent under the prior version of Article 5, which provided in Section 5-114(3) for immediate reimbursement to the issuer of any payment made under the credit in immediately available funds not later than the day before maturity of any acceptance made under the credit.

Under Section 5-117(a) of revised Article 5, "An issuer that honors a beneficiary's presentation is subrogated to the rights of the beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant." *UCC Section 5-117(d)* makes clear that this right of subrogation does not arise until the letter of credit is honored. Until that time, the issuer does not receive under *UCC Section 5-117* and rights forming the basis of a claim, defense, or excuse. The Official Comment to *UCC Section 5-117* states that the section does not "grant any right of subrogation. It grants only the right that would exist if the person seeking subrogation 'were a secondary obligor.'" The Comment goes on to state that "the section does no more than to remove an impediment that some courts have found to subrogation because they conclude that the issuer's or other claimant's rights are 'independent' of the underlying obligation." Finally, the Comment notes that the section "indorses the position of Judge Becker in *Tudor Development Group, Inc. v. United States Fidelity and Guaranty*."

Accordingly, to better understand the genesis of *UCC Section 5-117*, it is necessary to consider the *Tudor Development* case, which involved an issue of equitable subrogation for a letter of credit issuer.ⁿ³³ The account party under the letter of credit was Green Hill Associates ("Associates"), the issuer was Dauphin Deposit Bank and Trust Company ("Dauphin Deposit"), and the beneficiary was Susquehanna Township ("Township"). The standby letter of credit was issued to support Associates' obligation to complete various site improvements relating to a real estate project. United States Fidelity and Guaranty Company ("USF&G") issued performance bonds supporting the construction obligations of Susquehanna Construction Corporation ("SSC"), the general manager of the project. The reimbursement agreement between Dauphin Deposit and Associates did not contain an assignment to Dauphin Deposit of Associates' rights in the USF&G bonds in the event of honor of the Dauphin Deposit letter of credit. However, Associates did assign rights to the USF&G bonds to Green Hill Project Investors ("Investors"), a party not related to the Dauphin Deposit letter of credit. When SSC defaulted in the performance of its construction obligations, Associates therefore defaulted in the performance of its obligations to the Township, the Township drew on the Dauphin Deposit letter of credit, Associates asserted claims on the USF&G bonds, and, ultimately, \$594,000 of the proceeds of the USF&G bonds were deposited in court. Investors claimed rights to the proceeds of the USF&G bonds under the assignment made to it by Associates, but Dauphin Deposit claimed that it was equitably subordinated to the interest of Associates in the bond proceeds as the result of its payment to the Township under the Dauphin Deposit letter of credit. Thus, Dauphin Deposit was not asserting subrogation to the rights of the beneficiary of the letter of credit, but rather to the rights of its customer (the account party) under the letter of credit.

On appeal from a district court holding in favor of Investors, the assignee of the USF&G bonds, the United States Court

of Appeals for the Third Circuit held over the dissent of Judge Becker that Dauphin Deposit had no right of subrogation in respect of the USF&G bond proceeds inasmuch as it was satisfying a primary and independent liability under a letter of credit rather than a secondary liability under a guarantee or similar suretyship arrangement.ⁿ³⁴ Judge Becker, in the opinion cited with favor in the Official Comments to revised *UCC Section 5-117*,ⁿ³⁵ argued that Dauphin Deposit was of course primarily liable on its own obligation under the letter of credit to honor a draw, but was also " 'secondarily' liable in the sense that it paid the debt of another, Associates."ⁿ³⁶ Citing and quoting from *In re Valley Vue Joint Venture*,ⁿ³⁷ Judge Becker asserted that:

[T]he notion that an issuer's obligation to honor the letter of credit is a "primary obligation" should be interpreted to mean that, under the independence principle, the issuer may not avoid its obligation to honor the credit by identifying deficiencies in underlying contracts or by otherwise asserting defenses that are typically available to parties who are generally considered to be "secondarily liable" such as guarantors and sureties. Thus... the "primary obligation" language in the letter of credit context concerns itself with the issuer's ability to avoid honoring its letter of credit, whereas the "primary liability" language in the subrogation context concerns itself with whether the entity, after reducing a claim of a creditor, received the consideration from the creditor.

... .

As the issuer of a letter of credit, Dauphin Deposit had fewer defenses than would the issuer of a guaranty or performance bond, but the substance of Dauphin Deposit's obligation was nevertheless essentially similar to that of a guarantor or surety.ⁿ³⁸

Finally, commenting on the effect of recognizing a subrogation right on the independence principle, Judge Becker stated:

[T]he point of the independence principle is not to set up a wall for the sake of a wall, but to serve certain purposes. The independence principle undoubtedly requires the issuer to pay first, without looking through to the underlying transaction. Subrogation should therefore be unavailable before the issuer has paid the beneficiary. Once the issuer has done so, however, as Dauphin Deposit has here, the purpose of the independence principle has been served: the beneficiary has the money.

Insistence on perpetual separation is thus pointless formalism.ⁿ³⁹

Judge Becker's opinion, together with the language of and the Official Comments to revised *UCC Section 5-117*, can be viewed as a benefit to letter of credit issuers in that they clearly provide for an additional remedy, subrogation, that letter of credit issuers did not have prior to adoption of revised Article 5 of the UCC.

However, the language employed in Judge Becker's dissenting opinion and in the comment (particularly Judge Becker's comment, quoted above, that Dauphin Deposit's obligation was "essentially similar to that of a guarantor or surety")ⁿ⁴⁰ can be pushed to support the argument that letter of credit issuers should be treated under *sections 502(e) and 509 of the Bankruptcy Code* as entities "liable with the debtor." The argument would of course be that if letter of credit issuers are performing functions essentially similar to, and are entitled to the choice of remedies of, guarantors, then they should be subject to the same Bankruptcy Code benefits and restrictions applicable to guarantors. The import of this characterization would be that letter of credit issuers seeking reimbursement under section 502(e), and particularly those issuers seeking subrogation under section 509, would be subject to the same claims disallowance provisions of the Code as are direct creditors of the debtor, including the disallowance provisions of section 502(b)(6).ⁿ⁴¹

This argument can be taken further if it is noted that many guaranties are written as though they are primary, rather than secondary obligations. These guaranties provide, among other things, that: (1) they are guarantees of payment, not of performance, (2) the liability of the guarantor is direct and primary, and may be triggered without any requirement for

demand or presentation to the primary debtor, (3) the guarantor waives all claims relating to defects in and defenses with respect to the underlying obligation, and remains liable notwithstanding the invalidity of the underlying obligation, and (4) the guarantor's obligations are absolute and unconditional. These attributes of a well-written guarantee (from the creditor's perspective) bear some resemblance to the obligations of the issuer of a letter of credit, inasmuch as they provide for an unconditional obligation of payment without a right to assert any defenses relating to the underlying obligation.

Nevertheless, the availability to both letter of credit issuers and guarantors of two of the same remedies, reimbursement and subrogation, does not mean that a letter of credit issuer should be characterized as an entity that is liable on a debt with the debtor for the purposes of the Bankruptcy Code or otherwise. A letter of credit issuer is not liable on the same debt as is the primary obligor.

By virtue of documentation, banking law, the UCC and other laws,ⁿ⁴² a letter of credit issuer is liable on its own contract with a beneficiary to pay the sum or sums provided for in the letter of credit, conditioned only on the presentation by the beneficiary of documentation conforming to the provisions of the credit.ⁿ⁴³ The existence or not of an underlying debt of the account party to the beneficiary does not matter to the issuer of a letter of credit, nor does the existence or not of any defenses to enforcement of the underlying obligation matter to the issuer of a letter of credit.ⁿ⁴⁴ A letter of credit is issued in exchange for distinct, independent consideration. The history of mercantile and standby letters of credit evidences a development and evolution that occurred entirely apart from the laws of guaranty and suretyship.ⁿ⁴⁵ Although the ultimate result of honoring a draw on a letter of credit may be the same as the ultimate result of honoring an obligation under a guarantee, the method by which the result is achieved differs materially as between a letter of credit and a guarantee. Therefore, the issuer of a letter of credit is not an entity liable with a debtor within the meaning of *sections 502(e) and 509 of the Bankruptcy Code*, and the claims disallowance provisions of such sections do not apply to such issuers.

It should be noted, however, that if a letter of credit issuer asserts a claim against its account party under a theory of subrogation as provided for in section 5-117 of the revised UCC, then notwithstanding the inapplicability of *sections 502(e) and 509 of the Bankruptcy Code*, the issuer's claim necessarily cannot be accorded rights or status superior to the claim that is the subject of the subrogation. Accordingly, if a letter of credit has been issued for the benefit of a landlord under a real estate lease to provide for payment in the event of the account party--tenant's rejection of the lease as a debtor under the Code, the issuer asserting a claim in the tenant's case under a theory of subrogation will be subject to the same section 502(b)(6) allowance limitation as would the landlord asserting the same claim.

However, if in the same circumstance the issuer asserted a claim against the estate of the debtor--tenant by way of reimbursement, the claim would not be that of a landlord for damages resulting from the rejection of a real estate lease,ⁿ⁴⁶ but rather a claim by a letter of credit issuer for reimbursement pursuant to the provisions of its agreement with the account party and applicable letter of credit law. This would be a claim for an obligation in the nature of indebtedness, and not a claim for lost rental value.ⁿ⁴⁷ Accordingly, the disallowance provisions of section 502(b)(6) are not applicable to this claim.

[b] Avoidance of Preferential Transfers

Section 547(b) of the Code provides:

Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property--

- (1) to or for the benefit of the creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

- (3) made while the debtor was insolvent;
- (4) made--
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of the transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if--
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.ⁿ⁴⁸

Section 547(c) sets forth a number of circumstances in which the trustee cannot avoid a transfer that would otherwise be preferential and avoidable under section 547(b). Under section 547(c)(1)(A), a transfer cannot be avoided under section 547(b) to the extent that it was intended by the debtor and the creditor to or for whose benefit such transfer was made, to be a contemporaneous exchange for new value given to the debtor, and was in fact a contemporaneous exchange.

In a typical letter of credit transaction entered into within ninety days of the date of filing of a petition by the account party under the Bankruptcy Code, the issuing bank and the beneficiary can establish a defense under the section 547(c) new value and contemporaneous exchange exception described above. The transaction between the account party and the issuing bank is ordinarily in exchange for the payment of a fee by the account debtor, which should constitute a contemporaneous exchange for value. In addition, if the issuing bank honors the letter of credit within the preferential transfer period provided for in section 547(b), no preferential transfer should be deemed to have occurred because the funds being paid are the property of the bank and not the property of the debtor or of its estate.ⁿ⁴⁹ The transfer is not a transfer "of an interest of the debtor in property" under section 547(b) and does not diminish the estate available to creditors.

Moreover, when the account party's obligation to the issuing bank is unsecured, and the issuing bank honors the draw on the letter of credit, the reimbursement or subrogation rights of the issuing bank that become fixed upon payment under the credit should be viewed as merely the substitution of one unsecured obligation of the debtor for another. Upon the occurrence of the draw, there is no interposition of a new claim that will diminish the distribution available to other creditors.ⁿ⁵⁰ The claim of the primary creditor has been satisfied, and the claim of the issuing bank has replaced the claim of the primary creditor without dilution of the pool of claims against the debtor's estate.

It should be noted, however, that an unsecured issuing bank may be subject to a preference attack if it is reimbursed by the account party during the preferential transfer period under the Code. The reimbursement obligation becomes fixed immediately upon the bank's honor of a draw on the letter of credit, rendering any subsequent reimbursement to the bank a payment on account of an antecedent debt.

The analysis changes when the reimbursement obligations of the account party under a letter of credit are secured with assets of the account party. Where a letter of credit is secured, but the primary obligation is unsecured, the issuer's honor of the letter of credit will give rise to a secured debt owing to the letter of credit bank in lieu of an unsecured debt owing to the primary creditor. This will, of course, diminish the amount of the unsecured assets available to general creditors in the event of the bankruptcy of the account party.

Some courts have ruled that payments by a secured issuing bank to an unsecured beneficiary during the preference period are not avoidable as preferential transfers because the funds disbursed are property of the issuing bank and not property of the debtor.ⁿ⁵¹ Other courts have ruled that the grant to an issuing bank of a security interest contemporaneously with the issuance of a letter of credit occurring within the preference period constitutes an avoidable preferential transfer for the benefit of the beneficiary of the credit holding an antecedent debt of the account party.ⁿ⁵² In these circumstances, it is not the grant of the security interest to the bank that is viewed as preferential, inasmuch as the bank has engaged in a contemporaneous exchange of value with the debtor. Instead, when the grant of the security interest is deemed to be "for the benefit of a creditor" under section 547(b), and the "creditor" receiving the benefit is deemed to be the primary creditor and beneficiary under the letter of credit, it is the beneficiary, and not the issuer, that has received the "benefit of" an avoidable transfer. In these circumstances, in order to preserve the independence principle, the letter of credit is not voided, but the beneficiary is required to restore to the estate the value of the collateral to which the issuer is entitled in respect of the debtor's reimbursement obligation.ⁿ⁵³ The disgorgement by the beneficiary of an amount equal to the value of the collateral given to the issuer will restore the estate to the financial position existing before the security interest was granted.

The foregoing does not mean that the grant of a security interest as security for a reimbursement obligation under a letter of credit is always suspect or undesirable. If a standby letter of credit is issued and secured contemporaneously with the creation of the obligation between the account party and the beneficiary under the letter of credit, there is no antecedent debt being indirectly secured. Instead, there is a contemporaneous exchange of value between the account party and the beneficiary, and between the account party and the issuing bank.ⁿ⁵⁴ From the perspective of the unsecured creditors of the account party, viewing the beneficiary as the recipient of the indirect benefit of the security interest granted to an issuing bank renders the existence of the letter of credit irrelevant for purposes of preferential transfer law, inasmuch as the financial effect of the transaction is equivalent to the securing of an obligation of the account party to the beneficiary contemporaneously with the creation of that obligation, and the receipt by the account party of the benefits of the transaction between it and the beneficiary.

The above considerations are of course applicable to a transaction involving the issuance of a secured letter of credit to enhance the credit of a tenant for the benefit of a landlord. If the letter of credit is provided contemporaneously with the entry into the lease, and is also secured at that time, then for the reasons set forth in the immediately preceding paragraph, the posting of security for the tenant's reimbursement obligation should not be vulnerable to attack as a preferential transfer.

If, however, there is an antecedent debt owing from the tenant to the landlord in the form of past due rent or otherwise, then the issuance of a letter of credit and the posting of security therefor within the preference period may be viewed as an indirect preferential transfer of a security interest by the tenant for the benefit of the landlord.ⁿ⁵⁵ This type of transaction may occur in the context of a landlord--tenant workout involving a defaulted lease. If the letter of credit is drawn on, and the tenant subsequently files a petition under the Code within the section 547(b) preference period, the landlord should be entitled to keep the proceeds of the draw but nevertheless may be required to pay to the estate an amount equal to the collateral collected or collectable by the issuing bank.ⁿ⁵⁶

With respect to the issuing bank, the independence principle will have required it to honor the draw, but should permit it to keep the collateral pledged to it as security for the tenant's reimbursement obligation.ⁿ⁵⁷ This will maintain the integrity of the letter of credit process, while placing the risk of disgorgement on the landlord. The only solace for the landlord, apart from the possibility of some dividend from the tenant's estate, will be that the landlord will receive possession of the leased premises upon the rejection of the lease.ⁿ⁵⁸

[c] Avoidance of Fraudulent Conveyances

The types of letter of credit transactions discussed above are not inherently susceptible to successful attack under fraudulent conveyance law.

Section 548(a)(1) of the Bankruptcy Code provides:

The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the petition, if the debtor voluntarily or involuntarily

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer of obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in a business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Fraudulent conveyance analysis of the letter of credit transactions discussed herein should focus separately on: (1) the entry into the transaction, and (2) the honoring of the letter of credit.

With respect to the entry into the transaction, and putting aside the occurrence of an actual fraudulent conveyance under section 548(a)(1)(A), the exchange between the account party--tenant and the letter of credit issuer should not be subject to avoidance on fraudulent conveyance grounds. The letter of credit issuer is incurring an obligation to a third party, the beneficiary, at the request and for the benefit of the account party. This provides value to the account party. The account party is at the same time incurring an obligation to reimburse the letter of credit issuer if the letter of credit is honored. As discussed above, this obligation may or may not be secured. In either case, the account party is creating an obligation in exchange for the value of the benefits arising from the letter of credit. There should be no fraudulent conveyance issue within the confines of this relationship and bilateral transaction based on a lack of reasonably equivalent value received by the account party. This transaction should be viewed as the equivalent of a loan transaction.

With respect to the transaction between the account party--tenant and the landlord, the underlying leasing transaction, if made on market terms, should not be subject to fraudulent transfer attack. The existence of a letter of credit to enhance the tenant's credit should have no effect on the evaluation of the terms of the underlying leasing transaction, inasmuch as the leasing transaction exists separately from the letter of credit.

It may be argued, however, that the use of a letter of credit at the outset of a leasing transaction does adversely affect unsecured creditors in the sense that the claim allowance limitations of *section 502(b)(6) of the Code*,ⁿ⁶⁰ which would be applicable upon rejection of a real estate lease, will not be applicable if the claim of an issuing bank for reimbursement is substituted for the landlord's claim for damages arising out of such rejection.ⁿ⁶¹ Assuming the

amount of the reimbursement claim to be substantially similar to the lease rejection claim, the substitution of an "uncapped" reimbursement claim for a capped rejection damage claim will increase the pool of unsecured claims and dilute the return to unsecured creditors. Under the same analysis used in the "indirect preference" cases, to wit, that the beneficiary--landlord is receiving the benefits of a transfer of collateral to a letter of credit issuer and therefore has received an indirect preferential transfer (if the other elements of section 547(b) are also satisfied), it may be argued that a landlord--beneficiary under a letter of credit is receiving indirectly greater value than it would in the absence of the letter of credit. This would mean that the landlord is receiving more than reasonably equivalent value under a market rent lease with a letter of credit in comparison to the value received under the same lease without a letter of credit.

The better view would reject the foregoing as a fraudulent conveyance analysis. First, the payment under a letter of credit is not a "transfer of an interest of the debtor in property" or the incurrence of an obligation of the debtor within the meaning of *section 548(a) of the Code*. The transfer that is occurring upon honor of a draw on a letter of credit is that of the issuer's funds, and not the funds or other property of the debtor.ⁿ⁶² Second, although the existence of a reimbursement claim may dilute the unsecured claims pool to a greater extent than would a landlord's rejection claim limited under section 502(b)(6), it may be argued that the estate and its creditors received the benefits of a real estate lease that would not have been entered into by the landlord without the furnishing of the letter of credit in the first instance. The weak credit of the tenant, without enhancement, may have precluded the tenant's leasing of a facility from which to conduct business and create value. The existence of the letter of credit therefore may be viewed as providing value to the tenant's estate that would not exist in the absence of the credit. Thus the tradeoff that the debtor--tenant has made by substituting an uncapped reimbursement claim for a capped lease rejection claim is an exchange of reasonably equivalent value with respect to the landlord because there may well have been no lease in the absence of the credit enhancement.

FOOTNOTES:

(n1)Footnote 1. *See P 2.02[2][a] supra*.

(n2)Footnote 2. *See P 2.02[2][a] supra; cf. In re Madrid, 725 F.2d 1197 (9th Cir. 1984) ; In re Pelc, 34 B.R. 823 (Bankr. D. Or. 1983) .*

(n3)Footnote 3. *In re Valentine, 125 B.R. 11 (Bankr. S.D. Ohio 1991)* (setoff of \$200 security deposit was a "technical violation" of the stay).

(n4)Footnote 3a. 11 U.S.C. § 362(d)(2).

(n5)Footnote 4. *United States v. Whiting Pools, Inc., 462 U.S. 198, 207, 103 S. Ct. 2309, 2315 (1983) .*

(n6)Footnote 5. *See In re Sapolin Paints, Inc., 2 C.B.C.2d 854, 5 B.R. 412 (Bankr. E.D.N.Y. 1980) .*

(n7)Footnote 6. *See generally 3 Collier Bankruptcy Practice Guide, ch. 62 (Matthew Bender).*

(n8)Footnote 7. *Oldden v. Tonto Realty Corp., 143 F.2d 916 (2d Cir. 1944) ; In re Atlantic Container Corp., 26 C.B.C.2d 597, 604, 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991) ; In re Mainstream Access, Inc., 134 B.R. 743, 750 (Bankr. S.D.N.Y. 1991) ; see P 3.03[3] supra for a discussion on limitation of claims arising under guarantees of rejected leases.*

(n9)Footnote 8. *See note 7 supra*. However, one court has held that a landlord's damage claim, after giving effect to the landlord's recovery under a guaranty of the lease, should be pro-rated by multiplying the allowed damage claim by a fraction, the numerator of which is the total state law damage claim less the recovery under the guaranty, and the denominator of which is the total state law damage claim. *In re Steve's Furniture Warehouse, Inc., 46 B.R. 80 (Bankr. S.D. Cal. 1985) .* This holding is not consistent with the *Oldden* rule.

(n10)Footnote 9. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 353-54 (1977), *reprinted in* Vol. C Collier on

Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 10. *In re Standard Furniture Co.*, 2 C.B.C.2d 274, 279, 3 B.R. 527, 531 (Bankr. S.D. Cal. 1980) .

(n12)Footnote 11. See P 3.01[3][b][I] *supra*; *In re O.P.M. Leasing Services, Inc.*, 30 B.R. 642 (Bankr. S.D.N.Y. 1983) .

(n13)Footnote 12. 4A Collier on Bankruptcy, P 70.44[5] (Matthew Bender 14th ed. 1978), in discussing the former Bankruptcy Act, suggests that this formulation may avoid the recovery limitations created by the rule of *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944) .

(n14)Footnote 13. 4 Collier Bankruptcy Practice Guide, ch. 66 (Matthew Bender).

(n15)Footnote 14. 11 U.S.C. § 553.

(n16)Footnote 15. A setoff analysis rather than a cash collateral analysis was employed in *In re Scionti*, 40 B.R. 947 (Bankr. D. Mass. 1984) . Postpetition application by a utility company of a security deposit was permitted as a recoupment in *Brooks Shoe Mfg. Co. v. United Tel. Co.*, 11 C.B.C.2d 259, 39 B.R. 980 (E.D. Pa. 1984) . Postpetition application by a landlord of prepaid rent against the landlord's section 502(b)(6) damage claim was denied for lack of mutuality in *In re Orangebrook Concessions, Inc.*, 47 B.R. 858 (Bankr. S.D. Fla. 1985) . Setoff of a prepetition debt from the nondebtor party owing to the debtor against a claim arising under an executory contract with the debtor was denied as premature pending rejection of the contract. *In re Public Serv. Co.*, 884 F.2d 11 (1st Cir. 1989) .

(n17)Footnote 15a. *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 589, 17 C.B.C.2d 987 (5th Cir. 1987) .

(n18)Footnote 15b. *AMB Prop., L.P. v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d 961, 54 C.B.C.2d 955 (9th Cir. 2005) ; *Solow v. PPI Enters. (U.S.) (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 49 C.B.C.2d 1749 (3d Cir. 2003) ; *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 52 C.B.C.2d 815, 306 B.R. 295 (B.A.P. 9th Cir. 2004) .

(n19)Footnote 15c. 430 F.3d 260 (5th Cir. 2005) .

(n20)Footnote 15d. 430 F.3d 260, 264 .

(n21)Footnote 15e. *Faulkner v. EOP-Colonnade of Dallas, LP (In re Stonebridge Techs., Inc.)*, 291 B.R. 63 (Bankr. N.D. Tex. 2003) .

(n22)Footnote 15f. 430 F.3d 260, 269 .

(n23)Footnote 15g. 430 F.3d 260, 269-70 .

(n24)Footnote 15h. G. Hesse, *Letters of Credit and Leasehold Rejection Damages*, ABI Journal, Mar. 2006, at 20. The provisions that permit a debtor to file a proof of claim on behalf of a creditor are *Bankruptcy Code section 501(c)* and *Fed. R. Bankr. P. 3004*.

(n25)Footnote 16. In a case under the Bankruptcy Code, state law governs the rights and obligations of the parties to an agreement entered into under state law, in the absence of some compelling federal interest. *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) .

(n26)Footnote 16a. *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 210 (3d Cir. 2003) (parties intended for letter of credit to operate as security deposit; lease provided for letter of credit "in lieu of" cash security). See also *AMB Prop., L.P. v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d 961, 54

C.B.C.2d 955 (9th Cir. 2005) ; *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 52 *C.B.C.2d 815*, 306 B.R. 295 (B.A.P. 9th Cir. 2004) .

(n27)Footnote 16b. *EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260 (5th Cir. 2005) .

(n28)Footnote 17. See P 3.03[3] *supra*, for a discussion of the issues of interpretation arising from the language of section 502(b)(6) of the Code.

(n29)Footnote 18. See cases cited at P 3.03[2] notes 27-27d *supra*.

(n30)Footnote 19. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 353-54 (1977).

(n31)Footnote 20. As discussed below, the legislative history to section 509 states that a "surety or codebtor should not be entitled to increased rights by way of reimbursement or contribution, to the detriment of competing claims of other unsecured creditors, than would be realized by subrogation." See text accompanying note 27 *infra*. Although not on point on the facts, the opinions in *Oldden v. Tonto Realty Corp.*, 143 F. 2d 916 (2d Cir. 1944) , and *Hippodrome Bldg. Co. v. Irving Trust Co.*, 91 F. 2d 753 (2d Cir.) , cert. denied, 302 U.S. 748, 58 S. Ct. 265, 82 L. Ed. 578 (1937) , evidence a clear policy to limit lease rejection damage recoveries in order to protect other unsecured creditors from the effects of an overwhelming large claim.

(n32)Footnote 21. In a case under the Bankruptcy Code, state law governs the rights and obligations of the parties to an agreement entered into under state law, in the absence of some compelling federal interest. *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481 (1979) . The applicable state law is primarily Article 5 of the Uniform Commercial Code, which was revised in 1995 by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. Letters of credit are also governed by the International Chamber of Commerce Uniform Customs and Practices for Documentary Credit.

(n33)Footnote 22. See, e.g., Official Comment 1 to Revised Uniform Commercial Code Section 5-103.

(n34)Footnote 23. See Official Comment 1 to Revised Uniform Commercial Code Section 5-103; Revised Uniform Commercial Code Section 5-109 and Official Comments thereto.

(n35)Footnote 24. 11 U.S.C. § 502(e).

(n36)Footnote 25. 124 Cong. Rec. H11,094 (Sept. 28, 1978).

(n37)Footnote 26. 11 U.S.C. § 509.

(n38)Footnote 27. House debate on compromise bill, 124 Cong. Rec. H11,047-117, § 411 (Sept. 28, 1978).

(n39)Footnote 28. *CCF, Inc. v. First Nat'l Bank & Trust Co. (In re Slamans)*, 69 F. 3d 468, 476, 34 C.B.C.2d 1372 (10th Cir. 1995) ; *Beach v. First Union Nat'l Bank of N. Carolina (In re Carley Capital Group)*, 119 B.R. 646, 648 (W.D. Wis. 1990) ; *Berliner Handels-Und Frankfurter Bank v. East Tex. Steel Facilities, Inc. (In re East Tex. Steel Facilities, Inc.)*, 117 B.R. 235, 240 (Bankr. N.D. Tex. 1990) ; *Bank of Am. Nat'l Trust & Sav. Ass'n v. Kaiser Steep Corp. (In re Kaiser Steel Corp.)*, 19 C.B.C.2d 671, 89 B.R. 150, 154 (Bankr. D. Colo. 1988) ; *In re Munzenrieder Corp.*, 58 B.R. 228 (Bankr. M.D. Fla. 1986) ; *In re Economic Enters., Inc.*, 44 B.R. 230 (Bankr. D. Conn. 1984) . Contra, *In re Valley Vue Joint Venture*, 123 B.R. 199, 204 (Bankr. E.D. Va. 1991) ; *In re National Serv. Lines, Inc.*, 80 B.R. 144 (Bankr. E.D. Mo. 1987) ; *In re Sensor Sys., Inc.* 17 C.B.C.2d 1237, 79 B.R. 623, 626 (Bankr. E.D. Pa. 1987) ; *In re Minnesota Kicks, Inc.* 12 C.B.C.2d 821, 48 B.R. 93, 104-05 (Bankr. D. Minn. 1985) .

(n40)Footnote 29. See generally Dellas W. Lee, *Letters of Credit: What Does Revised Article 5 Have to Offer To Issuers, Applicants, and Beneficiaries?*, 101 Com. L.J. 234 (1996).

(n41)Footnote 30. *Rev. Uniform Commercial Code Section 5-101*, Official Comment.

(n42)Footnote 31. *Rev. Uniform Commercial Code Section 5-103*, Official Comment 1.

(n43)Footnote 32. *Rev. Uniform Commercial Code Section 5-117*.

(n44)Footnote 33. *Tudor Dev. Group, Inc. v. United States Fid. & Guar. Co.*, 968 F.2d 357 (3d Cir. 1992) .

(n45)Footnote 34. *Id.*

(n46)Footnote 35. *Rev. Uniform Commercial Code Section 5-117*, Official Comment 1.

(n47)Footnote 36. 968 F.2d 357, 365-66 .

(n48)Footnote 37. 123 B.R. 199 (Bankr. E.D. Va. 1991) .

(n49)Footnote 38. *Tudor Dev. Group, Inc. v. United States Fid. & Guar. Co.*, 968 F. 2d 357, 366 (3d Cir. 1992) .

(n50)Footnote 39. *Tudor Dev. Group v. United States Fidelity & Guar. Co.*, 968 F.2d 357, 368 (3d Cir. 1992) .

(n51)Footnote 40. *Tudor Dev. Group, Inc. v. United States Fid. & Guar. Co.*, 968 F. 2d 357, 366 (3d Cir. 1992) .

(n52)Footnote 41. The issue appears to be much clearer in the case of subrogation, inasmuch as the issuing bank is by definition asserting the same claim as the primary creditor--landlord. The landlord's lease rejection damage claim is of course subject to the claims disallowance provisions of *section 502(b)(6) of the Code*.

(n53)Footnote 42. *See* note 21 *supra*. The common law is also applicable. *See also Rev. Uniform Commercial Code Section 5-101*, Official Comment, and *Section 5-108*, Official Comment 8.

(n54)Footnote 43. *Revised Uniform Commercial Code Section 5-108*.

(n55)Footnote 44. *Revised Uniform Commercial Code Section 5-108(f)*.

(n56)Footnote 45. *See generally*, John F. Dolan, *The Law of Letters of Credit* (rev. ed. 1999).

(n57)Footnote 46. *See* P 3.03[3] *supra*.

(n58)Footnote 47. In a typical chapter 11 case, this claim would be placed in a different class from the claims of a landlord.

(n59)Footnote 48. 11 U.S.C. § 547(b).

(n60)Footnote 49. *E.g., In re Compton Corp.*, 831 F. 2d 586, 589, 17 C.B.C.2d 987 (5th Cir. 1987) ; *In re Metro Communications, Inc.* 115 B.R. 849, 854 (Bankr. W.D. Pa. 1990) .

(n61)Footnote 50. David Gray Carlson & William H. Widen, *Letters of Credit, Voidable Preferences, and the "Independence" Principle*, 54 Bus. Law. 1661, 1683-84 (1999); *see also* P 2.05[1] *supra*.

(n62)Footnote 51. *In re M.J. Sales & Distrib. Co.*, 7 C.B.C.2d 884, 25 B.R. 608 (Bankr. S.D.N.Y. 1982) ; *In re Price Chopper Supermarkets, Inc.*, 40 B.R. 816 (Bankr. S.D. Cal. 1984) .

(n63)Footnote 52. *In re Air Conditioning, Inc.*, 72 B.R. 657, 662 (S.D. Fla. 1987) . *In re Air Conditioning, Inc.*, 845 F. 2d 293, 18 C.B.C.2d 973 (11th Cir. 1988) ; *Martinez v. Dodge Printing Ctrs., Inc.*, (*In re Gates Cmty. Chapel of Rochester, Inc.*), 123 B.R. 77 (Bankr. W.D.N.Y. 1991) ; *In re Compton Corp.*, 831 F. 2d 586, 591, 17 C.B.C.2d 987

(5th Cir. 1987) ; *In re Val Decker Packing Co.*, 61 B.R. 831, 841 (Bankr. S.D. Ohio 1986) .

(n64)Footnote 53. See *In re Air Conditioning, Inc.*, 72 B.R. 657, 662 (S.D. Fla. 1987) .

(n65)Footnote 54. James A. Rodenberg, *Letters of Credit in Bankruptcy: Can the Independence Doctrine Survive Preference Attacks?*, 96 Com. L.J. 431, 451 (1991).

(n66)Footnote 55. *In re Air Conditioning, Inc.*, 845 F.2d 293 (11th Cir. 1988) ; *Martinez v. Dodge Printing Ctrs., Inc.*, (*In re Gates Cmty. Chapel of Rochester, Inc.*), 123 B.R. 77 (Bankr. W.D.N.Y. 1991) ; see *In re Compton Corp.*, 831 F. 2d 586, 591, 17 C.B.C.2d 987 (5th Cir. 1987) ; see also *In re Val Decker Packing Co.*, 61 B.R. 831, 841 (Bankr. S.D. Ohio 1986) .

(n67)Footnote 56. See *In re Air Conditioning, Inc.*, 72 B.R. 657, 662 (S.D. Fla. 1987) .

(n68)Footnote 57. See *In re Air Conditioning, Inc.*, 72 B.R. 657, 662 (S.D. Fla. 1987) .

(n69)Footnote 58. 11 U.S.C. § 365(d)(4).

(n70)Footnote 60. See P 3.03[3] *supra*.

(n71)Footnote 61. See P 3.04[2][a] *supra*.

(n72)Footnote 62. See *In re Compton Corp.*, 831 F. 2d 586, 589, 17 C.B.C.2d 987 (5th Cir. 1987) ; *In re Metro Communications, Inc.* 115 B.R. 849, 854 (Bankr. W.D. Pa. 1990) .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.05

P 3.05 Sublease Rentals

If a tenant under a real property lease sublet all or a part of the leased premises and thereafter filed a petition under the Bankruptcy Code, the generally accepted rule, prior to enactment in the 1984 Amendments of section 365(d)(3), was that the trustee was not obligated to pay use and occupation charges for the subleased space.ⁿ¹ The trustee was deemed to be not in possession of the subleased space, and the receipt of sublease rentals was not regarded as sufficient action to constitute use and occupation on the part of the trustee. If the trustee was not paying use and occupation charges, and ultimately rejected the prime lease, and if the estate was insolvent, it appears that the sublease rents that were collected by the trustee, as well as any sublease rents that were due or to become due, were impressed with an equitable lien in favor of the landlord and were not considered part of the estate, at least to the extent of any defaults in the payment of prime lease rent.ⁿ² Although not discussed in the cases, it appears that in view of the landlord's status as a secured party in respect of sublease rents, such rents should have been segregated by the trustee prior to the time when the lease was assumed or rejected, and paid over to the landlord upon rejection for application to the landlord's damages arising from the rejection. With respect to prepetition prime lease rent arrearages, it appears further that sublease rent due at the time of the filing of the tenant's petition became property of the estate, and not property of the landlord.ⁿ³ However, there did not appear to be any prohibition against a landlord's applying postpetition sublease rents to prepetition prime lease defaults.

The fabrication of an equitable lien doctrine was necessitated by application to the subletting situation of the traditional rules governing use and occupation payments. The trustee was deemed not to be in actual possession and, therefore, did not have to pay for the premises pending his decision to assume or reject the lease. The trustee was nevertheless receiving sublease rentals, and the estate would have become enriched unjustly if the trustee could retain the rentals while holding off the landlord. Thus the obligation to turn over the sublease rentals was deemed to arise from a lien theory nowhere found in the former Bankruptcy Act or in the Code in order to avoid the harsh consequences of the use and occupation doctrine.

Section 365(d)(3) of the Code, requiring timely performance of the obligations of a debtor-tenant arising under a nonresidential real estate lease from and after the entry of the order for relief, should result in payment by the trustee of amounts equal to the postpetition prime lease even if the premises have been sublet. If the equitable lien doctrine in respect of the landlord's rights to receive postpetition sublease rents resulted from the otherwise harsh consequences of the use and occupation rules, and if section 365(d)(3) is viewed as having abrogated such rules, then the continued viability of the equitable lien doctrine is subject to question. The doctrine may remain viable to deal with a trustee's

breach of its obligations for postpetition performance under section 365(d)(3), and perhaps as a means to provide a landlord with a collateral pool for the payment of damages if the trustee ultimately rejects the debtor's lease.

In view of the uncertain future of the equitable lien theory in the subletting context, consideration should be given to inclusion in all prime leases an assignment of rents provision covering any present or future sublease rentals. Section 552(b) of the code recognizes the effect of a security interest in postpetition rents and profits. Thus if postpetition sublease rentals are viewed as a form of cash collateral, the trustee may be required under section 363(c)(2) of the code to segregate such funds and to disburse the same only after notice to the landlord and approval by the court. In these circumstances, the landlord of a debtor-tenant in a Bankruptcy Code case in which the leased premises have been sublet should promptly after the filing of the petition seek to determine whether the sublease rentals are being properly segregated. If the sublease rentals are being commingled with other assets of the estate, the landlord should consider moving in the bankruptcy court for an order of sequestration.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *In re Unishops, Inc.*, 543 F.2d 1017 (2d Cir. 1976) ; *In re United Cigar Stores Co.*, 69 F.2d 513 (2d Cir. 1934) , cert. denied, 293 U.S. 556, 55 S. Ct. 76, 79 L. Ed. 665 (1934) .

(n2)Footnote 2. *In re United Cigar Stores Co.*, 69 F.2d 513 (2d Cir. 1934) , cert. denied, 293 U.S. 556, 55 S. Ct. 76, 79 L. Ed. 665 (1934) (insolvent estate); *Central Manhattan Props., Inc. v. Schulte, Inc.*, 91 F.2d 728 (2d Cir.) , cert. denied, 302 U.S. 743 (1937) (solvent estate).

(n3)Footnote 3. *In re United Cigar Stores Co.*, 69 F.2d 513 (2d Cir.) , cert. denied, 293 U.S. 556, 55 S. Ct. 76, 79 L. Ed. 665 (1934) .

(n4)Footnote 4. See P 2.03[1] *supra*.

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.06

P 3.06 Drafting Considerations

[1] Generally

The drafting considerations discussed in this paragraph are in large part directed at countering, from the landlord's point of view, the provisions of the Bankruptcy Code that have substantially diluted the degree of control which landlords have previously exercised over the use and disposition of leased premises. The lease provisions discussed herein, which are intended to ameliorate some of the problems arising from the rights of assumption and assignment created by the Bankruptcy Code, may be criticized generally as running contrary to the policy underlying the Code with respect to assignment and assumption of leases that below market real estate leases are a valuable asset of an estate and should be realized upon for the benefit of the estate and its general creditors.ⁿ¹ Thus, the argument runs, lease provisions that may have the effect of impairing a trustee's ability to assume and assign a lease may be rendered unenforceable or may be appropriately modified in the absence of demonstrable and material prejudice to the landlord.ⁿ²

It may be noted, on the other hand, that attorneys have always sought to draft documents to provide the maximum possible advantage for their clients within the context of a particular transaction and within the range of flexibility permitted by applicable law. Transactions are structured every day to afford clients the maximum savings in income and other taxes permitted under the Internal Revenue Code. Transactions are structured and drafted to afford clients the greatest permissible return as lenders in the light of applicable usury limitations. Hence there appears to be no reason why lease provisions cannot be employed to assist landlords in asserting and enforcing bargained-for rights that may be limited, but are not necessarily destroyed, by the Bankruptcy Code.

In considering provisions dealing with assignment of leases, the ability of the assignee to comply with lease provisions after an assignment, and the rights of a landlord to enforce its rights against an assignee who cannot comply with the original lease provisions, a distinction should be drawn between lease provisions that are contrary to the express provisions of the Code, and lease provisions that, if enforced, have consequences that may frustrate a trustee's objectives in a case under the Code. For example, a lease provision prohibiting assignment under any circumstances will be unenforceable under *section 365(f)(1) of the Code*, which renders unenforceable any lease provision that prohibits assignment of a lease. Similarly, a provision that terminates a lease upon assignment would be invalidated by *section 365(f)(3)*, which invalidates such clauses. However, a lease provision such as a specific use clause, a performance covenant or a financial covenant, which has been breached by the debtor and cannot be cured on assumption, or which cannot be the subject of adequate assurance of future performance by a prospective assignee, may have the effect of

preventing an assignment to a particular assignee. It is not in itself an anti-assignment clause.ⁿ³ Such covenants are, of course, intended to provide landlords with greater control over the disposition of their property than would be afforded in the absence of such covenants, but will not prevent an assignment under the Bankruptcy Code if the trustee and proposed assignee can in fact satisfy the requirements of these covenants.

Thus, the question to be resolved is whether the courts will enforce lease provisions that do not by their terms prohibit or restrict assumption and assignment but which require strict adherence to certain contractual requirements that may or may not be capable of satisfaction by an assuming trustee or proposed assignee. Under traditional bankruptcy law doctrine, an assuming trustee and his assignee must take up a lease subject to all of the provisions of that lease.ⁿ⁴ If that rule is to remain in effect, then specific use clauses, performance covenants, financial covenants and the like will be enforceable and prevent assignment to an assignee that is unable to comply. If, however, the Code is to be read as rendering unenforceable not only the specific anti-assignment clauses dealt with in section 365(f) but also any clause that would prevent consummation of an assignment transaction in a particular instance, then the traditional doctrine must be acknowledged to have been modified under the perceived new policies evidenced by the Code.

It is submitted that the Code nowhere evidences such a general policy. The most recent evidence of Congressional intent in this area suggests that lease covenants that clearly can be complied with only by the original tenant, and which are not material and therefore will not adversely affect the landlord if breached, should not be enforced by a bankruptcy court if the effect would be to preclude an assignment transaction beneficial to the estate.ⁿ⁵ However, lease covenants, such as use clauses, which have traditionally been regarded as material and as falling within the realm of a landlord's control over its premises and its relationship with the tenant, should not be susceptible to judicial modification with the resulting substitution of a judge for the landlord as the determinant of how the premises will be used for many years to come. In view of the foregoing, it is again necessary to caution that the suggested clauses contained in this paragraph are of uncertain efficacy, and are submitted in the belief that employment thereof can at best be helpful to a landlord's position and should not be harmful unless relied upon without appropriate counseling as to the issues discussed herein.

It should be further noted that the use of these clauses will necessitate even greater attention to the bankruptcy and creditors' rights exceptions contained in opinions of counsel. Certain styles of bankruptcy exceptions in opinions deal only with enforceability of remedies, and are drafted to deal solely with the consequences of the automatic stay and the powers of the bankruptcy court to deal with collateral. In the case of real estate leases, however, the provisions of *section 365 of the Code* may be viewed as going to the enforceability of substantive rather than remedial provisions, so that the bankruptcy exceptions in counsel opinions relating to real estate leases should deal with enforceability of substantive provisions as well as enforcement of remedies.

[2] Assignment Provisions

Section 365(f)(1) of the Code provides that an unexpired lease may be assigned notwithstanding any provision in the lease or applicable law that "prohibits, restricts or conditions" such assignment. *Section 365(f)(3)* states that a provision in an unexpired lease or of applicable law that terminates or modifies or permits the termination or modification of such lease on account of an assignment thereof will not be effective in respect of an assumption or assignment under the Bankruptcy Code. These sections may be viewed as reflecting a twofold legislative decision that (1) it is undesirable to compel a trustee who does not elect to assume and retain a lease to reject the lease and to give rise to an allowable claim for damages when the lease could have been assigned to a third party and damages avoided; and (2) the trustee should be free to dispose of all or a part of the debtor's business or assets for value in order to facilitate rehabilitation. The effect of sections 365(f)(1) and 365(f)(3), in the context of a real property lease under which the debtor is lessee, is to permit the trustee to sell the debtor's leasehold estate for consideration by means of an assignment of the lease. This right on the part of the trustee is available whether the leasehold is being sold as part of a going business or relates to nonessential facilities that have otherwise been abandoned by the debtor. Indeed, the right of assignment is available equally to debtors in possession in chapter 11 reorganization cases and to trustees in chapter 7 liquidations wherein all business operations have been discontinued. Thus, subsections (f)(1) and (f)(3) of section 365, in facilitating

assignments of lease for consideration, appear to give to the trustee and to the debtor-lessee and its creditors the economic benefits of any appreciation of value of the real property subsequent to the commencement of the lease term, even when such appreciation has resulted from general real estate market conditions and not from any efforts of the trustee or the debtor-lessee. There is a possibility, however, that appropriate drafting of lease assignment clauses may preserve for the landlord the benefits of increases in value of the assets or rights covered by such leases.

Section 365(f)(1) renders unenforceable provisions that "prohibit, restrict or condition" assignments of unexpired leases. Section 365(f)(3) renders unenforceable provisions that "terminate or modify" a lease on account of an assignment. Clearly, clauses that prohibit assignment, require consent to assignment, provide for a landlord's right to recapture the property on assignment, or that increase the rent or other consideration payable under a lease, shorten the term, or otherwise modify the lease in the event of an assignment will not be effective in a Bankruptcy Code case. It may be argued, however, that nothing in section 365(f)(1) and (3) prevents the parties from contracting with respect to the ownership of the proceeds of an assignment as long as the right of assignment is not prohibited, restricted or conditioned. Under such an agreement, for example, if a trustee is able to sell the interest of a debtor-lessee in a lease of real property for \$10,000, the landlord would receive this amount and the assignment transaction would be consummated. The assignment has not been prohibited, restricted or conditioned within the meaning of section 365(f)(1), because the trustee has been free to dispose of the lease pursuant to the provisions of the Bankruptcy Code. Moreover, the clause has not run afoul of section 365(f)(3), since the lease has not in any way been terminated or modified.ⁿ⁶ It may be argued, in opposition to the efficacy of the suggested clause, that it will deter assignments and frustrate the purpose of section 365(f)(1) inasmuch as the estate and its creditors will receive no consideration for the assignment, and, as such, the clause accordingly constitutes a "restriction" under section 365(f)(1).ⁿ⁷ However, there may be a substantial benefit to the estate and its creditors derived from the assignment as an alternative to the allowance of a claim for damages arising out of the rejection of a nonessential lease. It may be further argued in opposition that the suggested clause in fact "conditions" the assignment within the meaning of section 365(f)(1), because the assignment cannot be consummated unless the consideration is paid to the landlord. If, however, the clause is not written in conditional terms, it may be determined that the right of assignment has not been conditioned and that the clause embodies a valid agreement as to the allocation of assets between the parties.

The following is an example of how such a clause may be drafted in the context of what is otherwise a general prohibition against assignment and subletting in a real estate lease:

Lessee shall not assign, mortgage or encumber this lease, nor sublet, nor suffer or permit the demised premises or any part thereof to be used by others, without the prior written consent of Lessor in each instance; provided, however, that if this lease is assigned to any person or entity pursuant to the provisions of the Bankruptcy Code, *11 U.S.C. §§ 101 et seq.* (the "Bankruptcy Code"), any and all monies or other considerations payable or otherwise to be delivered in connection with such assignment shall be paid or delivered to Lessor, shall be and remain the exclusive property of Lessor and shall not constitute property of Lessee or of the estate of Lessee within the meaning of the Bankruptcy Code. Any and all monies or other considerations constituting Lessor's property under the preceding sentence not paid or delivered to Lessor shall be held in trust for the benefit of Lessor and be promptly paid or delivered to Lessor.

Ample precedent exists for the above clause in the context of negotiations relating to general assignment and subletting clauses in leases of office space. The landlord in such negotiations often asserts that it is entitled to control assignment and subletting because it is entitled to receive any benefits of enhanced rental value. The tenant, on the other hand, will be seeking the right to assign or sublet to achieve a degree of flexibility in its financial commitments or with respect to its physical location. These interests have been often accommodated by granting the tenant reasonably free rights of assignment and subletting, but granting to the landlord all or a part of any sublease rental which exceeds the rental rate provided for in the lease. Thus, the concept of "income sharing" in leases is not new and clearly may be justified by landlords in the negotiating and drafting process.

There are of course variables in the landlord-tenant relationship that may warrant a modification of the provision allocating to the landlord all of the proceeds of the assignment. If, for example, the lease in question were a ground lease under which the tenant erected a substantial building, it would be difficult to justify to the bankruptcy court an allocation of lease assignment consideration that would work a forfeiture of the debtor-tenant's investment in the building. Similarly, if the leased premises are utilized for a going business that is being sold together with the leasehold, an allocation between leasehold value and going concern value should be agreed upon by the landlord and the trustee in the context of a particular transaction. On the other hand, in the case of an office or store lease, wherein the debtor's investment in the improvement of the premises may be minimal, there may be no difficulty in justifying allocation of all of the assignment proceeds to the landlord. In these circumstances, the landlord may argue that the debtor did nothing to enhance the rental value of the property, that the debtor's business failure indeed may have had a depressing effect on the value of the property, that the allocation clause thus recognizes the landlord's investment in the premises, and that the landlord's efforts, and not the debtor's efforts, were responsible for the appreciated rental value of the premises.

The suggested clause has not been received favorably by the bankruptcy courts,ⁿ⁸ but has not been considered at the Court of Appeals level.

[3] Assumption Provisions

Section 365(k) of the Code provides that assignment by a trustee of a lease assumed under section 365 relieves the trustee and the estate from any liability for breaches occurring under the lease after the assignment. Nevertheless, there is no requirement in the Bankruptcy Code that an assignee assume the obligations arising under a lease on and after the date of the assignment. Absent such assumption, it is possible, in the case of real estate leases, that there will be no party personally liable for the performance of the obligations under the lease.ⁿ⁹ The trustee and the debtor will have been relieved of liability for post-assignment obligations pursuant to *section 365(k) of the Code*, and the assignee may be deemed to have received the leasehold estate "subject to" the terms of the lease. Although the landlord should be able to argue successfully that the assignee's express assumption must be provided as an essential element of adequate assurance of future performance, it may be helpful if the lease contains a clause requiring assumption in the context of a Bankruptcy Code assignment.ⁿ¹⁰ The clause could provide as follows:

Any person or entity to which this lease is assigned pursuant to the provisions of the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*, shall be deemed without further act or deed to have assumed all of the obligations arising under this lease on and after the date of such assignment. Any such assignee shall upon demand execute and deliver to Lessor an instrument confirming such assumption.

The clause has been written to avoid "conditioning" the assignment on the assignee's execution of an assumption agreement in order to comply with the proscriptions of section 365(f)(1).ⁿ¹¹ Thus, the assumption of obligations is intended to be self-executing, with the right on the part of the landlord to obtain a post-assignment confirmatory instrument.ⁿ¹²

The potential infirmity of the proposed clause is that it seeks to direct the bankruptcy court as to an essential element of adequate assurance of future performance, thereby trespassing upon the judicial authority to interpret and apply *section 365(f)(2) of the Code*. Indeed, there have been proposals for more elaborate clauses, which would define with specificity the type of assignee that would satisfy the requirements for adequate assurance of future performance, including financial and experiential standards.ⁿ¹³ These clauses may be viewed as efforts to impose upon the court a judgment clearly reserved to the court under the Code, and may therefore be unenforceable. The relatively narrow clause set forth above may in contrast be justified on the ground that it fills in a clear drafting gap in the Code and should be recognized as a matter of fundamental equity. If, however, the lease in question was originally a nonrecourse lease, then it may be difficult to convert the agreement to a recourse obligation if the trustee is seeking to assign the lease on a nonrecourse basis. Moreover, if the underlying real estate value is substantially in excess of the rental provided for in a recourse

lease, and it is apparent that the landlord will be fully protected by that value if it becomes necessary to recover the premises upon a default by the assignee, it is possible that a court will permit a nonrecourse assignment of a recourse lease if necessary to consummate the proposed assignment transaction. This will result in a definition of the standard of adequate assurance of future performance under section 365(f)(2) as including real estate value as an element in weighing the protections offered to the landlord.ⁿ¹⁴

[4] Financial Covenants

Section 365(b)(1) of the Code requires as a condition to assumption of unexpired leases that the trustee cure or provide adequate assurance of prompt cure of any default under the lease. Under section 365(b)(2), the cure requirements of section 365(b)(1) are made inapplicable to provisions dealing with (1) the insolvency or financial condition of the debtor at any time before the closing of the case, (2) the commencement of a case under the Bankruptcy Code, (3) the appointment of or taking possession by a trustee in a Bankruptcy Code case or a custodian prior to commencement of the case, and (4) the failure to satisfy any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations.^{n14a} Landlords who desire to seek additional means of preventing assumption and assignment of a lease may consider the utilization of financial and performance covenants in their documentation. Although an unexpired lease may not be terminated prior to the closing of a case for breach of a covenant dealing with the debtor's financial condition, there may nevertheless be several advantages to the insertion of financial condition covenants in lease forms which have heretofore traditionally omitted such clauses.

First, the covenant may well be breached during the period of financial difficulty preceding the filing of the petition, and it may be possible to effect a prepetition termination on the basis of the breach.ⁿ¹⁵

Second, if the trustee desires to assume the lease without an assignment to a third party, there is the possibility that the debtor will be unable to meet the requirements of the financial condition covenant after the closing of the case. The Code limits the period of unenforceability of financial covenant defaults to the time "before the closing of the case."ⁿ¹⁶ Accordingly, if a landlord effectively reserves its rights during the pendency of the case, it may have preserved the ability to terminate the lease after the Bankruptcy Code case has been closed by reason of the subsisting financial covenant default on the part of the debtor. In order to foreclose the possibility of a postclosing lease termination by the landlord, the court in the Bankruptcy Code case would be constrained to retain jurisdiction throughout the term of the lease after a chapter 11 plan has been confirmed, and to order the case not to be closed until the expiration of the lease term. In view of the courts' traditional reluctance to retain jurisdiction for protracted periods, the debtor in possession (or trustee) may be unable to rely on the existence of the lease after the case is closed. Thus, during the pendency of a case, a landlord may seek to forestall assumption with or without an assignment by setting forth in the record its intention to seek termination of the lease after the case has been closed. This statement of intention may be particularly effective if it has become apparent that the debtor will be in default under the financial condition covenant through the duration of the case and for a significant time thereafter. If the trustee as a condition to assumption will be requested to expend money to cure existing defaults, the threat of postclosing termination may be sufficient to deter assumption.^{n16a}

Third, if the trustee is seeking to assign a lease, the requirement for adequate assurance of future performance, which is imposed under section 365(f)(2) whether or not there has been a default, may be construed to require a demonstration that the assignee will be able to satisfy the financial condition covenants in the lease that is being assigned. If a prospective assignee in a transaction calling for consideration to be paid to the trustee for the assignment is faced with a postconsummation termination of the lease, it may be unwilling to enter into the transaction and risk the loss of its investment, or may feel constrained to approach the landlord with an offer of improved terms for the lease or other considerations. In any event, a financial covenant in a lease may narrow and improve the field of prospective assignees of the lease.^{n16b}

The language in section 365(e)(1)(A), rendering unenforceable lease termination provisions relating to the insolvency or financial condition of the debtor at any time before the closing of the case, appears to constitute a recognition of the

limitations upon the bankruptcy court's reach in modifying otherwise enforceable contractual provisions after the debtor has left the protection of the court. This limitation may have been recognized in the following cryptic passage contained in the House Report:

This subsection [section 365(e)] does not limit the application of an *ipso facto* or bankruptcy clause to a new insolvency or receivership after the bankruptcy case is closed. That is, the clause is not invalidated in toto, but merely made inapplicable during the case for the purpose of [disposition] of the executory contract or unexpired lease.ⁿ¹⁷

This passage appears to be saying that (1) after the closing of a case, if there is a state law receivership, or if the debtor is insolvent, and a lease clause permits termination under those circumstances, the clause will be enforceable notwithstanding that the Bankruptcy Code prevented termination under the same insolvency clause during the pendency of the case, and (2) in addition, the bankruptcy or *ipso facto* clause is merely suspended during the pendency of a case under the Code, and is fully resurrected thereafter. It is unlikely, however, that this passage can be read to mean that a landlord may, after a case is closed, terminate a lease because the debtor had been the subject of a Bankruptcy Code case. However, section 365(e)(1)(A) deals with both insolvency and financial condition clauses, so that the above passage appears applicable to financial condition as well as bankruptcy termination clauses. Thus section 365(e)(1)(A) can be read to say, with respect to financial condition clauses, that (1) a lease cannot be terminated during a Bankruptcy Code case on account of a debtor-tenant's failure to satisfy a financial standards test contained in the lease, (2) a lease cannot be terminated after the closing of a Bankruptcy Code case under a financial standards test in the lease on account of the debtor-tenant's failure to meet the test while the case was open, but (3) a lease can be terminated after the closing of a case under a financial standards test on account of the reorganized entity's continued failure after the closing of the case to meet the financial standards test in the lease. In other words, section 365(e)(1)(A) does not render unenforceable a financial covenant in a lease to the extent that there is a default under that covenant in existence after the closing of the case. To conclude otherwise would necessitate a showing that the Code authorizes the bankruptcy court to rewrite financial covenants in leases to accommodate a debtor's postclosing financial condition to the provisions of the lease. Section 1123(a)(5) permits the proposal of a plan that would cancel or modify any indenture or similar instrument, or which would cure or waive any default, but does not contemplate the modification of a real estate lease without the landlord's consent to eliminate the possibility of a postclosing financial covenant default. Such a reading would be contrary to the passage from the House Report set forth above, and to the traditional doctrine that assumption requires the trustee to accept the lease with all of its attendant burdens as well as benefits.ⁿ¹⁸

Financial covenants in leases should be drafted as simply and concisely as possible. Financial covenants, to be truly effective, should require financial reporting on the part of the tenant. The reporting requirements likewise should be kept at a minimum. Here is a suggested approach for a real estate lease:

Lessee shall not at any time during the term hereof permit its net worth, determined in accordance with generally accepted accounting principles consistently applied to be less than \$ If Lessee shall default in the payment of any installment of rent hereunder, Lessee shall deliver to Lessor within five business days after demand a balance sheet of Lessee as of a date not more than 30 days prior to the first day of the month during which said installment of rent was due hereunder, certified by Lessee's President or Chief Financial Officer to present fairly the financial position of Lessee as the date of such balance sheet. If Lessee fails to deliver its balance sheet in accordance with the provisions of the preceding sentence, Lessee shall be conclusively deemed to be in default under the first sentence of this paragraph. The obligations of Lessee under this paragraph are a material obligation of Lessee's tenancy under this lease.

In major leasing and other transaction, the financial covenants and reporting requirements may be set forth with greater definition and detail. It should be noted that under the clause set forth above, the failure to deliver the balance sheet is itself an independent default which may justify termination of the lease.

There is no assurance that a state court in a post-closing termination proceeding would enforce the financial covenant clause or that the court in the Bankruptcy Code case would be unwilling to issue some form of permanent injunction against termination. However, until the courts have ruled on these matters, the language of the Bankruptcy Code limiting the duration of the period of unenforceability of these default clauses may create considerable uncertainty in the assumption and assignment process.

[5] Use Clauses

The employment of a narrow use clause to limit the universe of potential assignees of a lease rests on the theory that any assignee must take the lease subject to all of its terms, must provide adequate assurance of future performance under the lease and will face postassignment termination efforts by the landlord if the use clause is violated.ⁿ¹⁹ A discussion of the arguments for and against the enforceability of specific use clauses in the context of an assignment under the Bankruptcy Code, and of the current case law, is set forth earlier in this chapter.ⁿ²⁰ As discussed above, the principal issue is whether lease provisions that do not by their terms prohibit or restrict assignment, but which if enforced will have the result of terminating an assignment transaction in a particular instance, should be viewed as unenforceable anti-assignment clauses or as ordinary lease terms that are as enforceable as any other provision in the lease.ⁿ²¹ Once again, there appear to be no adverse consequences to a landlord if it can bargain for a specific use clause, with the potential for a litigation advantage if the tenant later files a Bankruptcy Code petition and seeks to assign the lease to a different user.

[6] Nonfinancial Covenants and Uncurable Defaults

The categories of clauses under which unexpired leases may not be terminated, and under which cure of defaults need not be effected for purposes of assumption and assignment, are clauses relating to: (1) the insolvency of the debtor; (2) the financial condition of the debtor; (3) the commencement of a case under the Bankruptcy Code; (4) the appointment of a trustee or custodian; and (5) the failure to satisfy any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations.ⁿ²² Even with the amendment to section 365(b)(2) by the Bankruptcy Reform Act of 1994 that added the failure to perform nonmonetary obligations as a category of default that need not be cured for purposes of assumption and assignment, many types of covenants in leases do not clearly fit into any of the foregoing categories and which, if breached, would have to be cured in connection with an assumption of a lease. These covenants may, for example, cover subjects such as maintenance of insurance protection, maintenance of the physical condition of the subject property, compliance with law and the like. To the extent that these covenants require the expenditure of money by the debtor, it could be argued that they are monetary obligations and therefore must be cured notwithstanding the language of section 365(b)(2)(D) which excuses the debtor from curing defaults relating to "nonmonetary obligations." However, other kinds of covenants may also not fall into any of the above classes and which, if breached, may not be susceptible of cure. Examples of such covenants include: (1) requirements that specified individuals remain as officers or directors of the tenant; (2) prohibitions against transfer or other disposition of a specified portion of the tenant's assets; (3) restrictions on contracts and leases with third parties; (4) restrictions on assignment of the tenant's interest in contracts and leases with third parties; (5) requirements for continuation in force of designated contracts and leases; (6) cross-default provisions relating to other agreements between the landlord and tenant; and (7) cross-default provisions relating to agreements between the tenant and other parties. In the case of leases of retail space, including shopping center leases, consideration may be given to provisions relating to the tenant's performance as a merchant, including provisions for continuous operation, maintenance of adequate inventory, and perhaps even a "performance kick out" under which the landlord may terminate the lease if certain sales levels are not achieved after a specified period. These covenants are quite susceptible of breach by a troubled debtor either prior or subsequent to the filing of a Bankruptcy Code petition; if breached, it is highly unlikely that the default will be cured, given the almost irrevocable nature of the events that are dealt with by the covenants. Although the ability to prevent an assumption of a lease as a result of the breach of clauses of this type has been diminished by the addition of section 365(b)(2)(D) by the Bankruptcy Reform Act of 1994, the scope of this section, particularly the meaning of the term

"nonmonetary obligations," is ambiguous and likely to be the subject of future litigation.^{n22a} Thus, if the trustee is unable to cure a default under a covenant of this type, the landlord may assert that no adequate assurance of prompt cure can ever be furnished, that the requirements for assumption and assignment imposed by the Code have not and never can be satisfied, and that the lease must be rejected.

The inclusion of the types of provisions enumerated above is, of course, not appropriate or obtainable in all types of leasing transactions, and the clauses that are referred to are intended to illustrate an approach to drafting and do not constitute a "laundry list" of provisions that should be included in all leases. Under *section 365(c) of the Code*, contracts containing nondelegable duties, such as personal service contracts, may not, contrary to the provisions of section 365(b) and (e), be assumed and assigned without the consent of the nondebtor party. The type of provision discussed in this paragraph in substance seeks to bring real estate leases into the classes of agreements covered by section 365(c), by tailoring each transaction to the immediate parties, without expressly purporting to characterize a real estate lease as a nonassumable and nonassignable agreement under section 365(c).^{n22b}

These clauses may be attacked by a trustee on several grounds:

First, it may be argued that these provisions operate in the same manner as specific use clauses, inasmuch as they may be employed to avoid an assignment transaction contrary to the spirit of the Code.ⁿ²³

Second, they may in an appropriate case be viewed as immaterial in the context of the lease, so that a breach would not constitute grounds for termination under state law.

Third, certain types of noncurable default provisions may be construed as financial covenants or nonmonetary obligations and therefore unenforceable under section 365(b)(2)(D) and (e)(1)(A). Thus, a clause providing for the maintenance of a specified inventory level, or a performance kick out, may be viewed as a nonmonetary obligation or financial covenant.ⁿ²⁴ Indeed, it has been held that a cross-default provision in a lease relating to other leases between the same landlord and tenant was a financial covenant and, therefore, no cure of the defaults under the other leases was necessary as a condition to assumption and assignment of the subject lease.ⁿ²⁵ Although not articulated in the opinion, it appears that the court viewed the debtor's failure of performance under the other leases as a measure of the debtor's poor financial condition, thus converting the cross-default provision into a financial performance test.

It may be argued in opposition to the categorization of cross-default provisions as unenforceable financial covenants or nonmonetary obligations that financial condition clauses are traditionally written to require that specified numerical goals are to be achieved (a net worth test), or specified ratios are to be maintained (debt to equity, current assets to current liabilities, etc.), and are not couched in terms of performance under other agreements. Indeed, if cross-default provisions are financial condition clauses, then nearly every provision in a lease, including the rent clause, is a financial covenant because the nonperformance of such covenants will usually result from the tenant's financial inability to perform the covenant rather than from a desire to willfully default under the provision in question. Although defaults under other leases which run afoul of a cross-default clause will likely result from the tenant's poor financial condition, this does not mean that all covenants breached by reason of the tenant's financial distress are financial covenants. A cross-default provision, if breached, merely permits the landlord to take action under its lease and does not require it to stand by and await a separate default while other leases of the debtor are being terminated. The trustee will respond, however, that the cross-default clause does not relate to the lease in question as between the landlord and tenant, and is designed instead as a financial barometer, or early warning system, for the landlord to assess the continued creditworthiness of the tenant. Thus, the trustee will argue, a cross-default clause is as much a financial condition clause as a net worth test.

[7] Shopping Center Leases

The Code does not define the term "adequate assurance of future performance" except in the case of "a lease of real

property in a shopping center."²⁶ In that instance, as previously discussed, section 365(b)(3) sets out four standards to be employed in the determination of adequate assurance of future performance.²⁷

However, the Code does not define the term "shopping center." The leading approach for determining whether the lease involves a shopping center, and accordingly, whether the requirements of section 365(b)(3) are relevant, is the multi-factor test set forth by the Court of Appeals for the Third Circuit in *In re Joshua Slocum*.^{27a} In *Joshua Slocum*, the court called for consideration of the following factors to see if the term applied--whether there is present:

- (a) A combination of leases;
- (b) All leases held by a single landlord;
- (c) All tenants engaged in the commercial retail distribution of goods;
- (d) The presence of a common parking area;
- (e) The purposeful development of the premises as a shopping center;
- (f) The existence of a master lease;
- (g) The existence of fixed hours during which all stores are open;
- (h) The existence of joint advertising;
- (i) Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;
- (j) The existence of percentage rent provisions in the leases;
- (k) The right of the tenants to terminate their leases if the anchor tenant terminates its lease;
- (l) Joint participation by the tenants in trash removal and other maintenance;
- (m) The existence of a tenant mix;
- (n) The contiguity of the stores; and
- (o) The location of the stores.

One court has stated that "it is likely that the most important characteristic will be a combination of leases held by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area."^{27b}

In practice, the results of applying these tests to actual situations may not be clear--especially when the decision is to be made in hindsight by a court. Ordinarily, it should be a simple matter to determine whether a shopping center is involved. However, there may be circumstances under which the answer is uncertain. Some hypotheticals involve the following possible questions and fact patterns: Is the ground floor shopping area of an office building a shopping center? What if there are only three shops on the ground floor? What if there are 30? Is a row of stores in one building on an urban street a shopping center? Is the row of stores a shopping center if there is a reserved parking area behind the stores? Accordingly, it may be helpful to insert into certain leases a clause specifying that they are leases of real property in a shopping center, so that the landlord may seek to claim the protections afforded by the standards for adequate assurance set forth in the Code. The clause could provide: "This is a lease of real property in a shopping center

within the meaning of *section 365(b)(3) of the Bankruptcy Code, 11 U.S.C. § 365(b)(3)*." Although the clause could be challenged as being not binding in a Bankruptcy Code case, it will provide arguments for the landlord as to the intention and understanding of the parties at the time of signing of the lease. Moreover, if the debtor is the same party that executed the lease, the trustee will be constrained to explain why the clause was acceptable and accurate at the time of entry into the lease but no longer accurate after the filing of the debtor's petition.

[8] All Charges as "Rent" Under Leases of Real Property

Section 502(b)(6) of the Code, discussed in greater detail earlier in this chapter, limits the amount of damages recoverable by a landlord arising out of the rejection of a lease of real property.ⁿ²⁸ The limitations in *section 502(b)(6)* are expressed in terms of the amount of "rent" reserved in the lease over a stated period. In order to maximize the damages allowable to landlords arising out of the rejection of a lease of real property, leases should provide that all charges and payments of every nature therein provided for constitute "rent," "additional rent" or the like under the lease. This will, of course, provide landlords with the argument that the limitation on its allowable claim for damages should be greater than merely the total fixed rental reserved in its lease for the applicable time period. Although it has been held that the computation of rent for purposes of inclusion of amounts in a landlord's claim may cover charges payable by a tenant under the lease that are not denominated as rent, it is preferable to avoid the presence of a potential issue by the utilization of simple and generally accepted draftsmanship.ⁿ²⁹

The denomination of all charges as rent often has consequences under state laws providing for summary dispossession proceedings for nonpayment of rent. Therefore, in the course of negotiation, tenants may successfully resist an all-inclusive clause of the type referred to in the preceding sentence. There should be no objection, however, to a clause that provides that all charges are "rent" for purposes of computing an allowed claim under *section 502(b)(6)*. Such a clause could read as follows:

Notwithstanding anything in this lease to the contrary, all amounts payable by Lessee to or on behalf of Lessor under this lease, whether or not expressly denominated as rent, shall constitute rent for the purposes of *section 502(b)(6) of the Bankruptcy Code, 11 U.S.C. § 502(b)(6)*.

Under *section 365(b)(4) of the Code*, if a default has occurred under a lease, the landlord is not required to furnish services or supplies incidental to the lease unless compensated therefor under the lease terms.ⁿ³⁰ Although it may be desirable in leases to value separately the incidental services and supplies to be furnished thereunder to make available the benefits of *section 365(b)(4)* in the event of the filing by or against the tenant of a petition under the Bankruptcy Code, nothing in *section 365(b)(4)* appears to limit its applicability to charges that are *not* denominated as rent. Accordingly, consideration should be given to denomination of these separate charges as rent for purposes of *section 502(b)(6)* while preserving the concept of separate charges for incidental services and supplies for the purposes of *section 365(b)(4)*.

[9] Bankruptcy Default Provisions

A form of bankruptcy default clause for a mortgage is set forth above.ⁿ³¹ The clause may be readily modified for incorporation into a lease.

Notwithstanding the provisions of the Code rendering unenforceable bankruptcy termination provisions in leases, it is suggested that such provisions continue to be employed for substantially the same reasons that a bankruptcy default provision should continue to be included in a mortgage.ⁿ³² These provisions contemplate any number of events, such as the appointment of a state law assignee for the benefit of creditors, or the insolvency of the tenant, which constitute independent and enforceable defaults apart from the Bankruptcy Code context. Thus, if a tenant is insolvent but has not filed a petition under the Code, the lease may be declared in default and terminated.ⁿ³³ Moreover, as in the case of mortgages, the provisions of the Code rendering bankruptcy default provisions unenforceable deal with matters

involving the insolvency or financial condition of the debtor, but not with the insolvency or financial condition of any third party. Therefore, if there is a guarantor of the tenant's obligation under the lease, the bankruptcy default clause in the lease, if drafted with reference to the guarantor as well as the tenant, may be effective upon the insolvency of the guarantor. If the guarantor is a corporate parent or affiliate of the debtor, there is a reasonable likelihood that both entities will be insolvent, and that the bankruptcy default provision may be invoked.

[10] Prepetition Modification of Leases

A Bankruptcy Code case involving a tenant is often preceded by a period of late rental payments and other lease defaults reflecting the tenant's distressed financial condition. In view of the powers vested in a trustee with respect to curing defaults, lease assumptions and lease assignments, it is tempting for landlords during the period of difficulty preceding the tenant's filing to seek to modify the lease to make assignment and assumption less attractive in the event of a filing by the tenant. A landlord may, for example, have sufficient leverage to obtain a decrease in the term of the lease, or even convert the lease into a month-to-month tenancy. These modifications may be given in exchange for a forgiveness of a rental or other default, a settlement of the amount of arrearages of rental, or a recasting of the future rental obligations under the lease. In reconstituting leasing transactions in this manner, landlords should be aware of the bankruptcy court's power to reach back into the period preceding the filing of the tenant's petition to avoid certain transactions.

Under *section 548 of the Code*, the federal Bankruptcy Code fraudulent transfer statute, a trustee may avoid any transfer of an interest of a debtor in property that was made within two years before the filing of the debtor's petition, if the debtor received less than reasonably equivalent value in exchange for the transfer, and was insolvent on the date of the transfer or became insolvent as a result thereof.^{n33a} Under section 544(b), a trustee may also avoid transfers that are avoidable by unsecured creditors under applicable state laws, such as the Uniform Fraudulent Conveyance Act. Although such fraudulent transfer provisions are ordinarily looked upon as applying to transfers of tangible assets, a trustee may argue, in the case of a lease modification described above that: (1) the leasehold constituted an interest in property of the debtor; (2) the leasehold had substantial value if permitted to continue in effect for the balance of its originally stated term, whether in the hands of the debtor or viewed as a transferable asset; (3) the diminution of the term of the lease therefore effected a transfer by the tenant to the landlord of an asset of the tenant; and (4) the forgiveness or settlement of the particular rental default was not consideration reasonably equivalent to the loss of the value of the leasehold suffered by the tenant.

The trustee may also seek to attack the lease modification transaction as a voidable preference under section 547(b) if the transaction occurred on or within 90 days of the filing of the tenant's petition. The trustee would assert that the diminution of the lease term in consideration for the pre-existing lease defaults: (1) constituted a transfer, (2) while the debtor was insolvent, (3) made on or within the 90-day period, (4) which enabled the landlord to receive more than it would receive if the tenant were liquidated under chapter 7 of the Code.^{n33b} Under chapter 7, the trustee could have cured outstanding defaults under the lease as unmodified and assumed and assigned the lease, all without reversion of any part of the original lease term to the landlord.

The landlord may argue in opposition to the fraudulent transfer theory that (1) at the time of the lease modification the lease was in default, (2) the tenant's interest in the leasehold was in substantial jeopardy, (3) absent the modification transaction the tenant may have suffered a termination of the lease and the consequent loss of the entire asset represented by the leasehold, and (4) the lease modification transaction, instead of representing a transfer of an asset by the tenant to the landlord, indeed constituted, if anything, a transfer by the landlord to the tenant of a new lease in substitution of the former leasehold which had lost all of its worth as a consequence of the defaults thereunder. The landlord may also assert that the lease modification transaction, in shortening the term of the lease, in any event did not constitute a "transfer" within the meaning of the fraudulent conveyance provisions of the Code. As a further defense, the landlord may seek to demonstrate that the consideration given in the particular transaction constituted reasonably equivalent value under section 548(b).

In the case of an attack on the modification transaction on preference grounds pursuant to section 547(b), the same issue as to whether there has been a "transfer" will arise, and the landlord may assert the arguments outlined in the preceding paragraph. In the case of preferences, however, the landlord's forbearance from enforcing its rights under the lease may not constitute value for the purpose of the contemporaneous exchange defense under section 547(c).ⁿ³⁴ The landlord may argue, nevertheless, that assuming *arguendo* that a transfer took place, (1) the trustee's ability to cure defaults under and to assume and assign the lease, measured at the time at which the so-called transfer took place, was highly speculative, (2) the lease would have been surrendered to the landlord in any event notwithstanding a chapter 7 filing by the tenant, and (3) the landlord accordingly did not receive more than it would have received if the tenant were liquidated under chapter 7 of the Code. This argument appears to rest upon a factual assertion as to the low value of the leasehold and likelihood of surrender of the lease by the trustee in lieu of assumption and assignment.

There is little doubt that a surrender of a part of a lease term, whether effected by means of a lease modification, surrender of lease (and entry into a new lease with a shorter term) or assignment to the landlord, constitutes a transfer by the debtor of an interest in property within the meaning of the Bankruptcy Code.ⁿ³⁵ Under section 541(a), property of the estate is defined to include all legal interests of the debtor in property, and under 541(c) such legal interests are preserved for the estate notwithstanding restrictions on transfer, bankruptcy default or financial condition provisions in the governing instrument. Under section 365(b), (e) and (f), leasehold interests of a debtor may be protected through cure of defaults, assumed for the benefit of the estate, and assigned for the benefit of the estate. Given the express recognition (and indeed enhancement) in the Code of a debtor's property rights in real estate leaseholds, the surrender, cancellation, assignment or other disposition of such leaseholds likewise will be subject to scrutiny under the transfer avoidance provisions of the Code.ⁿ³⁶

Accordingly, the principal elements in an analysis of a lease modification transaction for fraudulent transfer avoidance purposes will be the determination of value of what the debtor gave up to the landlord and what was received in return. The valuation of a leasehold estate will require consideration of many factors, including: (1) the relationship of the rent reserved in the lease to the market rental value of the property; (2) the tenant's rights with respect to assignment and subletting; (3) the length of the remainder of the term and renewal options; (4) the value of improvements erected by the tenant; and (5) the questions whether (a) the tenant is in default under the lease, (b) the rental has been accelerated, (c) the lease has been properly terminated under state law and (d) the lease has been properly terminated for Bankruptcy Code purposes.

If the lease rental is greater than the market rental value of the premises, taking into account the value of any leasehold improvements constructed by the tenant, the inquiry may end at that point because the tenant will be viewed as having received substantial value in the form of release from a burdensome obligation in exchange for the disposition to the landlord of a low-value property.ⁿ³⁷ However, if a lease is carrying an above-market rental, but the property is of particular value to the tenant--perhaps because of a special location or a unique structure with a high replacement cost--then a simple market rental value analysis will not suffice.ⁿ³⁸

If a lease modification transaction involves the exchange of a valuable long-term lease that is in default for forgiveness of the defaults and a new short-term leasehold, the valuation of the property transferred by the tenant will include consideration of the effect of the default. As noted above, the tenant's trustee, in seeking to avoid the transfer to the landlord of the long-term lease, may assert that the lease defaults could be cured under *section 365(b)(1) of the Code*, the lease assumed under section 365(b) and perhaps assigned for substantial consideration under section 365(f). The landlord will assert that the value of the leasehold is to be measured as of the time of transfer, which was of course prior to the filing of the tenant's Bankruptcy Code petition, thus subjecting the lease to all of the landlord's state law termination rights and materially diminishing the value of the leasehold that was transferred to the landlord.ⁿ³⁹ The tenant's trustee may respond that the lease in its prepetition state must be construed and valued in the light of all applicable law, including the benefits prospectively available under the Bankruptcy Code, and that the outstanding prepetition defaults and attendant landlord remedies therefore should be discounted. The landlord may respond that

present valuation contemplating the future effect of a Bankruptcy Code case of the transferor would (1) be so speculative as to be meaningless, (2) eliminate all vestiges of certainty with respect to property transfers involving financially troubled transferors, and (3) require the courts in other contexts to consider the prospective depressing effect of a transferor's Bankruptcy Code filing on other assets of the debtor, including inventory and receivables.

If the tenant under a defaulted lease has an investment in improvements on the leased property that will revert to the landlord upon expiration of a shortened lease term, the courts may have some difficulty in finding that the debtor has received reasonably equivalent value for the transfer absent due compensation for such investment.ⁿ⁴⁰ The landlord may assert that the improvements cannot be valued apart from the leasehold property on which such improvements stand, and that the default status of the lease, therefore, must be the supervening consideration in valuing the property interests transferred to the landlord. The landlord may further assert that a fraudulent transfer valuation does not deal with what the landlord gained but rather the value of the property interests relinquished by the tenant. Nevertheless, in view of the courts' reluctance to permit "windfalls" of substantial assets to landlords, it cannot be concluded that the landlord's arguments on this point will necessarily prevail.ⁿ⁴¹

If a lease modification transaction is successfully attacked by a trustee, and the lease as modified was still in the hands of the tenant upon the commencement of a Bankruptcy Code case, then "avoidance" of the transfer may mean that the transaction will be unraveled and the lease returned to its original form. If the lease as modified had lapsed prior to the commencement of the case and no new tenant had taken possession of the premises, it appears that the lease in its original form would be reinstated by the court. If the lease as modified had lapsed prior to the commencement of the case, and a new tenant had taken possession of the premises under a new lease, would the new tenant's leasehold be subject to avoidance by the former tenant's trustee? Under *section 550(b) of the Code*, an "immediate or mediate" transferee of the initial transferee (the initial transferee is the landlord) will be immune from attack if it took for value, in good faith, and without knowledge of the voidability of the initial transfer. In most instances, a new arms-length tenant will not inquire or have reason to inquire into the circumstances giving rise to the availability of the premises, and should be deemed to be acting in good faith. However, if a new tenant, knowing of the prior tenant's financial distress and settlement with the landlord, walks into a bargain lease, there may be exposure to loss of the new leasehold if the prior tenant's trustee successfully attacks the original lease modification transaction. The result in this instance, however harsh, is similar to that reached in *Durrett v. Washington Nat'l Ins. Co.* and its progeny.ⁿ⁴²

Although each lease modification transaction should be evaluated on its facts, the principal guideline that may be offered is that the landlord should seek to create a clear record of the amount of consideration that the tenant is receiving in exchange for the lease modification. Thus, for example, if the tenant is in arrears for several months' rental, and the landlord has sent a notice of default, the lease modification document should recite the amount in default, the propriety of the notice, an acknowledgment (if appropriate) of the landlord's right to accelerate the balance of the lease rental, the forgiveness by the landlord of the arrearages and present waiver of the right of acceleration, and the benefits to the tenant in receiving the modified lease in good standing. If a lease modification transaction is ultimately avoided, and the original lease is reinstated, it appears that the landlord will not have been harmed as a result of the transaction unless it took action in reliance thereon. Thus, a lease modification transaction may possibly be helpful to a landlord, if the transaction is not attacked or withstands attack, and will not be harmful to the landlord if it acts with the knowledge that the lease could be returned to its unmodified form.

[11] Subleases

[a] Generally

The issues affecting sublessees in the context of a rejection of the prime lease by the trustee of either the prime lessor or the prime lessee are substantially similar to the issues concerning a leasehold mortgagee discussed earlier in this book.ⁿ⁴³ The sublessee is concerned generally that rejection of the prime lease may deprive the sublessee of its leasehold and of its investment in the subleased premises. If the prime lease is rejected by the trustee of the prime lessor

under *section 365(h) of the Code*, and the prime lessee elects to retain its rights under the lease, is the prime lease still in effect? What terms and conditions govern the relationship between the prime lessor and the prime lessee after rejection by the prime lessor and the prime lessee's election to remain in possession of the leasehold? If the terms and conditions differ from those in effect prior to the rejection, what is the effect of the change upon the provisions of the sublease? If pursuant to section 365(h)(1)(B) the prime lessee is permitted to offset against the prime lease rental the amount of any damages suffered as the result of the rejection of the lease, will this right of offset pass through to the sublessee? If the prime lessee's offset is claimed by the trustee of the prime lessor to be excessive, will the sublessee be subject to the loss of its subleasehold? Although many of these issues have been clarified as a result of the amendments to section 365(h) promulgated by the Bankruptcy Reform Act of 1994,ⁿ⁴⁴ several issues still remain.

In a subleasing transaction involving a relatively small investment by the sublessee, the issues raised above may be of little significance. These matters are of considerable concern in substantial transactions in which the premises demised under the prime lease and the sublease are co-extensive, and should be considered by sublessee's counsel. The following drafting suggestions seek to deal with the consequences of a rejection of the prime lease by the trustee of the prime lessor and of the rejection of the prime lease by the trustee of the prime lessee.

[b] Subleases; Drafting Considerations Relating to Issues Arising Under Section 365(h) of the Bankruptcy Code

The drafting suggestions for subleases in this paragraph relate to the effect on a sublessee of the rejection of the prime lease by the trustee of the prime lessor.

Under *section 365(h)(1)(A) of the Code*, the prime lessee under a rejected prime lease may elect to remain in possession of the leased premises for the balance of the term and to exercise renewal or extension options provided for in the lease, or may treat the prime lease as terminated. It is of paramount importance that a sublessee be empowered to assert control over the prime lessee's election.ⁿ⁴⁵ Under section 365(h)(1)(A)(i), as revised in the 1984 Amendments and reworded by the Bankruptcy Reform Act of 1994, the prime lessee may treat the prime lease as terminated only if "the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee..."ⁿ⁴⁶ This means that the sublease may contain an enforceable clause limiting the prime lessee's right to treat the prime lease as terminated.ⁿ⁴⁷ The following is a suggested clause requiring a prime lessee to obtain the sublessee's consent before electing to treat the prime lease as terminated:

Sublessor shall not without Sublessee's prior written consent elect to treat the Prime Lease [defined] as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code*, 11 U.S.C. § 365(h)(1)(A). Any such election made without Sublessee's prior written consent shall be void. This provision constitutes an "agreement made by the lessee" under the provisions of *Section 365(h)(1)(A)(i) of the Bankruptcy Code*, 11 U.S.C. § 365(h)(1)(A)(i).

If the choice is made to treat a rejected prime lease as terminated, consideration should be given to inclusion in subleases of a clause allocating between the prime lessee and the sublessee the proceeds of the claim for damages arising out of the rejection of the prime lease. In many instances, the parties may seek to allocate the proceeds of the claim in accordance with their respective losses suffered as a consequence of the rejection. The allocation may be effected in a manner similar to the allocation in the sublease of an award for a total condemnation of the premises, thereby reflecting, among other things, the sublessee's loss of its investment in the property and the prime lessee's loss of profit expectation relating to the spread between the sublease and prime lease rentals. The following is a suggested clause conferring upon the prime lessee the right to prosecute and realize upon the damage claim, with a right conferred upon the sublessee to participate in the prosecution of the claim and a cross-reference to the condemnation provision of the sublease for purposes of allocation of proceeds:

In the event of the rejection by [Prime Lessor] of the Prime Lease [defined] under the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.* (the "Bankruptcy Code"), and the election by Sublessee and Sublessor to treat the Prime Lease as terminated, Sublessor shall file and prosecute to completion all proofs of claim, complaints, motions and applications in respect of any and all claims for damages and other compensation payable by Prime Lessor arising out of the rejection of the Prime Lease. Sublessee may at own cost and expense and with separate counsel, to the extent permitted by applicable law, participate in all proceedings relating to such proofs of claim, complaints, motions and applications, but the conduct of such proceedings shall at all times remain under Sublessor's control. Any amounts received by Sublessor as damages or other compensation arising out of the rejection of the Prime Lease shall be applied first to all costs and expenses of Sublessor (including, without limitation, reasonable attorneys' fees) incurred in connection with the prosecution of such proceedings and then in accordance with Section of this Lease [application of condemnation proceeds].

If the subleasing transaction involves a substantial investment by the sublessee in relation to the investment by the prime lessee, the provision may be revised to provide for prosecution of the claim by the sublessee, with or without the prime lessee's right to participate. Under this formulation, the prime lessee would assign to the sublessee all of its rights and remedies in connection with the rejection by the prime lessor of the prime lease.

Under section 365(h)(1)(A)(ii) of the Code, if the prime lessee elects to retain its rights under a lease rejected by the trustee of the prime lessor, the prime lessee may offset against the prime lease rental any damages occurring after rejection caused by the nonperformance of any obligation of the prime lessor under the prime lease. However, the exercise by the prime lessee of the rights conferred under section 365(h)(1)(B) may give rise to disputes as to whether a particular obligation on the part of the prime lessor has in fact been performed, whether the prime lessee has been damaged by the prime lessor's nonperformance, and the extent and amount of any such damages. Indeed, the prime lessee's exercise of its section 365(h)(1)(B) rights may give rise to an unintended default under the prime lease, thereby placing in jeopardy the tenure of the sublessee. If, however, the offset is proper or otherwise not disputed by the trustee of the prime lessor, the amount of the offset should be passed through to the sublessee if it also has been damaged by the prime lessor's nonperformance of covenants. Accordingly, consideration should be given to inclusion in subleases of a provision conferring upon the sublessee control over the amount of rent to be offset by the prime lessee under section 365(h)(1)(B), and to a pass-through to the sublessee of the benefits of a proper offset. It may be anticipated that the prime lessee will object to a provision that places in the hands of the sublessee the right to control a major economic decision in respect of the prime lessor. Nevertheless, if the profit for the prime lessee in the spread between the sublease and prime lease rentals is maintained with or without the offset, then the sublessee should be entitled to control the decision to effect the offset under the prime lease to protect its subleasehold position. The following suggested clause relates to a sublease in which all of the premises demised under the prime lease are demised under the sublease:

If pursuant to Section 365(h)(1)(B) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(B), Sublessor seeks to offset against the rent reserved in the Prime Lease [defined] the amount of any damages caused by the nonperformance by the Prime Lessor of any of Prime Lessor's obligations under the Prime Lease after the rejection of the Prime Lease under the Bankruptcy Code, Sublessor shall, prior to effecting such offset, notify the Sublessee of its intent so to do, setting forth the amounts proposed to be so offset and the basis therefor. Sublessee shall have the right to object to all or any part of such offset, and, in the event of such objection, Sublessor shall not effect any offset of the amounts so objected to by Sublessee. If Sublessee has failed to object as aforesaid within days after notice from Sublessor in accordance with the first sentence of this Section, Sublessor may proceed to effect such offset in the amounts set forth in Sublessor's notice. Notwithstanding anything in this Lease to the contrary, the fixed rental reserved in this Lease shall be reduced to the extent and at the time when Sublessor shall effect any offset against the fixed rental reserved in the Prime Lease pursuant to this Section. As employed herein, the term "Bankruptcy Code" means 11 U.S.C. § 101 *et seq.* , as the same may be from time to time amended, modified or supplemented.

A similar concern relates to the right of the sublessee to take control of any litigation affecting the prime lease which may arise during the Bankruptcy Code case of the prime lessor. Such litigation may involve issues relating to the right of the trustee of the prime lessor to reject the lease, disputes relating to rental offsets taken by the prime lessee or the claim for damages against the prime lessor if the lease is treated as terminated.ⁿ⁴⁸ The interests of the sublessee may be affected by the outcome of such litigation, and therefore the sublessee may bargain for the option to control the proceedings in transactions under which the sublessee is making a substantial investment in the premises. The following is a suggested clause granting to a sublessee the option to control Bankruptcy Code litigation relating to the prime lease:

If any action, proceeding, motion or notice shall be commenced or filed in respect of the Prime Lease [defined] or the demised premises in connection with any case under the Bankruptcy Code, *11 U.S.C. §§ 101 et seq.*, Sublessee shall have the option, to the exclusion of Sublessor, exercisable upon notice from Sublessee to Sublessor, to conduct and control any such litigation with counsel of Sublessee's choice. Sublessee may proceed in its own name or in the name of Sublessor in connection with any such litigation, and Sublessor agrees to execute any and all powers, authorizations, consents or other documents required by Sublessee in connection therewith. Sublessor shall not commence any action, suit, proceeding or case, or file any application or make any motion, in respect of the Prime Lease in any such case under the Bankruptcy Code without the prior written consent of Sublessee.

Given the absence of privity and of a debtor-creditor relationship between the prime lessor and the sublessee, the sublessee will in all likelihood not receive direct notice of a Bankruptcy Code filing by or against the prime lessor. Accordingly, it may be advisable to include in the sublease a specific notice mechanism providing for immediate notice of such filing from the prime lessee to the sublessee. A suggested provision is set forth earlier in this book with respect to leasehold mortgages and is readily adaptable for a sublease.ⁿ⁴⁹

[c] Prime Leases; Drafting Considerations Relating to Issues Arising Under Section 365(h) of the Bankruptcy Code

In many subleasing transactions, the prime lease is being negotiated at the same time as the sublease as part of an overall financing and legal structure. The sublessee therefore has the opportunity to comment upon the prime lease, and to request the inclusion of provisions in the prime lease that may complement the sublease provisions discussed above.

One of the concerns of a sublessee in connection with the rejection of a prime lease under section 365(h) is the assertion of control over the prime lessee's election to treat the lease as terminated or to retain its rights in respect of the leased premises. It is suggested earlier that subleases include a provision granting to the sublessee the power to control the election.ⁿ⁵⁰ However, additional comfort may be provided to the sublessee if the prime lessor acknowledges in the prime lease that the right of election has passed to the sublessee.ⁿ⁵¹ The first of the following suggested clauses for a prime lease vests in the sublessee full control over the section 365(h)(1)(A) election. This approach may be objectionable to the prime lessee inasmuch as it permits the sublessee to elect to terminate the prime lease. The second of the suggested clauses provides in substance for an automatic election by the prime lessee to remain in possession of the premises demised under the prime lease.

Suggested clause for a prime lease limiting the right of a prime lessee that is also a sublessor to exercise the section 365(h)(1)(A) election:

If the demised premises are at any time sublet in accordance with the provisions of this lease, Lessor agrees, for the benefit of the sublessee under any such sublease, that the right of election arising under *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*, shall be exercised by such sublessee and not by the Lessee. Any exercise or attempted exercise by the Lessee of such right of election in violation of the preceding sentence shall be void.

Alternative suggested clause for a prime lease limiting the right of a prime lessee that is also a sublessor to exercise the section 365(h)(1)(A) election:

If the demised premises are at any time sublet in accordance with the provisions of this lease, and if Lessor or any trustee of the Lessor shall reject this lease pursuant to *Section 365(h) of the Bankruptcy Code, 11 U.S.C. § 365(h)*, (a) the Lessee shall without further act ordered be deemed to have elected under *Section 365(h)(1)(A) of the Bankruptcy Code, 11 U.S.C. § 365(h)(1)(A)*, to retain its rights under the lease for the balance of the term hereof and shall have the right to exercise any one or more of the extension options provided for in Article of this lease, and (b) any exercise or attempted exercise by the Lessee of a right to treat this lease as terminated under *Section 365(h)(1)(A) of the Bankruptcy Code* shall be void.

One of the principal concerns of a sublessee of all of the premises demised under a prime lease is the interpretation of the language employed in section 365(h) giving rise to the right of election on the part of the prime lessee to retain its rights under the lease.

Prior to the Bankruptcy Reform Act of 1994, the Code provided very little guidance as to the nature of the ensuing tenancy. The statute merely provided that the tenant had the option to either "treat the lease as terminated" or "*remain in possession of the leasehold*" (emphasis supplied). The 1994 Act worked a major revision of section 365(h)(1) by eliminating a serious issue as to the meaning of the term "possession" in the version of section 365(h)(1) that was previously in effect. Some courts had held that by its terms the section only protected possessory rights and, therefore, a lessee could not enforce other rights under the lease including assignment provisions and restrictive covenants.^{n51a} These issues were largely resolved by the major amendments to section 365(h) pursuant to the 1994 Act. Instead of speaking in terms of remaining in possession, the statute now speaks of the tenant's ability to retain certain rights under the lease and specifies the nature of such rights retained. The revised section makes it clear that a lessee may enforce all of its rights in the lease that are in or appurtenant to the real property and specifically lists subletting, assignment and hypothecation as protected rights. Prior to these amendments, in cases where the entire premises had been demised to the sublessee, it had been argued by the trustee of the prime lessor (1) that the prime lessee could not elect to "remain in possession" as the statute was phrased because it was not in possession, (2) that rejection therefore terminated the prime lease, and (3) that the sublease automatically fell with the prime lease.ⁿ⁵² As discussed earlier, it was highly unlikely that Congress intended to disenfranchise a lessee from making the section 365(h)(1)(A) election if all of the premises have been subleased.ⁿ⁵³ The use of the term "possession" in section 365(h)(1)(A), however unfortunate, was instead probably intended to describe the right of possession as between prime lessor and prime lessee, which survives any subletting of the premises, and to distinguish situations in which a lessee had been ousted from the premises or when the lease was not otherwise fully effective as an instrument of conveyance. Indeed, to assert that the lessee has lost its ability to protect the leasehold (and the subleasehold) under section 365(h) by reason of the subletting transaction, would have meant that if there was only one party to be protected (a lessee without a sublessee), the section 365(h) election would be in effect, but that if there were two parties to be protected (the lessee and sublessee), the benefits of section 365(h) should not apply. Congress appears to have rejected this interpretation as part of the 1994 Act by specifically providing in section 365(h)(1)(A)(ii) that the rights under the lease which the lessee can retain include "rights such as those relating to ... subletting."^{n53a} There is included earlier in this book a suggested clause for a prime lease evidencing the parties' intention as to the applicability of section 365(h) notwithstanding a subletting of the entire leased premises.ⁿ⁵⁴ Notwithstanding the amendments under the 1994 Act, given possible ambiguity in whether the reference to rights "relating to ... subletting" applies to subletting transactions in effect at the time of the bankruptcy filing or only refers to the prime lessee's future rights to sublet the premises, this suggested clause may still be useful.

There is also set forth earlier a discussion of whether the rejection of a real estate lease by the trustee of the prime lessor will result in a termination of the lease.ⁿ⁵⁵ Although the Bankruptcy Code indicates, but does not expressly provide, that a lease will survive rejection upon the lessee's election to remain in possession, a sublessee, like a leasehold

mortgagee, will seek to include in the relevant document provisions that may buttress the argument in favor of survival.ⁿ⁵⁶ There is included earlier a suggested clause, adaptable for a prime lease, which provides for survival of the lease upon rejection by the lessor's trustee under *section 365(h) of the Code*, which identifies the provisions of the lease that will remain in effect following such rejection, and which provides for the continuation of any mortgage (substitute sublease) encumbering the leasehold.ⁿ⁵⁷ The enforceability of the clause is also discussed earlier in this book.ⁿ⁵⁸

A similar concern for a sublessee is the possibility that an unjustified or excessive rent offset under the prime lease taken by the prime lessee under *section 365(h)(1)(B) of the Code* may result in a default under and possible termination of the prime lease. There is set forth above a provision for subleases granting to the sublessee control over the taking of a rental offset under the prime lease.ⁿ⁵⁹ A corresponding provision for a prime lease, which establishes a mechanism for resolving post-rejection disputes relating to rental offsets by a lessee under *section 365(h)(1)(B)*, is also set forth earlier in this book.ⁿ⁶⁰

[d] Subleases; Drafting Considerations Relating to Issues Arising Under Section 365(a) of the Bankruptcy Code

A sublessee, like a leasehold mortgagee, will be concerned not only with the rejection of the prime lease by the trustee of the prime lessor under *section 365(h)*, but also with the rejection of the prime lease by the trustee of the prime lessee under *section 365(a) of the Code*. Although this problem is generally dealt with in a nondisturbance agreement between the prime lessor and the sublessee, consideration may be given to dealing with the issue in the sublease as additional protection.ⁿ⁶¹ There is set forth earlier a suggested provision and related discussion with respect to an option for a leasehold mortgagee to assume a lease in lieu of rejection of the lease by the trustee of the lessee.ⁿ⁶² If this provision were adapted to a subleasing transaction, for inclusion in the sublease, the sublessee would under the clause become the direct tenant of the prime lessor under the prime lease, with the possibility of a merger of the sublease under which the sublessee has also become sublessor. If this is acceptable to the prime lessor, then the prime lease should also contain a clause recognizing the sublessee's right to assume the position of the rejecting prime lessee. There is set forth earlier a provision that may be adapted for use in a prime lease under which the prime lessor would recognize the sublessee's assumption of the prime leasehold position.ⁿ⁶³

FOOTNOTES:

(n1)Footnote 1. Simpson, *Leases and the Bankruptcy Code: Tempering the Rigors of Strict Performance*, 38 *Bus. Law.* 61 (1982).

(n2)Footnote 2. Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 *Minn. L. Rev.* 341, 364 (1980) (use clauses); Simpson, *Leases and the Bankruptcy Code: Tempering the Rigors of Strict Performance*, 38 *Bus. Law.* 61 (1982); see P 3.01 [5] *supra*, dealing with assumption and assignment of leases.

(n3)Footnote 3. See P 3.01[6] *supra*. But see *In re U.L. Radio Corp.*, 6 C.B.C.2d 430, 19 B.R. 537 (Bankr. S.D.N.Y. 1982) .

(n4)Footnote 4. E.g., *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951) , cited with approval in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499 (1984) .

(n5)Footnote 5. See P 3.01[6] *supra*.

(n6)Footnote 6. *In re Jamesway Corp.*, 201 B.R. 73 (Bankr. S.D.N.Y. 1996) , holds that any such profit sharing provision is rendered unenforceable under *section 365(f)(1) of the Code*, regardless of whether the sharing percentage is reasonable. See also *In re Boo.Com N. Am., Inc.* 2000 Bankr. LEXIS 1559 (Bankr. S.D.N.Y. Dec. 15, 2000) (invalidates profit sharing clause for subletting transaction) (*Editors' note: case designated not for publication*); *Robb v. Schindler*, 142 B.R. 589 (D. Mass. 1992) (invalidates provision for payment of 80% of assignment proceeds to lessor); *In re Standor Jewelers West, Inc.*, 129 B.R. 200 (B.A.P. 9th Cir. 1991) (invalidates provision for payment of 75 percent of

assignment proceeds to lessor); *In re National Sugar Ref. Co.*, 21 B.R. 196 (Bankr. S.D.N.Y. 1982), holds that a lease clause requiring assignment profits to be paid to the landlord will be strictly interpreted as applying to assignments consented to by the landlord but not to assignments by the debtor in possession under the Bankruptcy Code. There is a negative implication (but no express holding) to the effect that had the profit sharing clause been more broadly drafted it would have been enforced in the context of a Bankruptcy Code lease assignment by the debtor in possession. The court in *In re Lafayette Radio Elec. Corp.*, 3 C.B.C.2d 804, 8 B.R. 528, 533 (Bankr. E.D.N.Y. 1981), stated that the landlord had raised a "substantial question" as to the enforceability of a profit sharing clause relating to the subletting of the premises. An arguably analogous case, *In re Polycorp Associates*, 47 B.R. 671 (Bankr. N.D. Cal. 1985), holds that California's conditioning of the transfer of the debtor's liquor license upon payment of certain state taxes did not contravene section 541(c) of the Code, and that the attachment of the tax claim to the license merely served to define and limit the debtor's property rights therein. Similarly, the court in *In re FCX, Inc.*, 853 F.2d 1149 (4th Cir. 1988), cert. denied, 489 U.S. 1011, 109 S. Ct. 1118, 103 L. Ed. 2d 181 (1989), held that the debtor's interest in an agricultural cooperative's patronage certificates was established by and limited pursuant to the organization's by-laws and state law and remained unmodified by the filing of the debtor's Bankruptcy Code case. The court in *In re Howe*, 17 C.B.C.2d 614, 78 B.R. 226 (Bankr. D.S.D. 1987) invalidated a four percent assignment fee in a contract for deed under section 365(f)(1), and in *In re Mr. Grocer, Inc.*, 16 B.C.D. 564 (Bankr. D.N.H. 1987) invalidated under section 365(f)(1) a landlord's right of first refusal in a lease assignment provision as having a "chilling effect" on assignability. An interesting state court case evidencing the depth of the courts' hostility to restrictions on lease assignments is *Carma Developers (California), Inc. v. Marathon Development Cal., Inc.*, 211 Cal. App. 3d 1360, 259 Cal. Rptr. 908 (Ct. of App. 1989), invalidating a recapture provision as an unreasonable restraint on alienation. See also *In re David Orgell, Inc.* 117 B.R. 574 (Bankr. C.D. Cal. 1990) invalidating a provision for rent increase upon assignment.

(n7)Footnote 7. *Simpson*, note 1 *supra*, 38 Bus. Law. 61 at 86-89; *In re Jamesway Corp.*, 201 B.R. 73 (Bankr. S.D.N.Y. 1996); *In re Standor Jewelers West, Inc.*, 129 B.R. 200 (B.A.P. 9th Cir. 1991).

(n8)Footnote 8. See cases cited in note 6 *supra*. Section 541(c)(1) of the Code, dealing with property of the estate, provides that an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement or applicable nonbankruptcy law (a) that restricts or conditions transfer of such interest by the debtor, or (b) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property. This language is similar to that contained in sections 365(f)(1) and 365(f)(3). It has been held under section 541(c) that a state statute conditioning transfer of a liquor license upon payment of outstanding state tax liabilities is enforceable and that the state could refuse to transfer the license as part of a sale of assets of the debtor. *In re Farmers Markets, Inc.*, 792 F.2d 1400 (9th Cir. 1986); *In re Polycorp Assocs., Inc.*, 47 B.R. 671 (Bankr. N.D. Cal. 1985). *Contra In re Hoffman*, 16 C.B.C.2d 895, 65 B.R. 985 (D.R.I. 1986). It has also been held under section 541(c) that a shareholders' agreement providing for establishment of a transfer price and certain rights of first refusal for the benefit of the (non-debtor) shareholders of a close corporation are enforceable. The state statute and private agreement involved in these cases were viewed as creating, defining and limiting the property rights of the debtor in the asset prior to bankruptcy, and thus the asset was transferred to the estate subject to such limitations. See also *Chicago Bd. of Trade v. Johnson*, 68 L. Ed. 533 (1924). The rationale of these decisions arguably applies to a lease providing for profit sharing upon an assignment by a debtor-tenant.

(n9)Footnote 9. See *Mohonk Realty Corp. v. Wise Shoe Stores, Inc.*, 111 F.2d 287 (2d Cir.), cert. denied, 311 U.S. 654, 61 S. Ct. 47, 85 L. Ed. 418 (1940).

(n10)Footnote 10. New York State Bar Association, Proceedings of the Real Property Law Section, January 1980, at 36.

(n11)Footnote 11. See P 3.06[2] *supra*.

(n12)Footnote 12. State law should be consulted to determine whether a clause deeming an assignee to have assumed obligations is enforceable.

(n13)Footnote 13. *Cf.* Committee on Developments in Business Financing, Section of Corporate, Banking and Business Law, American Bar Association, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 *Bus. Law.* 1645, 1703-04 (1980).

(n14)Footnote 14. *See In re Sapolin Paints, Inc.*, 2 C.B.C.2d 854, 5 B.R. 412 (Bankr. E.D.N.Y. 1980) .

(n15)Footnote 14a. 11 U.S.C. § 365(b)(2)(A)-(D). Subparagraph (D) was added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised) and was amended by the 2005 Act, Pub. L. No. 109-8, § 328, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). The provision is discussed at P 3.01[5] *supra*.

(n16)Footnote 15. *In re LJP, Inc.*, 22 B.R. 556 (Bankr. S.D. Fla. 1982) ; *see* P 3.01[3][a] *supra*.

(n17)Footnote 16. 11 U.S.C. § 365(e)(1)(A).

(n18)Footnote 16a. A bankruptcy court may elect to decline jurisdiction over a post-assignment dispute between a landlord and the trustee's assignee. *In re Altime, Inc.*, findings of fact and conclusions of law, June 27, 1985, Case No. SA 84- 03587-RP (Bankr. C.D. Cal.). *See In re Harry C. Partridge, Jr. & Sons, Inc.*, 43 B.R. 669 (Bankr. S.D.N.Y. 1984) , for an example of an assumption case in which the debtor-tenant unsuccessfully sought a judicial declaration of default by the landlord.

(n19)Footnote 16b. A shopping center lease termination provision keyed to the tenant's achievement of a specified level of gross sales in the premises was upheld in the face of a proposed assignment to a user that would not meet the sales levels in *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 24 C.B.C.2d 581 (3d Cir. 1990) .

(n20)Footnote 17. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 349 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n21)Footnote 18. *E.g.*, *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951) , cited with approval in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499 (1984) . Indeed, the section 1129(a)(11) requirement of a feasibility finding as one of the conditions for plan confirmation may contemplate a determination that the debtor can comply with its material leases and contracts after the case is closed. *Cf. In re Cafe Partners/Washington* 1983, 90 B.R. 1 (Bankr. D.D.C. 1988) , holding as binding upon the debtor in the context of a lease assumption the lessee's obligation to repay a loan from the lessor incorporated into the lease as additional rent.

(n22)Footnote 19. *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951) , cited with approval in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499 (1984) . 11 U.S.C. § 365(b)(1)(C); P 3.06[4] *supra* .

(n23)Footnote 20. P 3.01[5][b][iii] *supra* .

(n24)Footnote 21. *See* P 3.06[1] *supra*.

(n25)Footnote 22. 11 U.S.C. § 365(b)(2), (e)(1).

(n26)Footnote 22a. *See* P 3.01[3][b][1][A] *supra*. *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9th Cir. 1997) , involved the breach by a debtor of a continuous operations clause in an automobile franchise agreement. The debtor argued that section 365(b)(2)(D) means that there is no requirement under section 365(b) to cure nonmonetary defaults as a condition to contract assumption. The court held, however, that section 365(b)(2)(D) means that in curing nonmonetary defaults, there is no obligation to make any payment under a

penalty rate provision in the governing agreement. The import of the case is that incurable prepetition nonmonetary defaults will result in the inability to assume an executory contract or unexpired lease. *See also In re Deppe*, 110 B.R. 898 (Bankr. D. Minn. 1990) ; *cf. In re R.H. Macy & Co.*, 170 B.R. 69 (Bankr. S.D.N.Y. 1994) (invalidating a continuous operations clause as it related to the postpetition period as inconsistent with a debtor's fiduciary duty to maximize the assets of the estate).

(n27)Footnote 22b. The inclusion in a lease of a percentage rent clause does not bring the lease within the coverage of section 365(c) as a personal service or special relationship contract. *In re Peaches Records & Tapes, Inc.*, 51 B.R. 583 (B.A.P. 9th Cir. 1985) . For a discussion of the application of section 365(c) to partnership agreements, *see P 4.07[2][c] infra*.

(n28)Footnote 23. *See P 3.01[5][b][ii] supra*.

(n29)Footnote 24. However, in *In re Phelia Associates, Inc.*, 17 B.R. 66 (Bankr. W.D. Ky. 1981) , the court found outstanding defaults under the quality standards provision of a motel lease and license agreement, and ordered the debtor in possession to propose a schedule for cure of the defaults before assumption of the lease and license.

(n30)Footnote 25. *In re Sambo's Rests., Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982) ; *cf. In re Madison's Partner Group, Inc.*, 67 B.R. 633 (Bankr. D. Minn. 1986) (cross-default provision in lease not enforced); *In re Wheeling-Pittsburgh Steel Corp.*, 13 C.B.C.2d 1143, 54 B.R. 772 (Bankr. W.D. Pa. 1985) (cross-default in insurance policy not enforced). *But see In re Easthampton Sand & Gravel Co., Inc.*, 7 C.B.C.2d 903, 25 B.R. 193 (Bankr. E.D.N.Y. 1982) (cross-default provision in lease requiring cure of a defaulted note was enforced).

(n31)Footnote 26. 11 U.S.C. § 365(b)(3).

(n32)Footnote 27. *See P 3.01[6] supra*.

(n33)Footnote 27a. 922 F.2d 1081, 24 C.B.C.2d 581 (3d Cir. 1990) .

(n34)Footnote 27b. *In re Ames Dep't Stores, Inc.*, 348 B.R. 91 (Bankr. S.D.N.Y. 2006) (citing 3 Collier on Bankruptcy (Matthew Bender 15th Ed. Revised)). Notably, in holding that a building consisting of a retail store and a medical practice did not constitute a "shopping center" the *Ames* court declined to adopt the definition of shopping center promulgated by a leading trade association, the International Council of Shopping Centers, which defines "shopping center" as "[a] group of retail and other commercial establishments that is planned, developed, owned and managed as a single property, with on-site parking provided." *Id.*

(n35)Footnote 28. *See P 3.03[3] supra*.

(n36)Footnote 29. *Picker v. Irving Trust Co. (In re United Cigar Stores Co.)*, 86 F.2d 629 (2d Cir. 1936) , *cert. denied*, 300 U.S. 679, 57 S. Ct. 671, 81 L. Ed. 883 (1937) . The Ninth Circuit Court of Appeals has held that payments denominated under a real estate lease as "further rent" which were admittedly required to provide for repayment of a debt from the tenant to the landlord constituted rent under the lease and were payable by the debtor/tenant as an administrative expense obligation pursuant to section 365(d)(3) of the Code. *Cukierman v. Uecker*, 265 F.3d 846 (9th Cir. 2001) .

(n37)Footnote 30. *See P 3.01[3][b][iv][A] supra*.

(n38)Footnote 31. *P 2.01[3] supra* .

(n39)Footnote 32. *See P 2.01[2] supra*.

(n40)Footnote 33. *In re LJP, Inc.*, 22 B.R. 556 (Bankr. S.D. Fla. 1982) .

(n41)Footnote 33a. 11 U.S.C. § 548(a)(1). The reach-back period was extended from one year to two years pursuant to Pub. L. No. 109-8, § 1402(1) (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n42)Footnote 33b. *In re Finelli Jewelry Co.*, 79 B.R. 521 (Bankr. D.R.I. 1987) (surrender of lease containing purchase option).

(n43)Footnote 34. *Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153, 15 C.B.C.2d 1368 (D.C. Cir. 1986); *In re Lario*, 36 B.R. 582 (Bankr. S.D. Ohio 1983) .

(n44)Footnote 35. *Darby v. Atkinson (In re Ferris)*, 415 F. Supp. 33 (W.D. Okla. 1976); *Energy Coop., Inc. v. SOCAP Int'l, Ltd. (In re Energy Coop., Inc.)*, 16 B.C.D. 1156 (7th Cir. 1987); *In re Pinto*, 89 B.R. 486 (Bankr. E.D. Pa. 1989); *Fitzgerald v. Cheverie (In re Edward Harvey Co.)*, 16 C.B.C.2d 131, 68 B.R. 851 (Bankr. D. Mass. 1987); *Spenciner v. Gettinger Assocs. (In re Brooklyn Overall Co.)*, 57 B.R.999 (Bankr. E.D.N.Y. 1986); *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985); *In re Fashion World, Inc.*, 44 B.R. 754 (Bankr. D. Mass. 1984); *In re Bentley*, 26 B.R. 69 (Bankr. S.D.N.Y. 1982); *cf. In re Sheppard's Dental Ctrs., Inc.*, 65 B.R. 274 (Bankr. S.D. Fla. 1986); *Pereira v. Checkmate Communications Co. (In re Checkmate Stereo & Elec., Ltd.)*, 9 B.R. 585 (Bankr. E.D.N.Y. 1981) . *In re Jermoo's Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984) , holds that termination of a franchise agreement does not constitute a transfer under section 548, and that *Darby v. Atkinson (In re Ferris) supra* is "anomalous." The court stated that a principal determinant under fraudulent conveyance law as to the existence of a transfer is whether the subject asset is transferable. The court determined that under the franchise agreement the franchise was not transferable without the franchisor's consent, but did not consider whether the franchise agreement came within the ambit of subsections 365(c) and (e)(2) or the effect of subsections 365(e)(1) and (f).

(n45)Footnote 36. The enhancement of the debtor's property rights in the leasehold may result from the invalidation of bankruptcy default provisions in the lease under *section 365(e) of the Code*, the liberal cure provisions in section 365(b) and the invalidation of anti-assignment provisions in section 365(f). The lease involved in *In re Fashion World, Inc.*, 44 B.R. 754 (Bankr. D. Mass. 1984) contained a reasonable consent clause for assignment.

(n46)Footnote 37. *See Gentry v. Bodan*, 347 F. Supp. 367 (W.D. La. 1972); *Zelman v. Esher (In re C.S. Mersick & Co.)*, 22 C.B.C. 386 (Bankr. D. Conn. 1979) .

(n47)Footnote 38. *Cf. Lesser v. Mendelson*, 352 F. Supp. 321 (S.D.N.Y. 1971) , *aff'd sub nom. Lesser v. Jewel Factors Corp.*, 470 F.2d 108 (2d Cir.1972) (month-to-month lease transferred as part of going business).

(n48)Footnote 39. 5 Collier on Bankruptcy, P 548.05[1][b] (Matthew Bender 15th Ed. Revised).

(n49)Footnote 40. *Darby v. Atkinson (In re Ferris)*, 415 F. Supp. 33 (W.D. Okla. 1976) .

(n50)Footnote 41. *See cases cited at P 3.01 note 2 supra* . The Uniform Fraudulent Transfer Act, which is designed to replace the Uniform Fraudulent Conveyance Act, includes in Section 8(e) a provision to the effect that a transfer resulting from the termination of a lease upon default of the debtor-tenant is not a voidable transfer under the Act. 7A U.L.A. 662 (1985). This provision eliminates the trustee's cause of action under section 544(b), which incorporates state fraudulent transfer laws, but does not affect the avoiding powers arising under section 548, which provides an independent federal Bankruptcy Code fraudulent transfer right of action *See P 2.04 supra*. It also should be noted that Section 8(e) of the Uniform Fraudulent Conveyance Act by its terms addresses lease terminations arising after a default but does not address lease modification transactions or other consensual lease termination transactions.

(n51)Footnote 42. 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980); *see P 2.04[1] supra*. The court in *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985) considered whether the transferee of the fee to the property following the avoidable (under section 548) lease termination was subject to a trustee's recovery action under section 550(b), and found the transferee to be without knowledge of the voidability of the lease termination.

(n52)Footnote 43. *P 2.01[4] supra* .

(n53)Footnote 44. *11 U.S.C. § 365(h)*, as amended by Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n54)Footnote 45. *See P 2.01[5] supra*, for a discussion of the enforceability of a clause conferring on a leasehold mortgagee control over the section 365(h)(1) election in the hands of a leasehold mortgagor.

(n55)Footnote 46. *11 U.S.C. § 365(h)(1)(A)(i)*(emphasis added).

(n56)Footnote 47. The Report of the Committee on the Judiciary, United States Senate, 98th Cong., 1st Sess., Report No. 98-65 (1983) states at page 77, with respect to the amendment to section 365(h)(1):

This amendment enables a sublessee or leasehold mortgagee to step in the position of the debtor's lessee in the event the lessee seeks to treat the trustee's rejection as a termination. It is not intended to limit the trustee's right of rejection.

The order of choice for succeeding to a tenant's interest will be in inverse order of priority. This will give the junior leasehold parties the opportunity to take over the tenant's position subject to senior leasehold mortgage interests. If a junior leasehold party does not elect to succeed to the interest, his leasehold mortgagee may elect to exercise the right in order to protect the mortgage interest. For leasehold rights of equal priority such as can occur with space tenants in a building, the court will determine on a case-by-case basis the allocation of the right of succession, based upon the equities of the case and the respective hardships of each party in interest.

Prior to the amendments to section 365(h) by the Bankruptcy Reform Act of 1994, the provision regarding the rights of a lessee to treat a lease as terminated required that "the disaffirmance by the trustee amounts to such a breach as would entitle the lessee ... to treat such lease as terminated by virtue of its own terms, nonbankruptcy law, or *other agreements the lessee ... has made with other parties.*" (emphasis added). The legislative history accompanying the amendment to 365(h) does not make reference to the change and it should be presumed that the change in language is merely stylistic. Thus, the legislative history quoted above from the report accompanying the 1984 amendments should still be relevant to explain the operation of section 365(h)(1)(A)(i).

(n57)Footnote 48. *See P 2.01[5] supra*.

(n58)Footnote 49. *See P 2.01[5] supra*.

(n59)Footnote 50. *P 3.06[11][b] supra* .

(n60)Footnote 51. *See P 2.01 [6] supra*, for a discussion of the enforceability of a similar clause in the context of a leasehold mortgage transaction.

(n61)Footnote 51a. *In re Harborview Dev.*, 152 B.R. 897 (D.S.C. 1993) ; *In re Carlton Rest., Inc.*, 28 C.B.C.2d 728, 151 B.R. 353 (Bankr. E.D. Pa. 1993) ; *In re Arden & Howe Assocs., Ltd.*, 152 B.R. 971 (Bankr. E.D. Cal. 1993) .

(n62)Footnote 52. *See P 4.03 infra*, for a discussion of the rejectability of nondisturbance agreements.

(n63)Footnote 53. *P 2.01[6] supra* .

(n64)Footnote 53a. *11 U.S.C. § 365(h)(1)(A)(ii)*.

(n65)Footnote 54. *P 2.01[6] supra* .

(n66)Footnote 55. *P 2.01[4] supra* .

(n67)Footnote 56. *P 2.01[4] supra* .

(n68)Footnote 57. *P 2.01[6] supra* .

(n69)Footnote 58. *P 2.01[6] supra* .

(n70)Footnote 59. *P 3.06[11][b] supra* .

(n71)Footnote 60. *P 2.01[6] supra* .

(n72)Footnote 61. *See P 4.03 infra*, for a discussion of the rejectability of nondisturbance agreements.

(n73)Footnote 62. *P 2.01[7] supra* .

(n74)Footnote 63. *P 2.01[8] supra* .

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.07

P 3.07 Subordination of Leasehold Estates to Senior Interests

[1] Introduction

This section deals with the effect of the Bankruptcy Code on the law of subordination as applied to leasehold estates in real property. Two cases decided by the Court of Appeals for the Second Circuit have raised a number of significant issues concerning the enforcement of senior liens and interests to the detriment of junior leasehold interests held by tenants entitled to the protections afforded Bankruptcy Code debtors. In *Roslyn Savings Bank v. Comcoach Corporation (In re Comcoach Corporation)*,ⁿ¹ the Court of Appeals held that a foreclosing mortgagee had no standing to seek modification of the automatic stay in order to name as a necessary defendant in the foreclosure action a Bankruptcy Code debtor that was a tenant under a subordinate lease of the mortgaged property. In *48th Street Steakhouse, Inc. v. Rockefeller Group, Inc. et al. (In re 48th Street Steakhouse, Inc.)*,ⁿ² the court held that a landlord under a prime lease could not send a notice of default and termination to the prime tenant under the lease because such action would violate the automatic stay applicable in the Bankruptcy Code case of the debtor-subtenant. The sending of the notice of default and termination under the prime lease would have resulted in the termination of the sublease and therefore would have constituted an act to obtain property of the subtenant's estate in contravention of the stay. In both *Comcoach* and *48th Street Steakhouse*, the direct obligor of the complaining creditor (the mortgagor, in *Comcoach*, and the prime tenant, in *48th Street Steakhouse*) had not filed a Bankruptcy Code petition. Nevertheless, in these cases, for the period during which the applicable automatic stay remained in effect,ⁿ³ both holdings changed the result that would otherwise have obtained in their commonplace fact patterns under long-standing state law doctrines of seniority and subordination. As noted above, the result was not changed by reason of a Bankruptcy Code filing by the primary obligor, but rather by reason of the Bankruptcy Code filing by a third party not in privity with the holder of the senior interest.ⁿ⁴

[2] The *Comcoach* Issues

[a] Facts and Holdings

The facts before the court in *Comcoach* were that a bank made a loan secured by real property located in New York. The property was thereafter sold by the mortgagor and the purchaser assumed the mortgage debt while contemporaneously leasing the property to Comcoach Corporation. The mortgage went into default for nonpayment on August 1, 1981 and the bank instituted foreclosure proceedings without naming Comcoach as a defendant in the foreclosure action. Comcoach filed a chapter 11 reorganization petition on October 26, 1981 and ceased paying rent under the lease. The bank commenced an action in the *Comcoach* chapter 11 case seeking a modification of the

automatic stay to permit the foreclosure proceeding to go forward, but was denied relief from the stay in both the bankruptcy and district courts. Subsequently, the chapter 11 reorganization case was converted to a chapter 7 liquidation case.

On appeal from the district court, the Court of Appeals made the following rulings: (1) the leasehold estate of the debtor-tenant was property of the estate entitled to protection under *section 362(a)(3) of the Bankruptcy Code*⁵ and the debtor was entitled to protection against lawsuits under *section 362(a)(1)*;⁶ and (2) the foreclosing mortgagee was without standing to seek modification of the automatic stay in order to name the debtor-tenant as a defendant in the foreclosure action because (a) only a "party in interest" may seek modification of the stay,⁷ (b) the term "party in interest" means either the debtor or a creditor of the debtor, and the mortgagee was not the debtor and was not a creditor of the debtor.⁸ The court held further that under New York law, the debtor-tenant was a necessary but not indispensable party to the foreclosure action and that the mortgagee therefore could elect to prosecute the foreclosure proceedings subject to the lease. In response to the argument that the court had left the mortgagee subject to the constraints of the automatic stay but had denied the mortgagee access to the bankruptcy court to seek to lift the stay, the court stated that the mortgagee could obtain appointment of a receiver of the mortgaged premises who could assert the rights of the mortgagor, as the landlord of Comcoach, to seek modification of the stay in order to enforce the landlord's rights under the lease.

[b] Certain Implications of the *Comcoach* Holdings

[i] Senior Leases

In the case of a lease that is senior to a mortgage and therefore cannot be cut off by a foreclosure, the *Comcoach* holdings appear to leave unaffected the result that would obtain if the tenant were not a Bankruptcy Code debtor and the automatic stay were not in effect. In these circumstances, if the lease were in good standing, the mortgagee would foreclose subject to the lease and the tenancy would remain undisturbed. If the lease were in default, the foreclosing mortgagee could seek the appointment of a receiver to enforce the landlord's rights and remedies under the lease or otherwise activate an assignment of leases in such a manner as to achieve standing to deal directly with the defaulted lease.⁹

[ii] Subordinate Leases With Nondisturbance Protection

The typical nondisturbance agreement executed by a mortgagee and a tenant under a subordinated lease provides, among other things, that (1) the lease is subordinate to the mortgage, (2) notwithstanding such subordination, the lease will not be disturbed by reason of the landlord's default under the mortgage as long as there is no default under the lease, and (3) in the event of a default by the landlord under the mortgage, the mortgagee will not name the tenant as a party defendant in any action to foreclose the mortgage.^{9a} Thus under the terms of a typical nondisturbance agreement, the treatment of a subordinated lease as a senior lease is conditioned on the absence of a default under the lease. Therefore, in the absence of the complications engendered by a Bankruptcy Code filing by the tenant, and if the lease is not in default, it will be treated as a senior lease in a foreclosure proceeding and will not be cut off by reason of the entry of a foreclosure judgment. If, on the other hand, the lease is in default, and a foreclosure action has been commenced, the leasehold will be treated as subordinate to the mortgage, and will be terminated by reason of the entry of the foreclosure judgment. In these circumstances there will be no requirement for invocation by the mortgagee or by a receiver of separate state law landlord-tenant proceedings seeking termination of the lease, because the leasehold will be cut off by entry of the foreclosure judgment as a consequence of its subordinate position vis-a-vis the mortgage.

If a tenant that is a party to a nondisturbance agreement becomes a debtor under the Bankruptcy Code, the *Comcoach* holdings will not affect the mortgagee's foreclosure action if the lease is not in default, that is, the nondisturbance agreement will remain in effect, the foreclosure will go forward without affecting the debtor's leasehold estate, and the foreclosure will be effected subject to the lease. If however, the lease is in default, the protections to the debtor-tenant

may not be available under the nondisturbance agreement, and hence the *Comcoach* holdings will come into play. In these circumstances, under *Comcoach*, the mortgagee will be stayed from naming the debtor-tenant as a party defendant in the foreclosure action and will be unable to cut off the lease during the period in which the automatic stay remains in effect.ⁿ¹⁰

It appears from the foregoing that the critical element for the protection of a tenant under a typical nondisturbance agreement is the absence of a default under the lease. If the tenant is also a debtor in a Bankruptcy Code case, there is a question whether the reference in the nondisturbance agreement to the existence of a default under the lease will be construed as a reference to a default as determined solely under state law, or whether the provisions of the Bankruptcy Code affecting grace periods, cure periods and the unenforceability of certain lease default provisions will be read into the standard language of the nondisturbance agreement.ⁿ¹¹ If the relevant Bankruptcy Code provisions are deemed applicable to the determination of whether a default exists under the lease for the purpose of the nondisturbance agreement, then instances may arise in which the nondisturbance agreement will operate to protect a debtor-tenant from the loss of its leasehold resulting from the foreclosure of a senior mortgage, whereas the same nondisturbance agreement would not be effective to so protect the tenant if it had not filed a Bankruptcy Code petition.

If the lease is deemed not to be in default by reason of the application of certain provisions of the Bankruptcy Code, and the nondisturbance agreement therefore is effective for the debtor-tenant, the mortgagee's foreclosure action must proceed subject to the lease. In these circumstances, a purchaser of the mortgaged premises at foreclosure would be taking title to the property subject to a lease with a tenant that is a Bankruptcy Code debtor.ⁿ¹² If, on the other hand, the lease is deemed to be in default, and the tenant thereunder is a debtor in a Bankruptcy Code case, then the foreclosing mortgagee should not be subject to the constraints of the nondisturbance agreement, but nevertheless will be subject to the automatic stay under the *Comcoach* holding. Although this may first appear to place the foreclosing mortgagee in precisely the same position as though the nondisturbance agreement had operated to protect the debtor's leasehold against termination by reason of the entry of a foreclosure judgment, it should be noted that the *Comcoach* holding protects the debtor-tenant only as long as the automatic stay remains in effect. Once the automatic stay is lifted, whether at the conclusion of the tenant's Bankruptcy Code case or otherwise,ⁿ¹³ the foreclosing mortgagee that is not subject to an operative nondisturbance agreement is free to foreclose and to cut off the tenant's subordinate leasehold interest in the property. Thus, in some instances, a foreclosing mortgagee may elect to suspend the foreclosure proceedings pending the conclusion of a tenant's Bankruptcy Code case.

[iii] Subordinate Leases Without Nondisturbance Protection

The problem created by the *Comcoach* holding for a foreclosing mortgagee is, of course, that in many instances as a practical matter, the mortgagee will not want to suspend its foreclosure action until completion of a tenant's Bankruptcy Code case. Therefore, if the lease in question provides for a below-market rental, and the value of the mortgaged property would be enhanced if the lease were cut off by the foreclosure, the *Comcoach* holding requires that the mortgagee suffer a decrease in value of the property for purposes of realization at a foreclosure sale. Indeed, in most instances, it is likely that no outside parties will bid for the property with the prospect of taking title to the mortgaged property subject to a material lease with a debtor-tenant or its trustee. Accordingly, the foreclosing mortgagee in these circumstances will be constrained to bid-in at the foreclosure sale and to hold the property until the status of the debtor's leasehold has been established.

The court of appeals in *Comcoach* indicated that the foreclosing mortgagee ultimately has a remedy for the above described difficulties through the appointment of a receiver. The court expressed the belief that if the debtor-tenant's lease were in default, the receiver could move in bankruptcy court for a modification of the automatic stay to permit recourse by the receiver to its state law landlord-tenant remedies.ⁿ¹⁴ However, this suggested solution fails to account for certain legal and pragmatic barriers to a successful motion to lift the stay in Bankruptcy Code cases involving debtor-tenants.

As a threshold matter, there is a question whether a landlord under a real estate lease may ever invoke the requirement for adequate protection under *section 362(d)(1) of the Bankruptcy Code* as a ground for lifting or modification of the automatic stay.ⁿ¹⁵ Indeed, it has been held that a landlord of a tenant that is a Bankruptcy Code debtor is confined to the remedies arising under section 365, and cannot proceed under section 362(d)(1) to obtain relief in order to pursue its state law lease termination remedies.ⁿ¹⁶ Moreover, it is generally recognized that a landlord will often encounter considerable difficulties in obtaining bankruptcy court approval to terminate or to seek to terminate a real estate lease with a debtor-tenant even if material defaults are outstanding thereunder. If the debtor-tenant has decided to assume the lease, whether for the purpose of retaining the leased premises for its own use or for the purpose of assigning the lease to a third party, the Bankruptcy Code provides to the debtor-tenant considerable latitude to cure outstanding defaults and to otherwise prevent a termination of the lease by the landlord.ⁿ¹⁷ Moreover, in the case of an assignment of a lease by a debtor-tenant to a third party, the consideration paid for the assignment will generally become the property of the debtor's estate, and will not be paid over to the landlord or its mortgage.ⁿ¹⁸ Accordingly, in the case of a below-market lease in a good real estate market, *Comcoach* may effect a practical deprivation to the foreclosing mortgagee of the appreciation in value of the real property that would result from termination of a subordinate lease, and instead results in the allocation of such appreciation in value of the real property to the estate of the debtor-tenant.

[iv] *Comcoach* in a Mandatory Cut-Off Jurisdiction

In some jurisdictions, such as New York, a foreclosing mortgagee may proceed to judgment in a foreclosure action without naming as defendants the holders of all junior interests.ⁿ¹⁹ The foreclosure is, in such circumstances, effected subject to these junior interests. In other jurisdictions, such as California, a judicial foreclosure automatically cuts off all junior interests, including subordinate leases.ⁿ²⁰ The foreclosing mortgagee is not given the option to omit selected defendants in its action; if the foreclosure goes forward, the junior interests are extinguished.

If the *Comcoach* holdings are viewed as generally applicable rules of bankruptcy law, then in the mandatory cut-off jurisdictions *Comcoach* may mean that the commencement and continuation of a foreclosure action, when an affected subordinate leasehold is held by a Bankruptcy Code debtor, necessarily violates section 362(a)(3) as an act to obtain possession of property of or from the debtor's estate. In other words, the filing of a Bankruptcy Code petition by a tenant of the borrower of a mortgage lender will, as long as the stay remains in effect, bar the mortgage lender from recourse to the property through any means that would cut off the lease.

It may be argued that the above-described result is acceptable in transactions in which the mortgage loan to the borrower was nonrecourse and the mortgagee relied principally on a credit judgment concerning the tenant. The lender in these circumstances may be deemed to have assumed the risks of the tenant's bankruptcy. However, the *Comcoach* holding arguably applies to other transactional structures in which the debtor-tenant's credit was not a material consideration in making the mortgage loan. For example, in a large commercial office building with one hundred space tenants and five of these tenants have become debtors in Bankruptcy Code cases, the *Comcoach* rule, if literally applied, would in a mandatory cut-off jurisdiction prevent the filing by a mortgagee of a foreclosure action affecting the building. Indeed, if only one of the tenants were a debtor in a Bankruptcy Code case, the same result should obtain.

[3] The Lease-Sublease Relationship--*48th Street Steakhouse*

[a] The Facts and the Holdings

48th Street Steakhouse ⁿ²¹ holds that a prime landlord is stayed under *section 362(a)(3) of the Bankruptcy Code* from sending to its tenant under a prime lease a notice of default and termination if the effect thereof would be to cause a termination of an underlying subleasehold in the hands of a Bankruptcy Code debtor. In *48th Street Steakhouse*, the prime tenant was a purchase money creditor of the subtenant and created the sublease relationship primarily as a security device to permit repossession of the leased premises in the event of a default in payment of the purchase money debt. The court held, for the purpose of the summary judgment motions before it, that the relevant agreements would be

treated as a lease and sublease. The court concluded on these facts that a subleasehold interest constitutes property of the debtor's estate, and that the prime landlord could not act, albeit indirectly, to terminate that interest in the face of the automatic stay. The court did not address the issue of the prime landlord's standing to seek modification of the stay, nor did it cite *Comcoach* in the course of its opinion.

The *48th Street Steakhouse* holding is of course consistent with the *Comcoach* decision in that both cases hold that the automatic stay reaches out to the holders of senior real estate interests who are not creditors of the debtor but who otherwise could exercise remedies that would have the effect of cutting off the debtor's subordinated rights.ⁿ²² Indeed, the facts and holdings in *48th Street Steakhouse* are analogous to the hypothetical circumstances discussed above under which the *Comcoach* rule would prevent a mortgagee from commencing a foreclosure action in a jurisdiction in which such action would automatically terminate a subordinate lease in the hands of a Bankruptcy Code debtor.ⁿ²³ The similarity of result in the two circumstances may be illustrated by the example of a commercial office building, held under a long-term ground lease, in which one of the many space tenants (in reality, a subtenant) is a Bankruptcy Code debtor. If, for some reason, the prime tenant under the ground lease defaults in the performance of its obligations to the ground landlord, the ground landlord will be stayed under *48th Street Steakhouse* from moving to terminate the ground lease, because such termination would also terminate the space sublease of a Bankruptcy Code debtor.

[b] Nondisturbance Considerations

The *48th Street Steakhouse* holdings raise questions affecting nondisturbance agreements protecting subleasehold positions similar to the questions raised in the context of a leasehold protected by a nondisturbance agreement with a fee mortgagee.ⁿ²⁴ For example, in the case of a sublease protected by atypical nondisturbance agreement that is conditioned on the absence of a default under the sublease, there is an issue as to whether the reference in the nondisturbance agreement to the existence of a default under the sublease will be construed as a reference to a default determined solely under state law, or whether the provisions of the Bankruptcy Code affecting grace periods, cure periods and the like will be read into the standard language of the nondisturbance agreement.ⁿ²⁵

However, there are also certain differences between (a) the relationship of a mortgagee to the holder of a subordinated leasehold position, and (b) the relationship of a prime landlord to the holder of a subleasehold position. In the case of a prime lease-sublease structure, if a default arises under the prime lease giving rise to a right of termination on the part of the prime landlord, there is generally no provision for the appointment of a "receiver" for the property, in contrast to the analogous fact pattern under a mortgage-subordinated lease structure. If, in the case of a prime lease-sublease structure, there is a typical nondisturbance agreement in effect between the prime landlord and the subtenant, then in the event of a default under and termination of the prime lease, the prime landlord will become the direct landlord of the subtenant under the sublease. In the absence of a nondisturbance agreement, or other consensual arrangement between the prime landlord and the subtenant, the termination of the prime lease will in these circumstances automatically terminate the sublease.

The court in *Comcoach* held that the foreclosing mortgagee in that case was without standing to seek the modification of the automatic stay applicable in the Bankruptcy Code case of the tenant under the lease of the mortgaged premises that was subordinate to the mortgage.ⁿ²⁶ The court found that it had not denied to the foreclosing mortgagee all recourse to the courts for relief, because the mortgagee could obtain the appointment of a receiver of the mortgaged property, who would have standing to seek the modification of the automatic stay in order to enforce state landlord-tenant rights against the debtor-tenant.ⁿ²⁷ The court's determination that the foreclosing mortgagee was without standing to seek the modification of the stay in the debtor-tenant's bankruptcy case was premised on the holding that only a creditor (or debtor) has such standing, that the foreclosing mortgagee was not a direct creditor of the debtor-tenant, and therefore did not have such standing.

If the *Comcoach* holding concerning standing to seek the modification of the automatic stay is applied to the facts in *48th Street Steakhouse*, then the prime landlord, who was not a direct creditor of the debtor-subtenant in that case by

reason of the nature of the prime lease-sublease structure, was without standing to seek the modification of the automatic stay involved in that case. However, unlike the mortgagee in *Comcoach*, who could attain the necessary standing as a landlord of the debtor-tenant through the appointment of a receiver of the mortgaged premises, the prime landlord in *48th Street Steakhouse* had no such option and remedy available to it, because there is no receivership or similar mechanism available in the prime lease-sublease structure (in the case of a termination of the prime lease).

Accordingly it appears that in some circumstances a prime landlord may wish to consider more frequent use of a nondisturbance and attornment agreement with the subtenants in the premises. The agreement, in its typical form, would provide for, among other things, the attornment by the subtenant to the prime landlord in the event of a termination of the prime lease and the creation of a direct landlord-tenant relationship between the parties under the terms of the sublease. The agreement may enhance the prime landlord's argument in favor of standing to seek the modification of the automatic stay in a Bankruptcy Code case of the subtenant, because the agreement purports to create a direct relationship between the prime landlord and subtenant and may therefore satisfy the court's requirement for "creditor" status as a condition to standing.ⁿ²⁸

FOOTNOTES:

(n1)Footnote 1. 698 F.2d 571, 7 C.B.C.2d 1191 (2d Cir. 1983) .

(n2)Footnote 2. 835 F.2d 427, 17 C.B.C.2d 1415 (2d Cir. 1987) , cert. denied, 485 U.S. 1035, 108 S.Ct. 1596, 99 L.Ed.2d 910 (1988) .

(n3)Footnote 3. Under section 362(c)(2) of the Bankruptcy Code, the stay continues until the earlier of (a) the time the case is closed, (b) the time the case is dismissed, or in an individual chapter 7 case or a case under chapter 9, 11, 12 or 13 of the Code, the time a discharge is granted or denied. Under section 362(c)(1) of the Code, the stay of an act against property of the estate terminates when such property is no longer property of the estate. See P 2.06 *supra*.

(n4)Footnote 4. The holdings in *Comcoach*, 698 F.2d 571, 7 C.B.C.2d 1191 (2d Cir. 1983) , and *In re 48th Street Steakhouse*, 835 F.2d 427 (2d Cir. 1987) , are consistent with precedent. See *Florida Inst. of Tech. v. Carpenter (In re Westec Corp.)*, 460 F.2d 1139 (5th Cir. 1972) (foreclosure by taxing authority against property in which Chapter X trustee held first and second mortgage position violates stay); *In re Reorganization of Pittsburgh Rys., Co.*, 111 F.2d 932, 935 (3d Cir. 1940) , *aff'd*, 312 U.S. 168, 61 S. Ct. 538 (1941) (*dictum*); *Texas Co. v. Hauptman*, 91 F.2d 449 (9th Cir. 1937) (district court had jurisdiction to enjoin state court action for foreclosure of senior lien on vessel to the detriment of bankrupt holder of subordinate lien); *In re Babco, Inc.*, 28 B.R. 656 (Bankr. W.D. Pa. 1983) (bankruptcy court can enjoin transfer of real and personal property that would result in extinguishment of debtor's leasehold interests); *In re Golden Plan of California, Inc.*, 39 B.R. 551 (Bankr. E.D. Cal. 1984) (foreclosure sale violated automatic stay because it eliminated estate's equitable interest in junior deed of trust); *In re Kash & Karry Wholesale, Inc.*, 28 B.R. 66 (Bankr. D.S.C. 1982) (same holding as *48th Street Steakhouse*); *cf. In re Investor Funding Corp. of N.Y.*, 633 F.2d 204 (2d Cir.1980) (district court in Chapter X case may enjoin prosecution of state court proceeding to reform wrap mortgage to the detriment of the estate as mortgage holder); *In re Bialac*, 16 B.R. 982 (Bankr. D. Ariz. 1982) (automatic stay violated by second creditor's sale of fractional interest in note and extinguishment of debtor's right to redeem as holder of the remaining fractional interest in the note). *Contra In re Copper Canyon Mining Co.*, 156 F. Supp. 535 (D. Del. 1957) (debtor's interest in mortgage insufficient to constitute property of the estate); *Juneau's Builders Ctr., Inc. v. First Nat'l Bank of Gonzales (In re Juneau's Builders Ctr., Inc.)*, 14 C.B.C.2d 540, 57 B.R. 254 (Bankr. M.D. La. 1986) (foreclosure sale adversely affecting debtor's lease not enjoined); *Smith v. North Georgia Prod. Credit Ass'n*, 16 B.R. 652 (Bankr. N.D. Ga. 1981) (foreclosure of first lien permitted notwithstanding adverse effect on second lien held by estate).

(n5)Footnote 5. 698 F.2d 571, 573, 7 C.B.C.2d 1191, 1192 .

(n6)Footnote 6. 698 F.2d 571, 573, 7 C.B.C.2d 1191, 1192 .

(n7)Footnote 7. 698 F.2d 571, 574, 7 C.B.C.2d 1191, 1193 .

(n8)Footnote 8. 698 F.2d 571, 574, 7 C.B.C.2d 1191, 1193 .

(n9)Footnote 9. See P 2.03[1] *supra*. For a discussion concerning the treatment of nondisturbance agreements as executory contracts, see P 4.03 *infra*.

(n10)Footnote 9a. The use and effects of subordination and nondisturbance agreements are described in Feinstein and Keyles, *Foreclosure: Subordination, Non-Disturbance, and Attornment Agreements*, 3 Prob. & Prop., No. 4 at 38(July/August 1989).

(n11)Footnote 10. See note 3 *supra*.

(n12)Footnote 11. See 11 U.S.C. §§ 108(b), 365(b) and 365(e)(1). See generally P 3.01[3][b] *supra*.

(n13)Footnote 12. Cf. *Polish Nat'l Alliance v. White Eagle Hall Co., Inc.*, 98 A.D.2d 400, 470 N.Y.S.2d 642 (2d Dept. 1983) .

(n14)Footnote 13. See note 3 *supra*.

(n15)Footnote 14. 698 F.2d 571, 574-75, 7 C.B.C.2d 1191, 1194 .

(n16)Footnote 15. P 3.01[2][b] *supra* .

(n17)Footnote 16. P 3.01[2][b] note 32 *supra* . The landlord's remedies include the right to (1) current payment of postpetition rental (section 365(d)(3)), (2) timely assumption or rejection of the lease (section 365(d)(4)), (3) cure or adequate assurance of prompt cure of outstanding defaults upon assumption of the lease (section 365(b)(1)), and (4) adequate assurance of future performance of an assumed lease that has been in default or that is being assigned to a third party (section 365(b)(1) and (f)(2)).

(n18)Footnote 17. See 11 U.S.C. §§ 108(b), 365(b) and 365(e)(1). See generally P 3.01[3][b] *supra*.

(n19)Footnote 18. P 3.06[2] *supra* .

(n20)Footnote 19. *Polish Nat'l Alliance v. White Eagle Hall Co., Inc.*, 98 A.D.2d 400, 470 N.Y.S.2d 642 (2d Dept. 1983) .

(n21)Footnote 20. The states in which automatic extinguishment of junior interests occurs upon foreclosure are identified in a chart accompanying Feinstein and Keyles, *Foreclosure: Subordination, Non-Disturbance, and Attornment Agreements*, 3 Prob. & Prop., No. 4 at 38(July/August 1989).

(n22)Footnote 21. 835 F.2d 427, 17 C.B.C.2d 1415 (2d Cir. 1987) .

(n23)Footnote 22. The *Comcoach* and *48th Street Steakhouse* holdings, dealing with the reach of the automatic stay to third party actions having an indirect but adverse effect on property of the estate, are distinguishable from the decisions enjoining suits *against* third parties, such as insurers of the debtor, who may confer a benefit on the estate. See, e.g., *In re A.H. Robins Co.*, 828 F.2d 1023, 17 C.B.C.2d 526 (4th Cir. 1987) ; *In re Johns-Manville Corp.*, 31 B.R. 965 (S.D.N.Y. 1983) . But see *In re Policy*, 242 B.R. 121 (S.D.N.Y. 1999) , holding that the automatic stay does not affect the rights of a debtor as lessee under a sublease where the prime lease terminated prior to the filing of the debtor's petition.

(n24)Footnote 23. See P 3.07[2][iv] *supra*.

(n25)Footnote 24. *See P 3.07[2][ii] supra.*

(n26)Footnote 25. *See P 3.07[2][ii] supra.*

(n27)Footnote 26. *698 F.2d 571, 574, 7 C.B.C.2d 1191, 1193 .*

(n28)Footnote 27. *698 F.2d 571, 574-75, 7 C.B.C.2d 1191, 1194 .*

(n29)Footnote 28. *698 F.2d 571, 574, 7 C.B.C.2d 1191, 1193 .*

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code §§ 3.08through 3.50

[Reserved]



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

*1-3 Collier Real Estate Trans & Bankruptcy Code P 3.51***P 3.51 Form--Notice of Motion and Application for Order Directing Assumption or Rejection of Lease, Payment of Rents and Charges, and Relief From Stay (S.D.N.Y.)**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	)	
	)	In Proceedings for
<i>In re</i>	)	Reorganization under
DOE REALTY CORP.,	)	Chapter 11
Debtor.	)	Case No.
	)	

Notice of Motion for Order Directing Assumption or Rejection of Lease, Payment of Rents and Charges, and Relief From Stay

PLEASE TAKE NOTICE, that upon the annexed application of JJ Landlord Corp. ("JJ"), the undersigned will move this Court before the Honorable, Bankruptcy Judge, at Room, United States Courthouse, Alexander Hamilton Customs House, One Bowling Green, New York, New York on, 2007, at 10:00 a. m., or as soon thereafter as counsel can be heard, for an order pursuant to *Rules 4001(a), 6006(b) and 9014* of the Bankruptcy Rules and *Bankruptcy Code §§ 362(d), 363(e), 365(d)(3) and 365(d)(4)*: (1) directing Doe Realty Corp., as debtor and debtor in possession (collectively: "Doe"), to surrender to JJ on March 1, 2007 the premises (the "Premises") demised to Doe Realty Corp. under the lease dated February 22, 2001 between JJ, as landlord, and Doe Realty Corp., as tenant (the "Lease"), and to suffer the Lease rejected unless Doe shall have theretofore assumed the Lease pursuant to *section 365(a) of the Bankruptcy Code* and *Bankruptcy Rules 6006 and 9014*; (2) directing Doe to pay to JJ, as and when due under the Lease, an amount equal to the base rent and other charges provided for in the Lease arising from and after the date of entry of the order for relief herein, and to perform its other obligations under the Lease arising from and after such date; (3) directing Doe to forthwith surrender to JJ the Premises and terminating, annulling or modifying the stay under *Bankruptcy Code § 362* to permit JJ to retake the Premises and relet the same; (4) directing Doe to forthwith provide JJ with adequate protection of its interest in the Premises pursuant to *Bankruptcy Code §§ 361 and 363(e)* and conditioning the continuation of the stay under *Bankruptcy Code § 362* upon prompt provision of such adequate protection; and (5) granting to JJ such other and further relief as the Court deems just and proper.

Dated: New York, New York

....., 20.....

[Attorneys for JJ Landlord Corp.]

By

A Member of the Firm

Office & Post Office Address:.....

Telephone Number:.....

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY CORP.,

Debtor.

)
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)
)
)

In Proceedings for
Reorganization under
Chapter 11
Case No.....

Application for Order Directing Assumption or Rejection of Lease, Payment of Rents and Charges, and Relief From Stay

To The Honorable, Bankruptcy Judge:

The application of JJ Landlord Corp. ("JJ") respectfully represents:

1. This is a contested matter brought pursuant to Bankruptcy Rules 4001(a), 6006(b) and 9014 and §§ 362(d), 363(e), 365(d)(3) and 365(d)(4) of the *Bankruptcy Code* for an order, *inter alia*:

- a) directing Doe Realty Corp., as debtor and debtor in possession ("Doe"), to surrender to JJ on March 1, 2007 the Premises (the "Premises") demised to Doe Realty Corp. under the lease dated February 22, 2001 between JJ, as landlord, and Doe Realty Corp., as tenant (the "Lease"), and to suffer the lease rejected, unless Doe shall have theretofore assumed the lease pursuant to *section 365(a) of the Bankruptcy Code* and *Bankruptcy Rules 6006 and 9014*;
- b) directing Doe to pay to JJ, as and when due under the lease, an amount equal to the base rent and the other sums payable under the Lease arising from and after the date of entry of the order for relief herein, and to perform its other obligations under the Lease arising from and after such date;
- c) directing Doe to forthwith surrender the Premises to JJ, and terminating, annulling or modifying the stay under *Bankruptcy Code § 362* to permit JJ to retake the Premises and relet the same or directing Doe to forthwith provide JJ with adequate protection of its interest in the Premises pursuant to *Bankruptcy Code §§ 361 and 363(e)* and conditioning continuation of the stay under *Bankruptcy Code § 362* upon the prompt provision of such adequate protection;
- d) granting JJ the costs and disbursements of this contested matter, including reasonable attorneys' fees; and

e) granting JJ such other and further relief as may be just and proper.

2. JJ is a corporation organized under the laws of the State of New York, having its principal place of business in New York, New York.

3. Doe purports to be a corporation organized and existing under the laws of the State of New York and having its principal place of business in New York, New York.

4. This contested matter arises in the case of *In re Doe Realty Corp.*, [case no.], a chapter 11 proceeding pending in the United States Bankruptcy Court for the Southern District of New York.

5. Jurisdiction is conferred on this Court by the provisions of 28 U.S.C. § 1334. This is a core proceeding within the meaning of 28 U.S.C. § 157(b).

6. On December 31, 2006, Doe filed its petition (the "Petition") seeking relief under chapter 11 of the Bankruptcy Code. Pursuant to §§ 1107 and 1108 of the Bankruptcy Code, Doe is continuing to operate its business as a debtor in possession.

The Premises and Lease

7. JJ is the owner of real property known as 999 East 84th Street, New York, New York on which there is a building containing approximately 32,000 square feet (the "Premises").

8. JJ, as lessor, and Doe, as lessee, entered into the lease covering the Premises for a period of 15 years commencing February 28, 2001. (A copy of the Lease is annexed hereto as Exhibit "A".)

9. Under Section III of the Lease, Doe is obligated to pay JJ rental in the amount of \$115,028.64 per year (the "Base Rent"), payable in equal monthly installment of \$9,585.72 in advance on the first day of each month throughout the term of the Lease. Doe is also obligated under Section III to pay, at its own cost and expense, all real estate taxes and special assessments imposed on or in respect of the Premises as additional rent during the term of the Lease.

10. Under Section VI(a) of the Lease, Doe is further obligated at its expense to insure the Premises against fire, lightning and all standard extended coverage perils for the full fair insurable value of the Premises (the "Casualty Insurance"). Under Section VI(b) of the Lease, Doe also is obligated at its own cost and expense to pay for general liability insurance covering the Premises (the "Liability Insurance").

11. Under Section VIII of the Lease, Doe is obligated to make all necessary repairs and improvements to the Premises and to use reasonable diligence to maintain the Premises in good order and repair throughout the term of the Lease. Under Section IX of the Lease, Doe is obligated to pay all real estate taxes relating to the Premises when such bill is presented by the applicable government authority.

12. Section XII of the Lease provides that Doe shall be in default if it fails to pay when due any installment of the Base Rent, any additional rent or any other sums owing by Doe under the Lease, and such failure continues for more than 10 days after written notice is given by JJ to Doe. Section XII of the Lease also provides that Doe shall be in default if it fails promptly and faithfully to keep and perform each other covenant of the Lease.

13. Among the various rights reserved to JJ on such defaults are the rights under Section XII to continue to demand from Doe fulfillment of Doe's obligations.

Defaults

14. *Section 365(d)(3) of the Bankruptcy Code* requires that Doe shall timely perform all of the obligations of Doe Realty Corp. arising under the Lease from and after the entry of the order for relief herein--to wit, December 31, 2006--unless the time for such performance is extended by this Court pursuant to section 365(d)(3). The time for such performance has not been extended by this Court.

15. Doe has failed to pay the monthly installment of Base Rent under the Lease, in the amount of \$9,585.72, for the month of January 2007. Doe has failed to pay the currently due premium for the Casualty Insurance and the Liability Insurance, and such insurance will lapse within twenty days after the date of this application unless such premiums are paid within such time. In addition, Doe has permitted the Premises to deteriorate, has failed to make necessary repairs to the roof of the Premises and has failed to make necessary repairs to the water tank at the Premises, all in breach of the obligations under Section VIII of the Lease. Moreover, Doe has failed to pay real estate taxes for the semi-annual period ended June 30, 2007, as required under Section IX of the Lease.

Doe Should Be Directed To Surrender the Premises to JJ on March 1, 2007

16. Doe currently is not conducting business in the Premises and has not made any proposal to resume the use and occupation thereof. JJ cannot relet or sell the Premises unless they are unencumbered by the Lease and are free of any rights of use and occupation which Doe may have under the Bankruptcy Code, the Lease, or otherwise. Any further delay will serve only to compound the prejudice already suffered by JJ.

17. Under the circumstances, it is submitted that JJ is entitled to require that Doe surrender the Premises to JJ on March 1, 2006 (which is 120 days after the date of entry of the order for relief herein) pursuant to *section 365(d)(4) of the Bankruptcy Code*, and to suffer the Lease rejected, unless Doe shall have theretofore assumed the Lease pursuant to *section 365(a) of the Code* and *Bankruptcy Rules 6006 and 9014*.

Payments and Performance of the Obligations Under the Lease

18. As set forth in paragraphs 14 and 15 above, *section 365(d)(3) of the Code* requires Doe to perform the obligations arising under the Lease from and after December 31, 2006, but Doe has failed to pay an amount equal to the Base Rent of \$9,585.72 due on January 1, 2007, to pay the premiums for the Casualty Insurance and the Liability Insurance, has not maintained the Premises in the condition required under the Lease, has not repaired the roof and the water tank at the Premises and has failed to pay real estate taxes for the semi-annual period ended June 30, 2007. The Court should direct Doe to forthwith perform each and all of such obligations, and to continue to pay and perform on a timely basis all of the obligations of Doe Realty Corp. hereafter to be performed under the Lease until the same is assumed or rejected.

Termination of Stay or Provision of Adequate Protection

19. The Premises is held by JJ for rental. By reason of the automatic stay provisions of *Bankruptcy Code § 362*, JJ is prevented from exercising its rights and remedies as landlord arising from Doe's defaults, including the retaking of the Premises and the renting of the same to third parties.

20. The inability of JJ to retake and relet the Premises decreases the value of its interest in the Premises by at least the amount of the rent that could be received under the lease through such renting, which, upon information and belief, is at least the amount of the Base Rent plus the other sums payable under the Lease. Accordingly, to the extent JJ does not receive payments equal to the Base Rent and other sums payable under the Lease, the value of JJ's interest in the Premises is being lost. In addition, the Premises are in jeopardy by reason of the possible lapse of the Casualty Insurance, the failure of Doe to properly maintain the Premises, and the failure of Doe to repair the roof and water tank at the Premises. Therefore, relief from the stay should be granted under *Bankruptcy Code § 362(d)(1)* because the

interest of JJ in the Premises is not being adequately protected.

21. *Section 362(d)(2) of the Bankruptcy Code* provides as a further ground for relief from the stay that the Court shall grant relief if "(A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization." This basis for relief is satisfied inasmuch as Doe as lessee has no equity in the Premises and, upon information and belief, the property is not necessary to an effective reorganization.

22. By reason of the foregoing and pursuant to *Bankruptcy Code § 362(d)*, JJ hereby requests that this Court (a) direct Doe to surrender the Premises forthwith and (b) terminate, annul, modify or condition the stay under *Bankruptcy Code § 362* to the extent necessary to permit JJ promptly to retake and rent the Premises or, if such relief is not granted, condition the continuation of such stay upon the prompt provision to JJ of adequate protection of its interest in the Premises pursuant to *Bankruptcy Code §§ 361 and 363(e)*.

WHEREFORE, JJ demands judgment against Doe and requests that this Court enter an order or orders:

(a) directing Doe to surrender the Premises to JJ on March 1, 2007, and to suffer the Lease rejected unless Doe shall have theretofore assumed the Lease pursuant to *section 365(a) of the Bankruptcy Code*;

(b) directing Doe to pay to JJ (and to such persons as maybe specified in the Lease with respect to sums other than Base Rent) (i) forthwith an amount equal to the Base Rent in the amount of \$9,585.72 which was due on January 1, 2007 and (ii) until the Lease is assumed or rejected, to pay and perform on a timely basis all obligations arising under the Lease from and after December 31, 2006, including without limitation, all obligations for Base Rent and other charges, the maintenance of the Premises in the condition required under the Lease, the payment of all premiums for Casualty Insurance and Liability Insurance, the repair of the roof and the water tank at the Premises and the payment of real estate taxes for the semi-annual period ended June 30, 2007; and

(c)(1) directing Doe to forthwith surrender the Premises to JJ, and terminating, annulling or modifying the stay under *Bankruptcy Code § 362* to permit JJ to retake the Premises and relet the same; or

(2) directing Doe to forthwith provide JJ with adequate protection of its interest in the Premises pursuant to *Bankruptcy Code §§ 361 and 363(e)* and conditioning continuation of the stay under *Bankruptcy Code § 362* upon the prompt provision of such adequate protection;

and, in all events--

(d) Granting JJ the costs and disbursements of this contested matter, including reasonable attorneys' fees; and

(e) Granting JJ such other further relief as may be just and proper.

Dated: New York, New York

January, 2007

.....

Attorneys for JJ Landlord Corp.

By

A Member of the Firm

Office & Post Office Address:.....

Telephone Number.....

FOOTNOTES:

(n1)Footnote 1. This form of motion is generally employed In the Southern District of New York. In other jurisdictions, motions often take the form of a notice of motion and affidavit.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.52

P 3.52 Form--Order Approving Agreement with Real Estate Consultant, Finder and Broker; Application for Order

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	)	
	)	In Proceedings For Reorganization Under Chapter 11
<i>In re</i>	)	Case No.
DOE REALTY CORP.,	)	ORDER APPROVING AGREEMENT WITH REAL
Debtor.	)	ESTATE CONSULTANT, FINDER AND BROKER
	)	[1]

Order Approving Agreement With Real Estate CONSULTANT, FINDER and Brokern1

Upon the annexed application of Doe Realty Corp., debtor in possession ("Doe"), the letter agreement (the "Agreement") among Doe, the Committee of Unsecured Creditors and XYZ Associates, Inc. ("XYZ"), and sufficient cause appearing therefor, it is

ORDERED, that the Agreement is hereby approved, and it is further

ORDERED, that XYZ shall be compensated for services to be rendered in the manner set forth in the Agreement, provided however, that XYZ shall be required to file an application for compensation with this Court upon completion of all services rendered pursuant to the Agreement.

.....

United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

)

<i>In re</i>	)	In Proceedings For A Reorganization Under Chapter
DOE REALTY CORP.,	)	11
Debtor.	)	Case No.
	)	

Application for Order Approving Agreement With Real Estate Consultant, Finder and Broker

To The Honorable, Bankruptcy Judge:

The joint application of Doe Realty Corp., debtor in possession ("Doe"), and the Committee of Unsecured Creditors appointed herein (the "Committee") respectfully shows and alleges:

1. On August 5, 2006 Doe filed a petition under chapter 11 of the Bankruptcy Code. Doe has continued in the management of its business as debtor in possession. No trustee has been appointed.
2. Doe is engaged in the business of operating retail department stores in several states in the United States. At the time of the filing of the chapter 11 petition herein, Doe operated approximately 200 retail department stores. Shortly after the filing of the chapter 11 petition and pursuant to an order of this Court dated September 10, 2006, Doe closed 66 stores and ceased operations therein.
3. Doe has no intention of resuming operations at its currently closed stores and intends to dispose of these stores through a leasehold marketing and disposition program. Doe has commenced to develop this program through its own personnel and with its own resources.
4. After the Committee reviewed with Doe its leasehold marketing and disposition program, the Committee advised Doe of its view that Doe should explore the possibility of retaining experts familiar with leasehold dispositions in reorganization proceedings and who were qualified to conduct appraisals of Doe's leaseholds and fee positions.
5. The Committee formed a subcommittee which, together with Doe's chief executive officer, met with the two real estate firms most widely known to have had experience in real estate dispositions in reorganization proceedings. Those firms, XYZ Associates, Inc. ("XYZ") and Roe Realty Inc., were interviewed by Doe and members of the subcommittee. After such interviews it was recommended that Doe pursue negotiations with XYZ for an agreement providing for services to be rendered and compensation to be received by XYZ.
6. Doe and members of the subcommittee thereafter engaged in negotiations with XYZ, resulting in the letter agreement in the form of Exhibit A to this application (the "Agreement"). The Agreement, which names both Doe and the Committee as parties, provides that XYZ will serve as the real estate consultant to Doe and the Committee and will aid Doe in the disposition of its presently closed stores. The Agreement provides that Doe shall supervise and retain primary responsibility for the disposition of its real estate assets and that the services of XYZ shall at all times remain subject to the direction of Doe with the participation of the Committee. This arrangement will enable the highly experienced real estate personnel within Doe to guide the real estate disposition process and call upon the experience and services of XYZ as required.
7. The services to be rendered by XYZ are described in the Agreement. Compensation to XYZ is based principally upon performance. The following are the terms of the Agreement relating to compensation of XYZ:
 - a) XYZ shall receive a retainer fee of \$75,000 (the "Retainer") for an appraisal of Doe's closed stores (which shall be completed within 45 days after entry of the pre-fixed Order), and for an appraisal of all of Doe's other real estate assets

(which shall be completed no later than December 31, 2006).

b) As compensation for services to be rendered in connection with specific leasehold dispositions, XYZ shall receive an amount equal to 3% of Net Sales Proceeds (as defined in the Agreement) up to \$10,000,000, 5% of Net Sales Proceeds in excess of \$10,000,000 and up to \$20,000,000, and 7-1/2% of Net Sales Proceeds in excess of \$20,000,000.

c) XYZ shall receive a minimum fee of \$5,000 for each lease terminated without liability to the estate, which shall be credited against the 3% charge against the first \$10,000,000 of Net Sales Proceeds. If the amounts payable to XYZ under the preceding sentence exceed \$300,000 (3% of \$10,000,000), the excess shall be credited against the 5% charge against Net Sales Proceeds described in subparagraph b) above. In addition, the Retainer will be credited against the 5% charge against Net Sales Proceeds described in subparagraph b) above.

d) The definition of the term Net Sales Proceeds, as set forth in the Agreement, is limited to actual cash received by Doe after deducting the cost of carrying the leased properties from and after the date of entry of the pre-fixed Order.

8. The Agreement may be terminated by Doe as of a date not less than 90 days after the entry of the pre-fixed Order, upon 30 days' prior written notice to XYZ.

9. Doe and the Committee both believe that the compensation arrangements made with XYZ are fair and reasonable, and the pre-fixed Order provides that XYZ shall be required to file an application for compensation with this Court upon completion of the services to be rendered by it.

10. No previous application for the relief sought herein has been made to this or any other Court.

WHEREFORE, Doe and the Committee respectfully pray for the entry of the pre-fixed Order and for such other and further relief as the Court may deem just.

Dated: New York, New York

....., 2006

DOE REALTY CORP.

Debtor in Possession

[.....]

Attorneys for the Debtor and Debtor in Possession

By:

A Member of the Firm

[.....]

Counsel to the Committee of Unsecured Creditors

By:

A Member of the Firm

Exhibit A

[Date]

Doe Realty Corp.

Debtor and Debtor in Possession

[address]

--and--

Official Committee of Unsecured Creditors of Doe Realty Corp.

c/o, Chairman

[Name and Address of Creditor]

Gentlemen:

This letter describes the services that XYZ Associates, Inc. ("XYZ") will perform as special real estate consultant to Doe Realty Corp., as debtor and debtor in possession (collectively, "Doe") under chapter 11 of the Bankruptcy Code, and to the Official Committee of Unsecured Creditors of Doe (the "Committee"), and the compensation to be paid to XYZ in connection therewith. Doe is operating under the jurisdiction of the United States Bankruptcy Court for the Southern District of New York (the "Court").

The properties owned or leased by the debtor identified on Schedule A hereto, consisting of stores that are presently closed (some of which will be reopened for limited periods for the conduct of liquidation sales), are individually referred to as "a Property" (which term includes leasehold improvements, if any) and collectively referred to as the "Properties". The removable personal property, fixtures and equipment located at or about a Property are referred to as the "Personalty". Each Property and the related Personalty is sometimes collectively referred to as an "Asset".

XYZ agrees with you that:

1. XYZ will perform an analysis and evaluation of each Property described on Schedule A hereto and of the remaining store properties of the debtor identified on Schedule B hereto (individually, a "Remaining Property," and collectively, the "Remaining Properties"), for the purpose of establishing an estimate of the maximum values achievable upon the disposition thereof. The analysis and evaluation will include:

- a) in conjunction with Doe's counsel, a review of the relevant documentation relating to the Properties and the Remaining Properties for the purpose of identifying legal restrictions that may affect the disposition thereof;
- b) a site inspection of each Property and Remaining Property to determine the physical condition thereof, the potential uses of each Property and Remaining Property and the potential market therefor under a disposition program;
- c) an analysis of the general market conditions in the area in which each Property and Remaining Property is located;

- d) an estimate of the period within which each Property and Remaining Property may be disposed of; and
- e) a written valuation of and recommendation for the disposition of each Property and Remaining Property.

XYZ shall complete the evaluation and analysis with respect to the Properties within 45 days after the date of entry of an order of the Court approving this Agreement (the "Approval Date"), and complete the evaluation and analysis with respect to the Remaining Properties by December 31, 1994.

2. XYZ will serve as real estate consultant to Doe and to the Committee with respect to the disposition of the Properties and the Remaining Properties, shall assist Doe in the implementation and execution of the disposition program, and except as otherwise expressly provided herein shall furnish all personnel and materials required therefor. Doe shall supervise and retain primary responsibility for disposition of the Properties and Remaining Properties. The services to be provided by XYZ shall be subject to Doe's direction and, where appropriate, to the direction of the Committee. XYZ shall at all times perform its responsibilities hereunder as a fiduciary but shall have no authority to bind Doe or the Committee in respect of any transaction or other commitment.

3. Upon completion of the analysis and evaluation of the Properties provided for in paragraph 1 hereof, XYZ and Doe shall establish marketing values (i.e., "asking prices") for each Property. XYZ shall thereafter commence its marketing program, as generally described below, for each Property. Prior to the implementation of a marketing program for a Property, XYZ will advise Doe with respect thereto, and Doe shall have the right to disapprove or modify the proposed program. Doe shall advise XYZ whether the Personalty is to be included in any proposed disposition. XYZ shall, at its own cost and expense, perform the following services:

- a) conduct direct telephone and letter solicitation of potential purchasers of any one or more Properties;
- b) prepare and distribute marketing brochures, which will include pertinent lease, mortgage and operating information and documentation (which Doe shall provide to XYZ);
- c) communicate with parties that have expressed interest in any of the Properties, and with the landlord under each lease of a Property;
- d) prepare advertising copy, and publish the same in accordance with an advertising program to be agreed upon with Doe, provided that the cost of such program to XYZ shall not exceed \$ in the aggregate;
- e) respond and provide information to, negotiate with, and obtain offers from, prospective purchasers of any one or more Properties, and make recommendations to Doe and to the Committee as to whether a particular offer should be accepted;
- f) arrange physical inspections of the Properties for prospective purchasers;
- g) meet periodically, and when requested, with Doe, its accountants and attorneys, and with the Committee and the Committee's accountants and attorneys, to review the status of the marketing program for the Properties;
- h) recommend to Doe and to the Committee the proper method of handling particular problems encountered with respect to the disposition of a Property and/or Personalty;
- i) if requested by Doe, organize and conduct any public auction sale of Properties, and solicit the attendance of all interested parties through direct communications in addition to any required legal notice procedure;

- j) negotiate with the successful bidder and with the landlord of each Property consisting of a leasehold estate with regard to the acceptance by the landlord of the successful bidder as an assignee of the lease thereof;
- k) negotiate with mortgagees and other interested parties to obtain consents and agreements, where necessary;
- l) endeavor to obtain releases for Doe from contingent obligations relating to the Properties;
- m) assist Doe in the conduct of "adequate assurance" hearings required in connection with the assignment of leases of Properties;
- n) assist Doe in responding to any adversary proceedings or contested matters relating to the disposition of any Property;
- o) work with Doe's counsel responsible for the implementation of each proposed transaction, informing them of the specific terms of each transaction, reviewing documents, negotiating sale agreements and attempting to resolve problems that may arise, provided, however, that XYZ shall be primarily responsible for arranging and supervising the closing of each disposition transaction; and
- p) if required, appear in the Court in respect of any other matters concerning the marketing or disposition of the Properties.

4. The retention of XYZ hereunder is subject to the following further terms and conditions:

- a) XYZ's retention shall be on an exclusive basis with respect to all Properties during the term hereof.
- b) All communications and inquiries received by Doe or the Committee regarding the Properties shall be directed to XYZ.
- c) Doe may in its sole discretion accept or reject any offer obtained by XYZ.
- d) No fees or other compensation (other than as hereinafter specifically provided) shall be due to XYZ unless and until the sale or other disposition of a Property actually closes.
- e) Neither the submission by XYZ of particular valuations pursuant hereto, nor the establishment of particular marketing prices, nor the receipt of any offers to purchase, whether or not approved or recommended by either Doe or XYZ, shall be deemed to or shall bind the Committee, which reserves, notwithstanding any of the foregoing as to any Property, all of its rights under the Bankruptcy Code with respect to the making of recommendations to Doe and to the Court for the approval or disapproval of any sale or other disposition of a Property.

5. XYZ shall be compensated by Doe for its services hereunder as follows:

- a)(i) XYZ shall be entitled to receive a fee equal to Three (3%) Percent of the first \$10,000,000 of Net Sales Proceeds (as hereinafter defined); Five (5%) Percent of Net Sales Proceeds in excess of \$10,000,000; and Seven and One-Half (7-1/2%) Percent of Net Sales Proceeds in excess of \$20,000,000.
- (ii) The term "Net Sales Proceeds" as used herein shall include, with respect to the disposition of a Property or Asset, the sum of (A) the total cash portion of the purchase price; (B) all amounts payable to Doe under any deferred payment arrangement; and (C) the amount of any liabilities of Doe constituting administrative or priority claims against the estate which accrued prior to the Effective Date of this Agreement (as hereinafter defined) and which are released or forgiven in connection with the disposition of a Property or Asset, less (D) an amount equal to the actual costs, as

hereinafter defined, to Doe (net of any reimbursement to Doe for such costs) for use and occupation of such Property arising under *section 365(d)(3) of the Bankruptcy Code* for the period (the "Carrying Period") commencing with the later to occur of (i) the date upon which Doe shall have executed this Agreement, or (ii) the Approval Date (the later of such dates being herein termed the "Effective Date"), and continuing until the date as of which Doe is relieved of responsibility for the costs of use and occupation, whether by reason of closing having occurred, by agreement with the purchaser or transferee of the Property or otherwise. For the purpose of this subparagraph 5 a)(ii), (x) a disposition of a Property or Asset shall include the surrender or termination of a leasehold estate of Doe, and (y) Net Sales Proceeds shall include only sums actually received by Doe.

(A) The costs of use and occupation referred to herein (collectively referred to as the "Carrying Costs") shall include fixed rent, real estate taxes, rent escalations for the applicable period, percentage rent actually accruing during the applicable period, security costs, common area charges and costs of water, sewer and other utilities which accrue with respect to the Carrying Period as to any Property. Notwithstanding the foregoing, the Carrying Period as to any Property shall in no event include any period of time during which such Property is being operated or actually used by any party, and regardless of whether such party is actually compensating Doe for occupancy, except that if substantially less than the entire Property is being so utilized during a time that would, but for this sentence, occur during the Carrying Period, the Carrying Costs that would otherwise be deducted from Net Sales Proceeds shall be reduced pro rata on an equitable basis.

(B) The cost of advertising, legal fees and closing costs or adjustments shall not be deducted from the computation of Net Sales Proceeds, nor from the computation of the fee to be paid to XYZ.

(C) The Net Sales Proceeds shall also include amounts, if any, paid to Doe by any other parties in connection with the release of such parties from liability under leases of Properties.

(D) The Carrying Costs shall not include, and the Net Sales Proceeds shall not be reduced by, amounts paid by Doe for alteration, maintenance, repair or restoration of any Property, notwithstanding that such costs may be required to be paid by the lessee under the terms of the applicable lease; provided that Net Sales Proceeds will be reduced by the amount of any closing adjustment to the purchaser to cover the cost of accrued repair obligations.

(E) To the extent that the Net Sales Proceeds are payable to Doe in installments, XYZ's fee as to a particular Property, if in excess of the minimum of \$5,000 which is provided to be paid upon closing of a transaction in accordance with subparagraph 5 c) below, shall be paid in installments, as the deferred payments of the Net Sales Proceeds are made to Doe, each such installment of the fee to bear the same relation to the total fee earned in respect of such Property as the installment of Net Sales Proceeds paid to Doe bears to the total Net Sales Proceeds in respect thereof.

b) Notwithstanding anything to the contrary contained in subparagraph 5 a) above, if XYZ shall recommend in writing to Doe and the Committee the sale of a particular Property to a prospective purchaser pursuant to the formal written offer to purchase submitted by such party and if Doe or the Committee shall reject such offer, and if such Property is subsequently sold during the term of this Agreement, XYZ's compensation in respect of such Property shall be calculated based upon the lesser of (A) the Net Sales Proceeds derived from the sale or other disposition of such Property, or (B) the purchase price proposed in the written offer that was recommended and rejected as aforesaid (which purchase price shall be deemed to constitute Net Sales Proceeds for purposes of subparagraph 5 c) below and paragraph 6 hereof); provided, however, that for purposes of calculating the amount of Net Sales Proceeds so derived, there shall not be deducted the amount of any Carrying Costs of such Property which relate to a period subsequent to the last to occur of (i) completion by XYZ of its evaluation of such Property in accordance herewith, (ii) receipt of an offer in writing to purchase such Property, (iii) recommendation by XYZ of acceptance of such offer, and (iv) the lapse of such additional period of time as would have been reasonably necessary to complete the closing of the sale of such Property pursuant to such offer, assuming it had been accepted.

c) Notwithstanding anything to the contrary contained herein, XYZ shall receive a fee equal to the greater of (A) \$5,000 (the "Minimum Fee") or (B) the amount provided to be paid under subparagraph 5 a) above with respect to each Property that is sold, assigned, or disposed of in any manner other than by reason of the disaffirmance of a lease of such Property. If a lease is rejected and disaffirmed, XYZ shall not be compensated with respect thereto. If XYZ shall earn fees in excess of \$300,000 in respect of transactions which, in the aggregate, provide Net Sales Proceeds of \$10,000,000 or less, and if Net Sales Proceeds realized shall thereafter exceed \$10,000,000, the amount by which the fees for transactions producing Net Sales Proceeds of \$10,000,000 shall have exceeded \$300,000 (such excess being called the "Excess Amount") shall be credited against any fees thereafter earned by and payable to XYZ in respect of particular transactions, to the extent that fees earned in respect of any particular transaction exceed Three (3%) Percent of the Net Sales Proceeds derived from such transactions, until such time as the Excess Amount shall have been reimbursed to Doe by means of such credits.

d) In the event that Doe shall enter into a written agreement for the assignment, sale or other transfer or disposition of a Property or Asset before the expiration of the term of this Agreement, but the closing shall not occur until after the expiration hereof, XYZ shall be entitled to a fee in respect of such transaction in accordance with the terms of this Agreement. If Doe shall assign, sell or otherwise transfer or dispose of a Property or Asset to a party with which XYZ negotiated on behalf of Doe, prior to the expiration of the term of this Agreement with respect to such Property or Asset, and if the closing of such transaction shall occur within 12 months after the expiration of the term of this Agreement, XYZ shall be entitled to a fee in accordance with the terms of this Agreement.

e) Except as provided in paragraph 6 hereof, no fees shall be paid by Doe to XYZ in connection with this Agreement unless and until the payment of such fees is expressly approved in an order of the Court.

6. Doe shall pay to XYZ a retainer of \$75,000 as compensation for the evaluation to be prepared by XYZ under paragraph 1 hereof. If the aggregate amount of Net Sales Proceeds shall equal \$10,000,000, Doe shall be entitled to a credit against any fees thereafter earned by and payable to XYZ in respect of subsequent transactions that increase the aggregate amount of Net Sales Proceeds beyond \$10,000,000, but only against that portion of subsequently earned fees that exceeds the greater of (A) the Minimum Fee as to any such subsequent transaction or (B) Three (3%) Percent of the Net Sales Proceeds derived from such transaction (provided that a credit to the extent of such excess fee in respect of a particular transaction shall not have been taken under subparagraph 5 c) above), until such time as Doe shall have been reimbursed for the full amount of the \$75,000 retainer by means of such credits.

7. Doe shall be liable for and shall pay when billed (or, if same shall have been previously paid by XYZ, shall, when billed by XYZ, reimburse XYZ for) all costs and expenses in excess of \$..... [see subparagraph 3 d)] incurred in connection with any advertising of any of the Properties or Assets for sale, lease or other disposition, provided that XYZ shall notify Doe and the Committee of any costs and expenses that are proposed to be incurred for advertising purposes (other than for legal notices or legal advertising) and Doe shall have the right to approve such costs and expenses in advance, which approval shall be deemed given unless Doe and the Committee shall notify XYZ of its disapproval within ten (10) days after XYZ shall have notified Doe and the Committee of the proposed placement and form and content of such advertising and the amount of such proposed costs and expenses.

8. XYZ shall hold in confidence all information relating to the Properties and Assets which may be provided to it from time to time by Doe or the Committee, and shall not disclose such information, other than in the regular and ordinary course of marketing the Properties or Assets, except with the prior approval of Doe or as directed by the Court.

9. XYZ shall be responsible for, and shall indemnify Doe from and against, the claims of third-party brokers with whom XYZ has dealt during the term of this Agreement, other than brokers engaged or retained by Doe or with whom Doe shall have dealt independently of XYZ.

10. This Agreement may be terminated by Doe upon thirty (30) days' prior written notice to XYZ and the Committee,

which shall not in any event be effective earlier than ninety (90) days following the Effective Date of this Agreement. XYZ shall have the right to terminate this Agreement upon like notice. This Agreement is subject to and contingent upon the entry of an appropriate order of the Court approving the terms and conditions hereof, which Doe shall use its best efforts to obtain. This Agreement shall be binding upon and shall inure to the benefit of the parties hereto, their respective successors and assigns.

11. If XYZ shall propose to undertake a future engagement on behalf of any proposed client selling or proposing to sell real estate assets that are located in geographical areas in which any Property is situated and which are reasonably comparable to such Property in terms of size and prospective utilization, XYZ will inform and confer with Doe and with the Committee before proceeding therewith.

12. Wherever this Agreement contemplates that reports or communications are to be made or given by XYZ to the Committee, the Committee will designate a representative or representatives for purposes of receiving such reports and communications and will so advise XYZ, which may rely upon such designation until it is superseded. In addition to the foregoing, the Committee is to have full, free and complete access to information, books, records and personnel of XYZ respecting the subject matter of this Agreement.

If the foregoing correctly sets forth our understanding and agreement, please execute and return the duplicate copy of this letter which is enclosed herewith.

Very truly yours,

XYZ ASSOCIATES, INC.

By:

(Title)

AGREED AND ACCEPTED:

DOE REALTY CORP.

Debtor and Debtor in Possession

By:

(Title)

Dated: October, 20

OFFICIAL COMMITTEE OF UNSECURED

CREDITORS OF DOE REALTY CORP.

By:

Dated: October, 20

SCHEDULE A

[*List of Closed Store Properties*]

SCHEDULE B

[*List of Open Store Properties*]

FOOTNOTES:

(n1)Footnote 1. The order, application and annexed agreement deal with the retention by the debtor and debtor in possession of "XYZ Associates, Inc." as a consultant, finder and broker to advise the debtor as to the best method of disposing of its leaseholds and to effect transfers of the leaseholds.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.53

P 3.53 Form--Order Approving Solicitation of Bids on Certain Leases; Application for Order

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY CORP.

Debtor.

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In Proceedings For A Reorganization Under Chapter

11.

Case No.

Order Approving Solicitation of Bids on Certain Leases

Upon the annexed application of Doe Realty Corp., debtor and debtor in possession (collectively "Debtor"); the proposed "Solicitation For Sale Of Leases" annexed to the application as Exhibit B; the solicitation for bids proposed by the Debtor in its application requiring the approval of this Court upon notice and a hearing pursuant to § 363(b) of the *Bankruptcy Code*; and it appearing that the solicitation for bids to purchase the Debtor's interest in and to each of the leases for the locations set forth in Exhibit "A" to the annexed application is in the best interests of its estate;

NOW, THEREFORE, IT IS

ORDERED, that the "Solicitation For Sale of Leases" annexed as Exhibit B to the annexed application be and it hereby is approved; and it is further

ORDERED, that the Debtor shall mail a copy of the "Solicitation For Sale of Leases" to all members of the Committee of Unsecured Creditors, counsel to the Committee, landlords of each of the affected premises, all persons or entities that heretofore have expressed an interest in acquiring the store locations owned by or leased to the Debtor, the United States Trustee and parties that have requested notice in these proceedings; and it further

ORDERED, that the "Solicitation For Sale Of Leases" approved hereunder shall be published in *The New York Times*, *The Wall Street Journal* and in such other publications and on such dates as the Debtor may determine.

Dated: New York, New York

November, 20.....

.....

United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY CORP.

Debtor.

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In Proceedings For A Reorganization Under Chapter
11.
Case No.

Application for Order Approving Solicitation of Bids on Certain Leases

To The Honorable, Bankruptcy Judge:

Doe Realty Corp., debtor and debtor in possession (collectively "Debtor"), by its attorneys, ..., respectfully shows and alleges:

1. Heretofore on August 5, 2006 the Debtor filed its petition for reorganization under chapter 11 of the Bankruptcy Code and was continued in the management and operation of its businesses and properties as debtor in possession. No trustee or examiner has been appointed.
2. Immediately prior to the filing of the chapter 11 petition herein, Debtor operated approximately 200 retail department stores throughout the continental United States, employing approximately 8,000 persons.
3. By order dated August 20, 2006 this Court approved the closing of sixty-six (66) stores operated by the Debtor, and extended until January 31, 1995 the date on which the debtor shall assume or reject its nonresidential leases of real property under *section 365(d)(4) of the Bankruptcy Code*. Such stores were closed to the public on August 21, 2006. Certain additional stores were closed to the public following orders of this Court dated October 22, 2006 and November 4, 2006. Twelve stores had been closed to the public by Doe Realty Corp. prior to the filing of the petition herein. The Debtor has been engaged in an extensive effort to market its leasehold and other interests in and to each of these locations.
4. The Debtor and XYZ Associates, Inc. ("XYZ"), real estate consultants in these proceedings, have determined that public solicitations for sale of the Debtor's interests in and to the store locations will constitute the most effective means of ensuring that the Debtor receives the highest possible offer for each of the leases being sold. A list of the leases is annexed hereto as Exhibit A.
5. The Debtor and XYZ propose to hold a public auction at which bids will be solicited for the various leasehold and other interests for the locations identified in Exhibit A. Offers will be subject to this Court's approval on the Debtor's application to assume and assign a lease or other interest. The Debtor will make separate applications to this Court for an order authorizing each assignment following the conclusion of the proposed auction. Use and distribution of all proceeds received by the Debtor arising from such assignments shall be subject to further order of this Court.

6. Annexed hereto as Exhibit B is a proposed "Solicitation For Sale Of Leases," which document sets forth the store number, location and approximate size of each store property together with the date, location, and terms and conditions of the proposed auction.

7. Bankruptcy Rule 6004(f)(1) provides that sales not in the ordinary course may be conducted by public auction or private sale. Rule 3(c) of the Local Rules of the Bankruptcy Court for the Southern District of New York specifies that, "[u]nless otherwise ordered by reason of special circumstances, sales shall be by public auction." The Debtor proposes to solicit bids for its interests in and to the affected leased locations by public auction to be conducted in the United States Bankruptcy Court, Alexander Hamilton Customs House, One Bowling Green, New York, New York pursuant to the terms and conditions of sale set forth in Exhibit B annexed hereto.

8. It is respectfully submitted that the public solicitation by auction proposed herein is in the best interests of the Debtor's estate and its creditors. Such solicitation in respect of the locations set forth in Exhibit A will serve to ensure that the Debtor will have marketed each of the leased locations widely and attempted to obtain maximum value therefor.

9. Under § 363(b) of the Bankruptcy Code, a trustee, after notice and a hearing, may sell, other than in the ordinary course of business, property of the estate. Under § 1107 of the Bankruptcy Code a debtor in possession has the rights and obligations of a trustee. The Debtor requests this Court to approve distribution of the proposed "Solicitation For Sale Of Leases" and to fix a date on which the proposed auction will take place, at which time the Debtor will consider any and all offers that may be made with respect to the leased locations.

10. Bankruptcy Rule 6004(a) provides that notice of a proposed sale of property other than in the ordinary course be given pursuant to Bankruptcy Rules 2002(a)(2), (c)(1), (i), and (k). Bankruptcy Rule 2002(a) provides for not less than 20 days notice to the debtor, the trustee and all creditors and indenture trustees of a sale outside of the ordinary course. Bankruptcy Rule 2002(i) provides that copies of all Rule 2002 notices shall be sent to each committee appointed in a case and its authorized agent, and the Court may dispense with the broad notice requirements of Bankruptcy Rule 2002(a)(2) and may instead require notice only to the committees or their authorized representatives and to creditors and equity security holders who have filed a request for notices with the Court. It is respectfully submitted that notice to the Committee of Unsecured Creditors herein, landlords of each of the affected premises, all persons or entities that have expressed an interest in the leased locations, the United States Trustee and parties that have requested notice in these proceedings, all as set forth in the proposed order, constitutes sufficient notice of the auction proposed herein in accordance with Bankruptcy Rule 2002(i). The notice contains the auction date, the terms and conditions for solicitation of bids for the Debtor's interests in the leased locations, and the procedure for filing objections to a proposed sale in accordance with Bankruptcy Rule 6004(b). The utilization of the Bankruptcy Rule 2002(i) procedure will provide ample notice to all affected parties while resulting in more economical administration of the estate.

11. Rule 3(c) of the Local Rules of the Bankruptcy Court for the Southern District of New York specifies publication requirements for public sales as proposed herein. The Rule also authorizes the Court to dispense with or modify such requirements.

12. It is respectfully requested that this Court authorize the Debtor to publish notice of the proposed sale in *The New York Times*, *The Wall Street Journal* and in such other publications and on such dates as the Debtor may determine. The Debtor recognizes that its interests will be best served by widely publicizing the proposed auction by placing notice in a variety of publications on various dates before the sale takes place.

13. No prior application for the relief requested herein has been made to this or to any other Court.

WHEREFORE, the Debtor prays for entry of the annexed order and for such other and further relief as to this Court may be just and proper.

Dated: New York, New York

November 12, 20.....

DOE REALTY CORP.

Debtor and Debtor in Possession

By its Attorneys

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.....

.....

By:

A Member of the Firm

EXHIBIT A

Leases For Which Bids Will Be Solicited

STORE NO.....LOCATION

Exhibit B

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY CORP.

Debtor.

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In Proceedings For A Reorganization Under Chapter

11.

Case No.

Solicitation for Sale of Leases

To All Interested Parties:

PLEASE TAKE NOTICE that on the 7th day of December, 2006, at 1:00 p.m. in Room 201, of the United States Bankruptcy Court, Alexander Hamilton Customs House, One Bowling Green, New York, New York 10004-1408, Doe Realty Corp., as debtor and debtor in possession (collectively "Doe"), will conduct a public auction of its leases and other interests relating to the following retail store locations:

Store No.	Store Location	Approximate Store Size (Sq. Ft.)

Bids for any or all of the leases and other interests will be considered subject to the Terms and Conditions of Sale set forth below.

Interested persons may submit written bids prior to the auction to XYZ Associates, Inc. ("XYZ") [address] [telephone number].n* Such bids must be accompanied by a check or money order subject to collection payable to.....
, as attorney for Doe, in an amount equal to 10% of the bid. Such payment will represent a nonrefundable deposit in the event that an order is entered approving an assumption of a lease and an assignment to the bidder.

Doe also reserves the right to withdraw any lease from the auction sale for any reason without notice, except announcement at the auction.

All offers are subject to the following terms and conditions which may be changed or modified by Doe up to and including the date of the auction.

Terms and Conditions of Sale

1. A nonrefundable deposit of 10% of the purchase price shall be paid by the successful offeror (the "Offeror") to attorneys for Doe, upon receipt of an offer at the auction sale as set forth in Paragraph 6 herein, such deposit to be made by check or money order subject to collection. Doe, in its discretion, may waive in whole or in part the amount of the deposit or permit the deposit to be made at a later time. Doe may, in its discretion, insist that a deposit be made by wire transfer or bank or certified check to be received by its attorney within one (1) business day after such request is made. Upon receipt of such deposit, [name of law firm] shall hold the proceeds in a segregated account until the closing of each transaction affecting a lease upon which offers are sought.
2. The balance of the purchase price shall be paid by wire transfer or unendorsed bank or certified check upon the execution and delivery of the closing documents.
3. The closing shall take place and the closing documents, including an Assignment and Assumption Agreement and Bill of Sale (where necessary) in form approved by the Court, shall be delivered on the next business day following entry of an order of the Court approving the assumption of the lease and assignment thereof to the Offeror or such later time as may be designated by Doe. Scheduling of the closing shall be at Doe's sole discretion but in any event no later than thirty (30) days after the entry of the order.
4. All due and unpaid rental obligations shall be paid at the closing. All adjustments to be made in connection with the closing including, without limitation, adjustments, if any, for rentals under the lease(s), shall be made as of December 15, 2006 (the "Adjustment Date"). Any adjustments attributable to escalation or pass-through charges which would be billed after the closing date shall be made based upon the most recent billing for such charges. The Offeror shall be liable for all lease obligations from the Adjustment Date forward and shall indemnify Doe with respect thereto.
5. In the event that Doe for any reason does not consummate a sale or execute and deliver the closing documents, the sole liability of Doe to the Offeror shall be for the return of the deposit without interest.
6. DOE SHALL RECEIVE THE HIGHEST BID OFFERED AT THE AUCTION WITH THE INTENTION OF ASSIGNING ITS INTEREST TO THE SUCCESSFUL BIDDER. FORMAL ACCEPTANCE OF THE BID WILL NOT OCCUR UNLESS AND UNTIL DOE SUBMITS THE BIDDER'S OFFER TO THE COURT FOR APPROVAL AND AN ORDER APPROVING THE OFFER IS ENTERED. DOE WILL HAVE NO OBLIGATION TO FORMALLY ACCEPT ANY OFFER PRESENTED AT THE AUCTION. IN THE EVENT DOE DETERMINES NOT TO SUBMIT A BID AND THE TRANSACTION CONTEMPLATED THEREBY TO THE COURT FOR APPROVAL, DOE'S SOLE OBLIGATION WILL BE TO REFUND, WITHOUT INTEREST, THE DEPOSIT DELIVERED BY THE OFFEROR.
7. Any sale, assignment or other disposition shall be without representations or warranties of any kind by Doe, its agents

or its estate. All leases and the premises covered thereby shall be transferred "as is" and "where is."

8. Doe reserves the right: (a) to determine in its sole discretion which offer for each location is the highest or best offer; and (b) to reject at any time prior to entry of an order of the Court approving an offer, any offer that in Doe's sole discretion is deemed to be inadequate or insufficient or not in conformity with the requirements of the Bankruptcy Code, the Terms and Conditions of Sale, or contrary to the best interest of the estate and its creditors.

9. All Offerors shall provide to Doe on the next business day after a request: (a) a current financial statement and such other proof of financial condition as Doe may reasonably request; and (b) a written statement of Offeror's intended use of the premises.

10. Doe, at or before the auction sale, may impose such other terms and conditions as it may determine to be in the best interest of its estate, creditors and other parties in interest.

11. Unless otherwise indicated by Doe at the auction sale, sales shall not include personal property, fixtures, trade fixtures, or other furnishings or equipment (collectively, the "FF&E") located in the premises except for heating, ventilating and air conditioning equipment owned by Doe and located therein. Doe reserves the right to either sell the FF&E to the Offeror or any other party or to abandon any or all of the FF&E at the premises covered by the lease(s). In the event of abandonment of the FF&E, the Offeror shall be responsible for removal thereof.

12. All of Doe's right, title and interest in and to the leases shall be sold free and clear of all liens, claims, encumbrances and security interests, with such liens, claims, encumbrances and security interests, if any, to attach to the proceeds of the sale.

13. Upset prices may be announced prior to the offering of any lease. All bidding shall be in units determined by Doe in its sole discretion. Bidding at the solicitation for store locations on which Doe has received a written offer prior to the date of the solicitation shall commence in an amount at least ten (10%) percent higher than the amount of the written offer.

14. Store locations will be sold in a sequence determined by Doe, and Doe may offer such leases individually or in groups. Any person desiring to bid on a group of two or more locations must submit an unconditional written bid to XYZ at its address set forth above no later than 5:00 p.m. New York City time on Such bid must be accompanied by a check or money order subject to collection payable to, attorney for Doe, in an amount equal to 10% of the bid, which will serve as a nonrefundable deposit in the event that the bidder is the successful Offeror, such deposit to be governed by paragraphs 1, 5 and 6 of the Terms and Conditions of Sale set forth above.

15. Neither oral nor written offers made at or before the auction sale may be withdrawn once made without the express written approval of Doe. The acceptance of any offer shall be subject to the provisions of Paragraph 6 herein and approval by the Court of the assumption and assignment of the lease or leases that are the subject of such offer.

16. The second highest offer for any leasehold shall remain open and irrevocable until In the event that Doe shall have failed prior to to consummate a transaction for such leasehold with the maker of the highest and best offer therefor pursuant to these written terms and conditions, Doe may, at its option, upon notice to the maker of such second highest offer given prior to, consummate such transaction with such maker pursuant to these written terms and conditions.

17. All bidders acknowledge that they have had an opportunity to review the leases and all pertinent documents with respect thereto prior to making offers and rely solely thereon and on their own investigation and inspection of the premises and the documents in making their offers. The leases and other pertinent documents will be available for inspection at the auction sale and will be available prior to the auction sale during business hours at the offices of XYZ.

18. All sales, transfer and recording taxes, if any, relating to the sale and assignment shall be the sole responsibility of the Offeror and shall be paid to Doe at the closing.

19. Doe and its estate shall not be liable for the fees of any broker, except fees payable to XYZ, which shall look only to the estate for payment of its fees.

PLEASE TAKE FURTHER NOTICE that objections, if any, for the sale of any leases shall be in writing, shall set forth the name of the objectant, the nature and amount of its claim or other interest, and the basis of such objection and shall be filed with the Court and served upon: [*name and address of Doe's attorney*]; XYZ, at the address set forth above; Doe Realty Corp. [*address*]; and, Attorneys for the Creditors' Committee, [*address*]. Objections must be served and filed as stated herein no later than 5:00 p.m. on

Dated: New York, New York

[*Date*]

.....

Counsel to Doe Realty Corp.

Debtor and Debtor in Possession

[*address and telephone no.*]

FOOTNOTES:

(n1)Footnote *. * "XYZ Associates, Inc." is functioning as the debtor's real estate consultant, finder and broker in connection with the lease disposition program dealt with in this form.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.54

P 3.54 Form--Order Approving Assumption of Lease and Assignment; ApplicationUNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK*In re*

DOE REALTY CORPORATION,

Debtor.

)
)
)
)
)
)In Proceedings for a Reorganization Under Chapter
11. Case No. ...**Order Approving Assumption of Lease and Assignment Re: Premises Located at (Store No.)n1**

Upon the annexed application dated, 2005 (the "Application") of Doe Realty Corporation ("Doe" or the "Debtor"), debtor and debtor in possession herein, seeking authority, *inter alia*, to assume in accordance with § 365 of the Bankruptcy Code and Bankruptcy Rule 6006(a) that certain lease dated (the "Lease") by and between Doe, as lessee, and (the "Landlord"), as lessor, for certain premises located at (the "Premises") and to assign the Premises to [assignee]; and the Court having examined and reviewed the Application; after due deliberation and sufficient cause appearing therefor and upon the consents affixed hereto by the Committee of Unsecured Creditors, by its counsel, ... (the "Committee"), the United States Trustee's office and the Landlord; it is

FOUND THAT the requirements set forth in sections 365(b) and 365(f) of the Bankruptcy Code are satisfied and that the assumption and assignment of the Lease is an exercise of sound business judgment and is in the best interests of the Debtor's estate and creditors, and it is further

FOUND THAT the consents of the Committee, the United States Trustee and the Landlord to this Order satisfy the "notice and a hearing" standards set forth in § 102(1) of the Bankruptcy Code as required by § 363(b) of the Bankruptcy Code, and no further notice of, or hearing on, the relief sought in the Application is required, it is

NOW, on motion of, counsel to Doe, debtor and debtor in possession,

ORDERED, ADJUDGED AND DECREED THAT:

1. Doe be, and it hereby is, authorized to assume the Lease in accordance with the provisions of *11 U.S.C. § 365(a)*;
2. Any default under the provisions of the Lease arising from Doe's commencement of the instant reorganization proceedings is of no force and effect pursuant to the provisions of *11 U.S.C. § 365(b)(2)(B)*;
3. Doe's only defaults under the Lease are the nonpayment of rent [*additional rent, real estate taxes, common area maintenance, etc.*] for the months of, which defaults are in the aggregate amount of \$ (the "Defaults");
4. Doe be, and it hereby is, authorized and empowered pursuant to the provisions of *11 U.S.C. § 365(b)(1)(A)* to cure the Defaults by the payment of the sum of \$ to the Landlord within thirty (30) days following the entry of this Order, and upon the making of such payment the Defaults shall be deemed cured and shall not be actionable and the Lease shall be in full force and effect;
5. Doe has paid and performed all of its obligations under the Lease in accordance with *section 365(d)(3) of the Bankruptcy Code* from and after the date of entry of the order for relief herein to and including the date of this order;
6. The use of the Premises for [*insert use to be made by assignee*] does not violate any provision of the Lease;
7. Doe be, and it hereby is, authorized and empowered to execute such documents and do such things as may be necessary to implement and effectuate the assumption of the Lease and the assignment of Doe's interest in and to the Premises to [*assignee*] and such assignment is approved in all respects; and
8. Pursuant to *section 365(k) of the Bankruptcy Code*, effective as of the date of the assignment of the lease to [*assignee*], Doe and its estate shall be relieved from any and all liability for any breach of the Lease occurring thereafter.

Dated: New York, New York

....., 20.....

.....

United States Bankruptcy Judge

ENTRY OF THE FOREGOING ORDER
IS HEREBY CONSENTED TO BY:

.....

Counsel to the Committee of Unsecured Creditors

By:

A Member of the Firm

UNITED STATES TRUSTEE'S OFFICE

By:

[LANDLORD]

By:

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK*In re*DOE REALTY
CORPORATION,
Debtor.)
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)
)In Proceedings For a Reorganization Under Chapter
11.
Case No.....**Application**

To The Honorable , Bankruptcy Judge:

The application of Doe Realty Corporation ("Doe"), by its attorneys, ..., respectfully represents:

1. Heretofore on August 5, 2006, Doe filed a petition for reorganization under chapter 11 of the Bankruptcy Code and was continued in the management and operation of its businesses and properties as debtor in possession. No trustee or examiner has been appointed.
2. Immediately prior to the filing of the chapter 11 petition herein, Doe operated approximately 200 retail department stores throughout the continental United States, employing approximately 8,000 persons.
3. By order dated August 20, 2006 this Court approved the closing of sixty-six (66) stores operated by Doe, and extended until January 31, 2007 the date on which Doe shall assume or reject its leases of nonresidential real property pursuant to *section 365(d)(4) of the Bankruptcy Code*. Such stores were closed to the public on August 21, 1994. Certain additional stores were closed to the public by orders of this Court dated October 22, 2006 and November 4, 2006. Twelve (12) stores had been closed to the public by Doe prior to the filing of the petition herein.
4. Since the filing of the petition, Doe and its real estate consultants have been engaged in an extensive effort to market Doe's leasehold interests in and to each of the locations no longer necessary for Doe's continuing operations.
5. One of such locations is located at and identified by Doe as Store No. (the "Premises"). The Premises was leased from
..... (the "Landlord") by lease dated (the "Lease"). The Lease will expire on and contains options to renew. A copy of an abstract of the Lease is annexed hereto as Exhibit A.
6. Although Doe has ceased its retail operations at the Premises, the Premises are valuable to Doe insofar as the current market rent for the Premises exceeds the rent reserved under the Lease.

7. At a solicitation for bids for various leases held with the approval of this Court on November 9, 1994, Doe received an offer from (the "Assignee") to enter into an assignment for Doe's interest in and to the Premises. The Assignee has agreed to pay to Doe the sum of \$ for its interest in and to the Lease and the Premises. The Assignee has given Doe a deposit equal to 10% of the purchase price which Doe is currently holding in a special account maintained by its attorneys, ...
8. Before it may consummate the Assignment, Doe is required to assume the Lease in accordance with the provisions of § 365 of the *Bankruptcy Code* and *Bankruptcy Rule 6006(a)*, and to cure all defaults that exist under the Lease.
9. At the time of the assumption of the Lease, Doe, by the payment of the sum of \$ to the Landlord, will cure all defaults arising from nonpayment of rent or other charges due under the Lease which accrued prior to the entry of the order for relief herein. This sum represents: (a) unpaid rent for the months of; and (b) unpaid real estate taxes (\$) for the months of
10. From and after the entry of the order for relief herein, Doe has paid and performed all of its obligations under the Lease pursuant to *section 365(d)(3) of the Bankruptcy Code*.
11. The concept of "adequate assurance of future performance" has been incorporated into § 365 of the *Bankruptcy Code* to protect a landlord's economic interests in leasing its premises to financially responsible entities. Unless a landlord affirmatively raises the issue of "adequate assurance of future performance," this Court need not make an independent inquiry as to whether it has been provided. In the instant case, the Landlord has given its consent to the assumption of the Lease and the assignment herein. The Landlord's consent is affixed to the order annexed hereto.
12. The contemplated assignment will constitute a sale of property of the estate, and it is therefore necessary for Doe, as debtor in possession, to give notice of its intention to assign the Premises in accordance with the *Bankruptcy Code* and *Bankruptcy Rules 2002(a)(2), (c), (i) and 6004(a)*.
13. Under § 363(b) of the *Bankruptcy Code*, a trustee, after notice and a hearing, may use, sell or lease other than in the ordinary course of business, property of the estate. Under § 1107 of the *Bankruptcy Code*, a debtor in possession has the rights and obligations of a trustee.
14. "After notice and a hearing" is defined by § 102(1) of the *Bankruptcy Code* to mean "after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances." An actual hearing, however, is not required if such notice is given properly and if: (a) such hearing is not requested by a party in interest; or (b) there is insufficient time for a hearing to be commenced before such act must be done and the Court authorizes such act.
15. The "notice" contemplated by *Bankruptcy Rule 2002(a)(2)* for the use, sale or lease of property of the estate is normally twenty (20) days' notice to all parties in interest. This Court, however, for cause shown can shorten the twenty (20) days' notice requirement, can order a sale without notice, and can otherwise circumscribe ordinary notice requirements pursuant to *Bankruptcy Rules 2002(i) and 9006(c)*.
16. Doe respectfully requests this Court to find that the consents of the Committee of Unsecured Creditors (the "Committee"), the United States Trustee's office and the Landlord, which consents are affixed to the annexed order, constitute a sufficient basis upon which to determine, consistent with § 102(1) of the *Bankruptcy Code* and *Bankruptcy Rules 2002(i) and 9006(c)*, that no further notice of, or hearing on, the relief requested herein is required. This request is made to this Court inasmuch as: (a) only the Landlord, the Committee and Doe have a direct interest in the assumption and assignment of the Lease; (b) the Committee is capable of safeguarding the interests of the creditor body at large; (c) any security interests that may be claimed in and to the Lease are protected under the terms and conditions of sale for

the Lease, which provide that the Lease shall be sold free and clear of all liens or other interests with such liens or other interests, if any, to attach to the net proceeds of the sale; and (d) all of the requisite parties to this assignment transaction have given their consent thereto and no purpose would be served in delaying this Court's consideration of this application for an additional twenty (20) day period. Moreover, both the cost of such notice and the additional charges for use and occupation of the Premises that would accrue through the date of such hearing can and should be avoided.

17. No previous application for the relief sought herein has been made to this or any other Court.

WHEREFORE, Doe prays for entry of the annexed order and for such other and further relief as to this Court may be just and proper.

Dated: New York, New York

....., 20.....

DOE REALTY CORPORATION

Debtor and Debtor in Possession by its Attorneys

.....

.....

.....

.....

By:.....

[Address and Telephone Number]

FOOTNOTES:

(n1)Footnote 1. Under Bankruptcy *Rule 6006(a)*, a proceeding to assume or assign an unexpired lease other than as part of a plan is a contested matter governed by *Rule 9014*. If an assumption and assignment motion is not brought on with the consent of all affected parties (the above form is on consent), a notice of motion also should be served with the supporting application. See *P 3.51 supra* for a form of notice of motion.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.55

P 3.55 Form--Assignment and Assumption Agreement

Assignment and Assumption Agreement

The following sets forth the background of this Assignment Agreement:

A. By lease dated (which, as amended by instruments dated, ... and, is hereinafter referred to as the "Lease"), ... ("Landlord") leased to Doe Realty Corporation ("Doe") certain premises (the "Demised Premises") situated in the City of New York, County of New York, State of New York, as more fully described in the Lease, a Memorandum of which was recorded in the office of the City Register, New York County in Miscellaneous Book, Page

B. On or about August 5, 2006, Doe filed a petition with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") for relief pursuant to Chapter 11 of the Bankruptcy Reform Code (Title 11, United States Code).

C. By order of the Bankruptcy Court dated, 1994 (the "Order"), Doe, as debtor and debtor in possession (collectively, "Debtor"), was authorized and empowered to assume the Lease and to assign the Lease to ("Assignee"). Pursuant to the Order, Debtor now wishes to sell, assign and transfer all of its right, title and interest in and to the Lease, and the leasehold estate created thereby, to Assignee and Assignee wishes to accept the same.n1

NOW THEREFORE, in consideration of the mutual covenants and agreements herein contained and of other good and valuable considerations, the receipt and sufficiency of which are hereby acknowledged, Assignee and Debtor hereby agree as follows:

1. *Assignment.* Effective as of, 1994 (the "Effective Date"), Debtor hereby grants, conveys, sells, assigns and transfers to Assignee, and Assignee hereby purchases and assumes, all of Debtor's right, title and interest in and to, and obligations under, the Lease, Debtor's interest in the Demised Premises and all fixtures permanently affixed thereto, but expressly excluding all trademarks, tradenames, corporate names, inventory, equipment, machinery, removable trade fixtures and removable leasehold improvements, all of which shall remain the sole property of Debtor. Assignee hereby agrees with Debtor that, from and after the Effective Date, it will perform and observe all terms, covenants and conditions in the Lease contained and on the part of Debtor therein to be performed and observed, whenever the same

may have arisen.

2. *Obligations.* The performance of any and all obligations of Debtor arising out of, pursuant to, or in connection with the Lease shall be the sole obligation of Assignee.

3. *No Recourse.* The assignment by Debtor to Assignee contained herein shall be without recourse to Debtor or any guarantor of Debtor's obligations under the Lease, and Assignee specifically releases and forever discharges Debtor, its controlling, affiliated and subsidiary corporations and all such guarantors of and from, and shall indemnify and save harmless Debtor, its controlling, affiliated and subsidiary corporations and all such guarantors from and against, any and all claims, loss, liabilities, suits, causes of action, damage, cost and expense (including, without limitation, attorneys' fees) which now exist or may arise in the future out of, under or in connection with, the default or alleged default of any party at any time holding the lessee's interest in and to the Lease, whenever such default may have, or is alleged to have, arisen, or out of or in connection with the occupancy by any such party, at any time, of the Demised Premises or any part of them.

4. *Disclaimer of Warranties.* Except as otherwise expressly set forth in this Assignment Agreement, no representations or warranties are being provided to the Assignee by Debtor, its agents or attorneys, with respect to the Lease or the transactions contemplated by this Assignment, including but not limited to any warranty with respect to the maintenance, repair, condition, design or marketability of the Demised Premises; the dimensions, size or acreage of any real property described in the Lease or any improvements thereon; the availability or existence of any water, sewer or utility rights; or otherwise. Except as otherwise expressly set forth in this Assignment Agreement, the Demised Premises are to be transferred to the Assignee in their present condition and state or repair, "AS IS" and "WHERE IS," with all faults. Except as otherwise expressly set forth in this Assignment Agreement, the Assignee assumes the responsibility and risks of all defects and conditions of the Demised Premises, including such defects and conditions, if any, that cannot be observed by casual inspection. Assignee acknowledges that it has reviewed copies of the Lease heretofore provided to it by Debtor or Debtor's representatives.

5. *Assignee's Representations.* Assignee hereby represents and warrants to Debtor as follows: (a) Assignee has all requisite corporate or partnership power, as the case may be, to enter into this Assignment Agreement and to consummate the transactions contemplated hereby, (b) the execution and delivery of this Assignment Agreement and the consummation of the transactions contemplated hereby will not result in a breach of the terms or conditions of, or constitute a default under the certificate of incorporation and by-laws or partnership agreement of Assignee or of any mortgage, note, agreement or other instrument or obligation to which Assignee is a party or by which any of its assets or property may be affected, or violate any order, writ, injunction or decree of any court, administrative agency or governmental body, and (c) Assignee has retained no broker to represent Assignee in connection with this Assignment or the transaction represented hereby. Assignee shall indemnify and save Debtor harmless from and against any and all claims, loss, cost, damage, liability or expense (including, without limitation, attorneys' fees), arising out of or in connection with the claim of any broker that it has represented Assignee in connection with this Assignment or such transaction. Assignee acknowledges that no representations, promise or inducements of any kind, except as expressly set forth herein have been made to Assignee by Debtor or anyone else to induce Assignee to sign this Assignment Agreement.

6. *Debtor's Representations.* Debtor hereby represents and warrants to Assignee as follows: (a) Debtor has all requisite corporate power to enter into this Assignment Agreement and, [upon the entry of the Order and provided that the Order is not stayed,]n2 to consummate the transactions contemplated hereby, (b) the execution and delivery of this Assignment Agreement and the consummation of the transactions contemplated hereby will not result in a breach of the terms or conditions of, or constitute a default under the certificate of incorporation and by-laws of Debtor or of any mortgage, note, agreement or other instrument or obligation to which Debtor is a party or by which any of its assets or property may be affected, or violate any order, writ, injunction or decree of any court, administrative agency or governmental body, including without limitation any order of the Bankruptcy Court.

7. *Amount Due Broker.* All amounts due and owing to XYZ Associates, Inc. for services rendered in connection with this Assignment and the transaction represented hereby shall be paid by Debtor.

8. *Successors.* This Assignment shall be binding upon and inure to the benefit of the respective heirs, executors, administrators, successors and assigns of the parties hereto.

9. *Payments.* In consideration of the assignment of the Lease by Debtor to Assignee, Assignor shall pay to Debtor at the closing of the transactions contemplated hereby in cash or by wire transfer of immediately available funds pursuant to instructions provided by Debtor, an amount equal to \$ less any credits or prorations due Assignee pursuant to this Assignment Agreement. *[Include provisions regarding proration of rents, taxes payable and other charges payable under Lease].*

10. *Governing Law.* This Assignment Agreement shall be governed by and construed in accordance with the laws of the State of New York. The parties agree that the Bankruptcy Court shall have exclusive jurisdiction over any disputes hereunder, and they each consent to such jurisdiction.ⁿ³

11. *Construction.* Headings in this Assignment Agreement are for reference purposes only and shall not be deemed to have substantive effect.

12. *Amendments and Waivers.* This Assignment Agreement may be modified only by a written instrument duly executed by each party. No breach of any agreement contained herein shall be deemed waived unless expressly waived in writing by the party that may assert such breach.

13. *Miscellaneous.* This Assignment Agreement is not intended, and shall not be construed, as an amendment of modification of the Lease except with respect to the substitution of Assignee for Debtor thereunder. The provisions of this Assignment Agreement shall survive the closing of the transactions provided for herein.

14. *Counterparts.* This Assignment Agreement may be executed simultaneously in any number of counterparts, each of which when so executed and delivered shall be an original, but all of which taken together shall constitute one and the same instrument.

EDITOR'S NOTE:

IN THE EVENT THAT THE ASSIGNMENT AND ASSUMPTION AGREEMENT IS ENTERED PRIOR TO THE ISSUANCE OF THE BANKRUPTCY COURT ORDER, THE FOLLOWING ADDITIONAL CLAUSES OR SIMILAR CLAUSES SHOULD BE INCLUDED IN THE AGREEMENT:

15. *Closing Date/Conditions to Closing.* The closing of the transactions provided for herein (the "Closing") shall occur in New York, New York at the offices of, or at such other location as is mutually agreed upon by Debtor and Assignee, on a date (the "Closing Date") that is not later than three business days after the following conditions to Closing have occurred:

a. The Bankruptcy Court has issued the order (the "Order") that grants to Assignee the protections provided to a good faith purchaser under *section 363(m) of the Bankruptcy Code*, which Order is not subject to a stay issued by a court of competent jurisdiction;

b. The Order has become final and nonappealable, provided however that this condition to Closing may be waived by a writing signed by Assignee and delivered to Debtor; and

c. Debtor has assumed the Lease pursuant to *section 365(a) of the Bankruptcy Code* and has cured all defaults if any, as of the Closing Date.

Debtor shall deliver possession of the Demised Premises to Assignee at the Closing. Notwithstanding anything contained in this Assignment Agreement to the contrary, this Assignment Agreement may be terminated at any time prior to the Closing Date by Assignee in writing, without liability to Debtor (provided Assignee is not otherwise in material default of this Assignment Agreement) if the Closing does not occur on or before, 2007.

16. *Approvals.* Within ten (10) business days following receipt by Debtor's attorneys of a fully executed original of this Assignment Agreement, Debtor shall file with the Bankruptcy Court a motion seeking approval of this Assignment Agreement and authorizing consummation of the transactions contemplated hereby (the "Motion"), Assignment of the Lease, and performance in accordance with the terms described herein, are expressly subject to and contingent upon approval of the Bankruptcy Court. Assignee shall, at Assignee's sole cost and expense, cooperate in good faith with the reasonable requests of Debtor regarding the preparation, filing and prosecution of the Motion and in any proceedings in connection therewith or in furtherance thereof. Assignee shall be responsible for providing adequate assurance of future performance under the Lease within the meaning of *section 365 of the Bankruptcy Code*. Except for the provisions of this section, this Assignment Agreement shall be of no force or effect unless and until it is approved by the Bankruptcy Court.

IN WITNESS WHEREOF, the parties hereto have executed this Assignment Agreement as of, 20

[Assignee]

By:

DOE REALTY CORPORATION

By:

[Acknowledgments]

FOOTNOTES:

(n1)Footnote 1. This recital can be eliminated if the Assignment and Assumption Agreement is executed prior to the issuance of the order of the Bankruptcy Court authorizing Debtor to assume the Lease and assign the Lease to Assignee. In that event, the Assignment and Assumption Agreement should contain a clause that conditions the Effective Date on the issuance of such order.

(n2)Footnote 2. This bracketed phrase should be used if the Assignment Agreement is executed prior to the date that the Order is entered.

(n3)Footnote 3. Of course, the parties may negotiate different provisions concerning bankruptcy court jurisdiction, including fixing jurisdiction in state court or providing for concurrent, rather than exclusive, jurisdiction of the bankruptcy court.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.56

P 3.56 Form--Order Approving Termination of Lease; ApplicationUNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK*In re*

DOE REALTY

CORPORATION

Debtor.

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)

)

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)

)

In Proceedings For A Reorganization Under Chapter

11.

Case No.

Order Approving Termination of Leases¹

Upon the annexed application dated, 2006, of Doe Realty Corporation, debtor and debtor in possession herein (collectively, "Doe" or the "Debtor"), seeking authority, *inter alia*, in accordance with § 365 of the *Bankruptcy Code* and *Bankruptcy Rule 6006(a)* to terminate that certain lease (the "Lease") by and between Doe, as lessee, and JJ Landlord Corp. (the "Landlord"), as lessor, for certain premises located at 999 East 85th Street, New York, New York and upon the subjoined consent of the Committee of Unsecured Creditors, by its counsel, ... (the "Committee") and the subjoined consent of the Landlord; and sufficient cause appearing therefor, it is

FOUND THAT the rejection of the Lease is an exercise of the Debtor's sound business judgment and is in the best interests of the Debtor's estates and creditors, and it is further

FOUND THAT the consents of the Committee and the Landlord to this Order satisfy the "notice and a hearing" standards set forth in § 102(1) of the *Bankruptcy Code*, and no further notice of, or hearing on, the relief sought in the Application is required, it isn²

NOW, on motion of.....

....., attorneys for Doe,

ORDERED, ADJUDGED AND DECREED THAT:

1. Doe be and it hereby is authorized to reject, terminate and disaffirm the Lease pursuant to § 365 of the *Bankruptcy Code* provided that (I) the Landlord shall pay to Doe the sum of \$100,000, and (ii) the Landlord shall waive any claims for damages against Doe arising out of rejection of the Lease, any claims for rental and other charges payable under the Lease prior to the entry of the order for relief herein, any claims for rental and other charges payable by Doe under *section 365(d)(3) of the Bankruptcy Code* from and after the date of entry of the order for relief herein to and including the date of rejection, termination and disaffirmance of the Lease;

2. The closing of the transaction authorized in paragraph 1 of this Order shall occur within ten days after the date of entry of this Order; and

3. Doe be and it hereby is authorized and empowered to do such things and execute such documents as may be necessary to implement and effectuate the termination of the Lease including the execution and delivery of the termination agreement substantially in the form of Exhibit B to the annexed application, which termination agreement is authorized and approved in all respects.

Dated: New York, New York

..... , 20

.....

United States Bankruptcy Judge

CONSENTED TO:

JJ LANDLORD CORP.

Landlord

By:

.....

Counsel to the Committee of

Unsecured Creditors

By:

A Member of the Firm

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY

CORPORATION

Debtor.

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)
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)
)
)

In Proceedings For A Reorganization Under Chapter

11.

Case No.

Application

To The Honorable, Bankruptcy Judge

The application of Doe Realty Corporation, as debtor and debtor in possession (collectively, "Doe"), by its attorneys, ..., respectfully submits:

1. On August 5, 2006 Doe filed a petition for reorganization under chapter 11 of the Bankruptcy Code and continued in the management and operation of its businesses and properties as debtor in possession. No trustee or examiner has been appointed.
2. Immediately prior to the filing of the chapter 11 petition herein, Doe operated approximately 200 retail department stores throughout the continental United States, employing approximately 8,000 persons.
3. By order dated August 20, 2006 this Court approved the closing of sixty-six (66) stores operated by Doe, and extended to January 31, 2007 the date on which Doe shall assume or reject its leases of nonresidential real property pursuant to *section 365(d)(4) of the Bankruptcy Code*. Such stores were closed to the public on August 21, 2006. Thirteen (13) additional stores were closed to the public by orders of this Court dated October 22, 2006 and November 4, 2006. Twelve (12) stores had been closed to the public by Doe prior to the filing of the petition herein.
4. Since the filing of the petition, Doe and its real estate consultants have been engaged in an extensive effort to market Doe's leasehold interests in and to each of the locations no longer necessary for Doe's continuing operations.
5. One of such locations is located at 999 East 85th Street, New York, New York and identified by Doe as Store No. 100 (the "Premises"). The Premises was leased from JJ Landlord Corp. (the "Landlord") pursuant to a lease of real property described in the abstract annexed hereto as Exhibit A (the "Lease").
6. For the period commencing from the entry of the order for relief herein until November 30, 2006, Doe has paid and performed all of its obligations under the Lease pursuant to *section 365(d)(3) of the Bankruptcy Code*. Doe has not paid the installment of rental due under the Lease on December 1, 2006.
7. There were no bids for the Lease submitted in connection with the solicitation for bids for various leases held with the approval of this Court on December 9, 2006. Doe and the Landlord have therefore agreed that (i) the Lease shall be terminated pursuant to *§ 365 of the Bankruptcy Code*, (ii) the Landlord shall pay to Doe the sum of \$100,000, and (iii) the Landlord shall release all claims for damages arising from the rejection of the Lease, all claims for rental and other charges payable under the Lease prior to the entry of the order for relief herein and all claims for rent and other charges payable by Doe under *section 365(d)(3) of the Bankruptcy Code* from and after December 1, 2006 to and including the date of rejection and disaffirmance of the Lease.
8. A closing ("Closing") shall be conducted to consummate the transaction described in paragraph 7 hereof within ten days after entry of the annexed order. At the Closing, all sums payable by the Landlord shall be paid to Doe, and Doe and the Landlord shall execute and deliver the termination agreement in the form of Exhibit B annexed hereto.
9. Doe respectfully requests this Court to find that the consents of the Committee of Unsecured Creditors (the "Committee"), and of the landlord which are affixed to the annexed order constitute a sufficient basis upon which to hold, consistent with *§ 102(1) of the Bankruptcy Code* and *Bankruptcy Rules 6006(a), 6006(c) and 9014*, that no further notice of, or hearing on, the relief requested herein is required. This request is made on the grounds that: (a) only the Landlord, the Committee and Doe have a direct interest in the termination of the Lease; (b) the Committee is capable of safeguarding the interests of the creditor body at large; and (c) all of the requisite parties to this termination transaction

have given their consent thereto and no purpose would be served in delaying the Court's consideration of this application.

10. No previous application for the relief sought herein has been made to this or any other Court.

WHEREFORE, Doe prays for entry of the annexed order and for such other and further relief as to this Court may be just and proper.

Dated: New York, New York

..... , 20

[.....]

Attorneys for the Debtor and Debtor in Possession

By:.....

[Address and Telephone No.]

Exhibit A Doe Lease Resume Store No. 100

Location	999 East 85th Street New York, New York	
Tenant	Doe Realty Corporation [address]	
Landlord	JJ Landlord Corp. [address]	
Date		
Area		
Term Expires		
Options To Extend		
Rent	\$..... per month	
Additional Rent	(i)	Percentage Rent.
	(ii)	Real Estate Taxes
	(iii)	Utilities.
		None.
Use		Any purpose.
Restrictions on	(i)	Radius Restriction.
Tenant's Use		None.
	(ii)	Other.
Mortgagee		None.
Miscellaneous		

Exhibit B**Termination Agreement**

Agreement dated this day of, 2007 between JJ LANDLORD CORP., a New York corporation, having an address at ("Landlord") and DOE REALTY CORPORATION, debtor and debtor in possession, having an address at ("Doe").

Recitals:

A. Pursuant to a lease dated May 13, 2001 ("the Lease"), Landlord demised to Doe Realty Corporation the premises described by metes and bounds on Exhibit A hereto together with all buildings and structures located thereon ("the Premises").

B. On August 5, 2006, Doe Realty Corporation filed with the United States Bankruptcy Court for the Southern District of New York (the "Court") a petition under chapter 11 of the Bankruptcy Code and continued in the management and operation of its businesses and properties as debtor and debtor in possession.

C. Landlord and Doe have agreed to terminate the Lease upon the terms and conditions hereinafter set forth.

IT IS THEREFORE AGREED:

1. Doe hereby rejects, terminates and disaffirms the Lease and Landlord accepts such rejection and disaffirmance.
2. In consideration for the rejection and disaffirmance of the Lease, Landlord is concurrently herewith paying to Doe the sum of \$100,000 and is releasing all of its claims against Doe as more fully set forth in Paragraph 3 hereof.
3. Landlord hereby waives, relinquishes and surrenders, and releases and discharges Doe and its successors and assigns from, any and all claims, demands, actions and causes of action which Landlord now has, may hereafter have and heretofore has had in connection with the Lease, the Premises and the rejection and disaffirmance of the Lease, including, without limitation, all claims for damages and other compensation arising from or relating to the rejection, termination and disaffirmance of the Lease, all claims for rental and other charges accruing under the Lease prior to the entry of the Order for Relief in Doe's chapter 11 case, and all claims in respect of rent and other charges payable by Doe pursuant to *section 365(d)(3) of the Bankruptcy Code* from and after the date of entry of the order for relief to and including the date of this agreement.
4. Doe hereby waives, relinquishes and surrenders, and releases and discharges Landlord and its successors and assigns from, any and all claims, demands, actions and causes of action which Doe now has, may hereafter have, or heretofore has had in respect of Landlord, the Lease, and the Premises.
5. Doe represents and warrants that it has executed and delivered this Agreement in accordance with an order of the Court dated, 2006 (the "Order"), that the order has not been stayed, that no appeal therefrom is pending, and no notice of appeal therefrom has been filed in respect of the Order. Doe represents and warrants that no broker has brought about the transaction provided for herein other than XYZ Associates, Inc. ("XYZ"). Doe shall be solely

responsible for all commissions and compensation payable to XYZ.

6. This Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

IN WITNESS WHEREOF, the parties have executed this agreement as of the date first above written.

JJ LANDLORD CORP.

By:

DOE REALTY CORPORATION

Debtor and Debtor in Possession

By:

[Acknowledgments]

FOOTNOTES:

(n1)Footnote 1. Under Bankruptcy *Rule 6006(a)*, a proceeding to reject an unexpired lease other than as part of a plan is a contested matter governed by *Rule 9014*. If a rejection motion is not brought on with the consent of all affected parties (the above form is on consent), a notice of motion also should be served with the supporting application. *See P 3.57 infra*, for a form of notice of motion in a lease rejection motion.

(n2)Footnote 2. Although there is no "notice and hearing" requirement in *section 365(a) of the Bankruptcy Code*, *section 365(a)* requires court approval of a lease rejection. Bankruptcy *Rule 6006(a)* classifies lease rejection proceedings as contested matters and *Rule 6006(c)* requires the court to set a hearing thereon.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

*1-3 Collier Real Estate Trans & Bankruptcy Code P 3.57***P 3.57 Form--Notice of Motion Authorizing Rejection of Lease; Application**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK*In re*

DOE REALTY

CORPORATION

Debtor.

)
)
)
)
)
)

In Proceedings For A Reorganization Under Chapter

11.

Case No.

Notice of Motion Authorizing Rejection of Lease

Sirs:

PLEASE TAKE NOTICE that upon the annexed application, Doe Realty Corporation, debtor and debtor in possession (collectively, "Doe"), will move before the Honorable, United States Bankruptcy Judge, at the United States Courthouse, 40 Foley Square, New York, New York 10007, Room 201 on the day of, 2006 at 9:00 o'clock in the forenoon of said day or as soon thereafter as counsel can be heard, for an order pursuant to § 365(a) of the Bankruptcy Code, *inter alia*, authorizing Doe to reject the lease entered into with JJ Enterprises, Inc. for certain premises located at 1025 East 19th Street, New York, New York, as more particularly described in the annexed application.

PLEASE TAKE FURTHER NOTICE that answering papers, if any, must be served upon the undersigned at least three (3) business days prior to the return date of said motion and must be filed with the Bankruptcy Court at least one (1) business day prior to such return date.

Dated: New York, New York

....., 20

[.....]

Attorneys for the Debtor and Debtor in Possession

By:

[Address and Telephone No.]

TO: SEE THE ANNEXED SCHEDULE

SCHEDULE

[List of Counsel for Creditors' Committee, Landlord, Mortgagee, Real Estate Consultant, Office of the United States Trustee and other persons filing requests for notices]

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

	)	
<i>In re</i>	)	In Proceedings For A Reorganization Under Chapter
DOE REALTY	)	11.
CORPORATION,	)	Case No.
Debtor.	)	
	)	

Application

To The Honorable, Bankruptcy Judge:

The application of Doe Realty Corporation, as debtor and debtor in possession (collectively, "Doe"), by its attorneys, ..., respectfully represents:

1. On August 5, 2006 Doe filed a petition for reorganization under chapter 11 of the Bankruptcy Code and continued in the management and operation of its businesses and properties as debtor in possession. No trustee or examiner has been appointed.
2. Immediately prior to the filing of the chapter 11 petition herein, Doe operated approximately 200 retail department stores throughout the continental United States, employing approximately 8,000 persons.
3. By order dated August 20, 2006 this Court approved the closing of sixty-six (66) stores operated by Doe, and extended to January 31, 2007 the date on which Doe shall assume or reject its leases of nonresidential real property pursuant to section 365(d)(4) of the bankruptcy Code. Such stores were closed to the public on August 21, 2006. Certain additional stores were closed to the public by orders of this Court dated October 22, 2006 and November 4, 2006. Twelve (12) stores had been closed to the public by Doe prior to the filing of the petition herein.
4. Since the filing of the petition, Doe and its real estate consultants have been engaged in an extensive effort to market Doe's leasehold interests in and to each of the locations no longer necessary for Doe's continuing operations.
5. One of such locations is located at 1025 East 19th Street, New York, New York ("Store No. 333"). Store No. 333 was leased from JJ Enterprises, Inc. ("Landlord") by lease dated January 24, 2002, as amended (the "Lease"). The Lease will expire on November 30, 2017 and contains five successive five year renewal options. A copy of an abstract of the Lease

is annexed hereto as Exhibit "A".

6. Doe has determined that Store No. 333 is unnecessary for Doe's continued operations. Moreover, as a real estate asset, Store No. 333 has no asset value as is demonstrated by the fact that Doe has been unable to obtain any party interested in assuming Doe's interest in and to the Lease despite extensive efforts on the part of Doe and its real estate consultants. The Lease must therefore be considered as a liability to the estate with no likelihood of providing a monetary return to Doe or its creditors.

7. Doe seeks authorization from this Court to reject the Lease pursuant to the provisions of § 365 of the *Bankruptcy Code* and *Bankruptcy Rules 6006(a), 6006(c) and 9014*.

8. By letter dated October 22, 2006 Doe returned the keys to Store No. 333 and surrendered possession of the premises to the Landlord. Doe's surrender of the premises and termination of its interests therein was effective on October 25, 2006. A copy of the letter surrendering possession of Store No. 333 is annexed hereto as Exhibit "B."

9. It is respectfully submitted that Doe is entitled to an order of the Court declaring the Lease to be rejected as of October 25, 2006 and fixing that date as the last date on which rental and other charges are payable under *section 365(d)(3) of the Code*. It is further requested that the order direct the Landlord to file a proof of claim in these proceedings with respect to any claims that it may have against Doe arising from the rejection of the Lease.

WHEREFORE, Doe prays for an order:

(a) authorizing Doe to reject the Lease;

(b) fixing October 25, 2006 as the date on which Doe's interest in and to Store No. 333 terminated;

(c) fixing October 25, 2006 as the last date on which rental and other charges are payable in respect of the Lease under *section 365(d)(3) of the Code*;

(d) directing the Landlord to file a proof of claim with respect to any claims that it may have against Doe; and

(e) granting Doe such other and further relief as to this Court may be just and proper.

Dated: New York, New York

....., 20

DOE REALTY CORPORATION

Debtor and Debtor in Possession

By Its Attorneys

[.....]

By:

A Member of the Firm

[address and telephone no.]

Exhibit A. Lease Abstract

STORE NUMBER: 333
 ADDRESS: 1025 East 19th Street
 New York, New York
 LEASE EXPIRES: November 30, 2017
 OPTIONS: 5-5 year
 ANNUAL RENT: \$.....
 PERCENTAGE RENT: Yes
 REAL ESTATE TAXES: Yes
 COMMON AREA MAINTENANCE: None
 LANDLORD: JJ Enterprises, Inc.
 [address]
 MORTGAGEE: None

Exhibit B

***[Letterhead of Doe Realty Corporation, as debtor and
 debtor in possession]***

..... October 22, 2006

JJ Enterprises, Inc.
 [address]

Re: Location 333 New York, New York

Gentlemen:

Reference is made to a certain lease dated January 24, 2002, as amended (the "Lease"), between you, as lessor, and Doe Realty Corporation ("Doe"), as lessee, pursuant to the provisions of which you leased to Doe certain premises known as 1025 East 19th Street, New York, New York (the "Premises").

The undersigned hereby elects to terminate the Lease and surrender the Premises effective October 25, 2006. Keys to the building are enclosed herewith. Kindly signify your acceptance of this notice and delivery of the Premises by signing the enclosed copy of this letter and returning same to the undersigned in the enclosed envelope.

Yours truly,

DOE REALTY CORPORATION,

Debtor and Debtor in Possession

By:

Accepted:

JJ Enterprises, Inc.

By:

Enclosures

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

*1-3 Collier Real Estate Trans & Bankruptcy Code P 3.58***P 3.58 Form--Notice of Motion for Order Extending Time for Assumption or Rejection of Leases**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

<i>In re</i>	)	
DOE REALTY CORP.	)	In Proceedings for a Reorganization Under Chapter
Debtor.	)	11.
	)	Case No.
	)	

Notice of Motion for Order Under 11 U.S.C. §§ 105 and 365 (i) Extending the Time of the Debtor in Possession to Assume or Reject Certain Unexpired Leases of Nonresidential Real Property; and (ii) Establishing Administrative Procedures for the Assumption or Rejection of Leases

PLEASE TAKE NOTICE that upon the annexed application (the "Application") of Doe Realty Corporation, debtor and debtor in possession (collectively, "Doe"), the undersigned will move before the Honorable, United States Bankruptcy Judge, Room of the United States Bankruptcy Court, The Old Customs House, One Bowling Green, New York, New York, on the day of, 20 at 2:00 p.m., or as soon thereafter as counsel may be heard, for the entry of an order substantially in the form annexed to the Application (the "Order") (i) extending Doe's time to assume or reject all unexpired leases of nonresidential real property under which Doe is the lessee (the "Leases"), until confirmation of a plan of reorganization in Doe's chapter 11 case; (ii) establishing administrative procedures for handling motions filed by lessors which seek to compel Doe to assume or reject any of the Leases; and (iii) granting Doe such other and further relief as the Court deems just and proper.

PLEASE TAKE FURTHER NOTICE that objections, if any shall be in writing and shall be served upon and filed with the Court so as to be received no later than three (3) business days prior to the hearing.

Dated: New York, New York

....., 20.....

.....

Attorneys for the Debtor and Debtor in Possession

By:

[Address and Telephone No.]

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.59

P 3.59 Form--Motion for Order Extending Time for Assumption or Rejection of Leases

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re
DOE REALTY CORP.
Debtor.

)
)
)
)
)

In Proceedings for a Reorganization Under Chapter
11.
Case No.

Motion for Order Under 11 U.S.C. §§ 105 and 365 (i) Extending the Time of the Debtor in Possession to Assume or Reject Certain Unexpired Leases of Nonresidential Real Property; and (ii) Establishing Administrative Procedures for the Assumption or Rejection of Leases

To The Honorable, Bankruptcy Judge:

Doe Realty Corporation, debtor and debtor in possession (collectively, "Doe") respectfully represents:

General Background

1. On February 20, 2007 (the "Filing Date"), Doe filed a voluntary petition for relief under chapter 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.* (the "Code") with the Clerk of this Court and was thereupon continued in the management and operation of its businesses and properties as debtor in possession pursuant to §§ 1107 and 1108 of the Code.

2. This Court has jurisdiction of this Application pursuant to 28 U.S.C. §§ 1334 and 157 and the "Standing Order of Referral of Cases to Bankruptcy Judges" of the District Court (Ward, Acting C.J.), dated July 10, 1984. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). Venue in this district is proper pursuant to 28 U.S.C. § 1409. The statutory predicates for the relief sought herein are §§ 365(a) and 105(a) of the Code, as complemented by Rules 6006 and 9014 of the Bankruptcy Rules.

3. Doe currently operates 150 department stores in ten (10) states located in the eastern region of the United States and has its principal fashion buying office in New York City. Doe's department stores offer a broad range of brand name and other first quality general merchandise, including apparel, footwear, domestics, home furnishings, jewelry, housewares, toys and other family oriented items. For fiscal year ended December 31, 20, Doe generated total sales of nearly \$1.5 billion.

4. By this Application, Doe seeks, *inter alia*, the issuance and entry of an order extending its time to assume or reject all of the "Leases" (as hereinafter defined).

5. As of the Filing Date, Doe was lessee under approximately 150 unexpired leases of nonresidential real property (the "Leases"). Most of the Leases are for space utilized for conducting retail store operations and are assets of Doe's estate. One of the Leases is for space utilized by Doe for its corporate headquarters. Although Doe expects periodically to seek this Court's permission to reject some of the Leases, many of the Leases will prove to be vital to the continued operation of its business. In addition, other Leases, while not necessary for Doe's operations, may prove to be "below market" leases, the assumption and assignment of which will yield value to the estate. Until Doe has (a) finalized its overall business plan, (b) determined pursuant to its business plan which store locations to close and which to retain, (c) reviewed and discussed its business plan with the Unsecured Creditors' Committee, and (d) negotiated a plan of arrangement with its creditors and shareholders, it cannot identify which Leases should be assumed and assigned and which should be rejected. In addition, once Doe has determined which of its stores it no longer wishes to operate, it will be necessary to appraise and canvass the real estate market to ascertain the feasibility of assigning the Leases of such stores to third-party users.

6. Section 365(d)(4) of the Code provides:

(4)(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of--

(i) the date that is 120 days after the date of the order for relief; or

(ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

The court, therefore, for cause shown, may extend the period during which Doe must assume or reject the Leases by 120 days. The statutory 120-day period expires on June 20, 2007.

7. Thus, Doe requests entry of the proposed order annexed hereto as Exhibit "A" (the "Order"), extending the time to assume or reject the Leases until September 20, 2007. This represents a 90-day extension as contemplated by section 365(d)(4). Annexed hereto as Exhibit "B" is a list of the Leases as to which Doe seeks an extension of time to assume or reject.

8. Doe has conducted a thorough review of its files in an attempt to identify all Leases to which an extension of time to assume or reject should be sought. It is possible, however, that leases in addition to those on Exhibit "B" may exist or certain financing arrangements may be determined by this Court to be leases. Doe requests, therefore, that its time to

assume or reject all leases, including those not identified on Exhibit "B," also be extended so as to avoid the automatic forfeiture of potentially valuable assets of the estate that would result absent an extension of time. In the event that additional leases respecting nonresidential real property are discovered during the process of reviewing Doe's books and records, such leases will be listed in the Debtors' statement of executory contracts to be filed with the Court.

9. The Leases as a whole are integral to Doe's business and constitute assets of Doe's estate. Some of these Leases will be vital for ongoing operations. Other Leases, even if not necessary to Doe's post-confirmation operations, may prove to have value to the estate if they are assumed and assigned, since they have reserved rents at or below market rates and relate to properties in desirable locations. Doe respectfully submits that business decisions regarding whether to assume, assign, or reject the Leases can be properly made only after an analysis of each Lease by Doe, an analysis which must take place in the context of a comprehensive business plan which Doe is hopeful can be completed within the 90-day extension period requested hereby and contemplated by *section 365(d)(4)(B)(i) of the Bankruptcy Code*.

10. Clearly, Doe should not be compelled to assume any Leases without having made the necessary business analyses and judgments based upon sound information. However, absent an extension of time, Doe will be compelled to assume virtually all of the Leases in order to protect and preserve its business, assets and future prospects, in order to avoid 365(d)(4)'s forfeiture provision. Doe is devoting substantial time and effort to develop a business plan that will provide the cornerstone for its reorganization. Until that plan is developed, however, Doe cannot determine whether it is financially prudent to assume Leases (thereby incurring significant administrative liabilities) or to reject Leases (thereby losing a potentially valuable asset of the estate). As its analysis progresses, Doe will move to reject, or perhaps to assume and assign, Leases which it determines are not needed for its ongoing operations.

11. The size of Doe's estate and businesses and the complexity of its chapter 11 case contribute to its inability to assume or reject the Leases by June 20, 2007. Since the Filing Date, Doe and the professionals retained to render services for and on its behalf have been working to continue the operations of its businesses, handle numerous administrative and business decisions and comply with the numerous legal and other requirements imposed upon debtors in possession by the Code and other applicable laws.

12. Extending the time within which Doe may assume or reject the Leases by the 90-day extension period contemplated by section 365(d)(4)(B)(i) will prevent premature decisions regarding the Leases and will prevent the Landlords under the Leases from reaping windfalls at the expense of the Debtors' estates and creditors. Doe submits that this modest period of extension will not unduly prejudice landlords while being of great benefit to the debtor and its estates. As contemplated by the statute, any further extensions will only be requested upon the written consent of the relevant Landlords.

13. Doe will timely perform its post-Filing Date obligations (except those specified in § 365(b)(2) of the Code) until the Leases are assumed or rejected. In addition, if and when Leases are assumed, Doe will cure (or provide adequate assurance that it will cure) any prepetition defaults under such Leases and will provide adequate assurance of future performance, as required by the Code.

Conclusion

14. The relief requested herein will provide Doe with sufficient time to make reasoned determinations, based upon a comprehensive business plan and negotiations with parties in interest, regarding the assumption or rejection of the Leases. Furthermore, it will prevent the inadvertent forfeiture of assets by extending the time period for assumption or rejection to all Leases. Finally, by setting clear procedures for dealing with Landlord motions to compel assumption or rejection, the requested relief will promote the efficient administration of the estate.

15. The Debtors will serve copies of this Motion on the United States Trustee for the Southern District of New York,

....., counsel for the Committee of Unsecured Creditors, and any entity which has served with a Notice of Appearance herein, and all the Landlords for the locations listed on Exhibit "B" hereto.

16. No prior request for the relief requested herein has been made to this or any other court.

WHEREFORE, Doe respectfully requests entry of the attached order (i) extending its time to assume or reject all Leases up to September 20, 2007; (ii) establishing an administrative procedure for handling motions, filed by Landlords, which seek to compel Doe to assume or reject any of the Leases; and (iii) granting Doe such other and further relief as this Court deems just and proper.

Dated: New York, New York

March 1, 2007

.....

Attorneys for the Debtor and Debtor in Possession

By:

[Address and Telephone No.]

EXHIBIT A

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

DOE REALTY CORP.

Debtor.

)
)
)
)
)
)

In Proceedings for a Reorganization Under Chapter
11.
Case No.

Order Under 11 U.S.C. §§ 105 and 365 (i) Extending the Time of the Debtor in Possession to Assume or Reject Certain Unexpired Leases of Nonresidential Real Property; and (ii) Establishing Administrative Procedures for the Assumption or Rejection of Leases

Upon the application dated March 1, 2007 (the "Application"), of Doe Realty Corporation, debtor and debtor in possession (collectively, "Doe") seeking entry of an order (i) pursuant to *Section 365(d)(4) of the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq.* (the "Code"), extending by 90 days Doe's time to assume or reject all unexpired leases of nonresidential real property under which Doe is the lessee (the "Leases"), until the entry of an order confirming a plan of reorganization in Doe's chapter 11 case (the "Case"); and (ii) establishing an administrative procedure whereby motions with respect to any of the Leases brought by one or more lessors (the "Landlords") seeking to compel Doe to assume or reject specific Leases may only be heard at certain intervals; and it appearing that sufficient notice of the Application has been given; and upon the record of the hearing held before this Court on March 20, 2007; and sufficient cause appearing therefor; and it appearing that the relief requested is in the best interests of Doe's estate and in the best interests of its creditors and other parties in interest; and after due deliberation; it is

ORDERED, that pursuant to *Section 365(d)(4) of the Code*, the time for Doe to assume or reject any of the Leases is hereby extended until September 20, 2007.

ORDERED, that the term "Leases" referred to in the above paragraph shall encompass those Leases listed in Exhibit "B" to the Application together with all other unexpired nonresidential real property leases pursuant to which Doe is or is determined to be a lessee; and it is further

ORDERED, that nothing herein shall relieve Doe from its obligation to render timely postpetition performance under its respective Leases as required by *section 365(d)(3) of the Code*, and it is further

ORDERED, that nothing herein shall be deemed an approval of the assumption or rejection of any of the Leases.

Dated: New York, New York

May 1, 2007

.....

United States Bankruptcy Judge

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 3 Leases *

1-3 Collier Real Estate Trans & Bankruptcy Code P 3.60

P 3.60 Form--Notice of Election of Lessee to Retain Rights Under Rejected Lease (S.D.N.Y.)

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

<i>In re</i>	)	
DOE REALTY CORP,	)	In Proceedings for a Reorganization Under Chapter
Debtors.	)	11.
	)	Case No.
	)	

NOTICE OF ELECTION UNDER SECTION 365(h)(1)(A)(ii)

On February 24, 200____, Doe Realty Corp. the debtor and debtor in possession rejected that certain Lease Agreement dated November 16, 1995 (the "Subject Lease") with tenant XYZ Store, Inc. ("Tenant" pursuant to that certain "Order Rejecting Real Property Leases" entered on such date (Docket No.....). A copy of the Subject Lease is attached as Exhibit A hereto.

Tenant hereby gives notice of its election to retain its rights under the Subject Lease as provided in *Section 365(h)(1)(A)(ii) of title 11 of the United States Code* (the "Bankruptcy Code") for the balance of the term of such Subject Lease and all renewal terms provided therein.

Tenant hereby expressly reserves all rights under the Subject Lease and applicable law except to the extent that such rights are explicitly not effective by reason of *Section 365(h)(1)(B) of the Bankruptcy Code*.

Dated: New York, New York

March _____, 200_____

.....

[Attorneys for Tenant]

By

A Member of the Firm

[Address of Firm]

Attorney for XYZ Store, Inc.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code 4.syn

§ 4.syn Synopsis to Chapter 4: Miscellaneous Transactions *

P 4.01 Contracts for Sale

[1] The Seller as Debtor

[2] The Purchaser as Debtor

P 4.02 Option Agreements

[1] Introduction

[2] Option Contracts Separate From Leases

[3] Option Contracts Contained in Leases

P 4.03 Nondisturbance Agreements

P 4.04 Operating and Easement Agreements

P 4.05 Mortgage Participation Transactions

[1] Characterization

[2] Bank Participation Agreements

[3] Conclusion

P 4.06 Secondary Mortgage Market Transactions

P 4.07 Partnership Agreements and Limited Liability Company Operating Agreements

[1] Introduction

[2] The Effect on a Partnership of the Bankruptcy of a General Partner

[a] Bankruptcy Code Provisions--Termination of a Partnership Upon the Bankruptcy of a General Partner

[b] State Law--Assumption and Assignment of the Partnership Agreement by the Trustee of a General Partner

[c] Bankruptcy Code Provisions--Assumption and Assignment of a Partnership Agreement by the Trustee of a General Partner

[3] The Effect on a Limited Liability Company of the Bankruptcy of a Managing Member

[4] The Effect of the Bankruptcy of a General Partner on Nonrecourse Creditors of the Partnership

P 4.08 Management Contracts

[1] The Manager as Debtor

[2] The Manager as Custodian

P 4.09 Timesharing Agreements

§§ 4.10through 4.50 [Reserved]

P 4.51 Form--Mortgage and Security Agreement



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.01

P 4.01 Contracts for Sale

[1] The Seller as Debtor

A contract for the sale of real property is an executory contract which, under *section 365(a) of the Code*, may be assumed or rejected by a trustee of the seller or purchaser subject to the approval of the bankruptcy court.ⁿ¹ The Code does not define the term "executory contract," but the House Report states that the term "generally includes contracts on which performance remains due to some extent on both sides."ⁿ² This formulation appears to have been adopted from a definition proposed in a leading law review article by Professor Vern Countryman prior to the enactment of the Code and has become widely accepted by courts. The Countryman definition is:

[An executory contract is] a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.ⁿ³

A contract for sale of real property will ordinarily require the seller to deliver a deed and take other steps to convey title to the purchaser, and will require the purchaser to pay the purchase price specified in the contract and to accept the deed. If the seller fails to deliver the deed or to otherwise consummate the transaction, the purchaser will be excused from its obligation to pay the purchase price. If the purchaser fails to pay the purchase price, the seller will be excused from its obligation to convey title. Thus, under a typical contract for sale of real property there are obligations on the part of each party which if not performed will excuse performance by the other party. Hence such a contract, under the classic Countryman definition and the definition used in the House Report prior to performance thereunder, is ordinarily an executory contract for the purposes of *section 365 of the Code*.

In cases where the debtor is the purchaser, the treatment of the contract for sale as an executory contract can place a burden on the debtor given the often difficult requirements of assumption (such as the requirement for prompt cure of defaults) and the harsh consequences of rejection, including possible forfeiture of amounts theretofore paid under the contract. In cases involving installment land sale contracts, a number of courts have avoided this Hobson's choice by recharacterizing such a contract as a mortgage.^{n3f} Those courts have recognized an exception to the mechanical application of the Countrymen definition where, under the facts of the case and state law, the agreement of sale is in fact a security instrument.^{n3g} In cases where the debtor is the seller under a real property sale contract, the traditional analysis of executory contracts has been utilized by the courts.

A distinctive attribute of contracts for the sale of real property is the general availability of the remedy of specific performance against a defaulting seller. If, however, the seller is a debtor under the Bankruptcy Code, and rejects the contract, it is highly unlikely that a bankruptcy court will decree specific performance for the benefit of the complaining purchaser particularly where state law provides a damage remedy for the disappointed seller.^{n3h} Under the former Bankruptcy Act, in most instances in which the bankrupt seller rejected its obligations under a real property contract, the courts would not decree specific performance and would relegate the purchaser to a claim for damages.ⁿ⁴ The reason for the denial of the specific performance remedy is that the issuance of a specific performance decree would deny the estate the benefits intended to be realized by rejection by compelling the trustee's adherence to the very contract it was seeking to reject.

This policy appears to have been carried through under the Bankruptcy Code (with a significant exception set forth in section 365(i)). Although the remedy of specific performance is not expressly denied under the Code, the Code recognizes a "claim" only if it can be reduced to money. In section 101(5)(B), a "claim" is defined as including a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment."ⁿ⁵ This language means that if monetary damages can be calculated as an alternative to a specific performance decree, a complaining purchaser under a rejected real estate contract may file a claim that should be allowed in the seller's Bankruptcy Code case.ⁿ⁶ Absent an allowed claim, which must be dealt with in a plan under chapter 11 or 13 or upon liquidation under chapter 7, there is no mechanism specified in the Code to provide recourse to the complaining purchaser.^{n6a}

Section 365(i), however, recognizes a specific performance right in limited circumstances. Section 365(i) provides:

(i)(1) If the trustee rejects an executory contract of the debtor for the sale of real property ... under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property. ...

(2) If such purchaser remains in possession--

(A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the non-performance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.ⁿ⁷

The legislative history indicates that section 365(i) was intended to apply to land installment sales contracts, or "contracts for deed," which may be viewed as financing instruments rather than as executory contracts.ⁿ⁸ However, the express language of section 365(i) appears applicable to any contract of sale in which the purchaser is in possession of the premises.^{n8a}

Another circumstance in which a nondebtor purchaser may be able to obtain a specific performance decree arises when the seller has deposited the deed in escrow prior to the inception of the seller's Bankruptcy Code case. If the seller is without power to revoke the escrow, the courts appear to characterize the contract as no longer executory and therefore no longer rejectable.^{n8b} The delivery of the deed by the escrow agent is regarded as merely a ministerial act.^{n8c}

If the purchaser is not in possession of the premises, or if the seller has not deposited the deed in escrow, the purchaser will be unable to obtain specific performance, or assert rights under section 365(i) in the event of rejection by the seller's trustee. In view of the foregoing, it may be advisable, in circumstances in which the purchaser will be relying upon the occurrence of the closing (rather than the availability of damages in the case of the seller's breach), to evaluate the seller's financial condition and prospects for the period from contract execution to scheduled closing. If, for

example, the prospective purchaser is dealing with a troubled seller that is disposing of certain assets, and there is a possibility of a Bankruptcy Code filing by or against the seller prior to the scheduled closing, the purchaser should seek to condition or limit its commitments relating to the consummation of the transaction to become effective only upon closing. Thus, if the prospective purchaser intends to accept a mortgage loan commitment to fund the acquisition, it should seek to limit the amount of any nonrefundable commitment fee and obligation to pay the lender's expenses, with the balance of the fee and expense reimbursement to be payable only upon closing.

Similarly, if possible, the purchaser may wish to obtain possession of the premises prior to closing through a short term lease in order to avail itself of the benefits of section 365(i) in the event of a bankruptcy filing by the seller. The availability of such section 365(i) protections may also provide leverage to the prospective purchaser in encouraging the debtor to ultimately assume the purchase agreement. Of course, the seller is likely to strongly resist placing the prospective purchase in possession prior to closing, and the availability of this type of protection will likely depend on the relative bargaining power of the parties.

In addition, the prospective purchaser may wish to consider including default provisions in the contract which would permit the purchaser to terminate its obligations under the agreement upon the occurrence of certain specified adverse events that could signal that a filing under the Bankruptcy Code has become more probable. Such specified events could include cross defaults to debt obligations of the seller and the entry of a judgment against the seller in excess of a stated amount.^{n8d} In this way, the purchaser could evaluate its position if the seller's financial condition deteriorates significantly, and, by terminating prior to a bankruptcy filing, seek to avoid the uncertainty of being a contract vendor of a bankrupt seller that has not yet decided whether to assume or reject the agreement.^{n8e}

Another possible approach to protect the prospective purchaser is to obtain a lien on the subject property as security for the seller's obligation to close on the transfer of the property. Such lien would be intended to secure the damages arising from a rejection or other breach of the contract. Although a seller is likely to resist this type of structure, and it may be prohibited in situations where the seller already has a mortgage on the subject property, it may be possible in situations where the prospective purchaser has enhanced bargaining leverage.

In addition to the foregoing enforcement problems, a prospective purchaser from a troubled seller is concerned with the recovery of any deposit under the contract if the seller becomes a Bankruptcy Code debtor before the closing. If the purchaser under a real property contract has paid a portion of the purchase price and then suffered the intervention of the seller's bankruptcy, the Bankruptcy Code in section 365(j) grants a lien on the subject property for the benefit of the purchaser to the extent of the payment. This lien is also given to purchasers who elect under section 365(i) to surrender possession of the subject premises and treat the contract as terminated. Section 365(j) constitutes for contract purchasers a substantial improvement upon the former Bankruptcy Act, whereunder a purchaser's lien for a contract downpayment was generally not recognized by the courts.ⁿ⁹ Thus, under the former Act, contract vendees were merely unsecured general creditors with respect to contract downpayments, whereas under the Code such purchasers must be dealt with as secured creditors.

Section 365(j) does not speak to the priority of the lien created thereunder relative to pre-existing mortgages, real estate tax liens and other encumbrances on the subject premises. Section 365(j) also leaves unanswered questions relating to the moment of attachment of the purchaser's lien, the circumstances under which the lien may be enforced, and the manner of enforcement. If, for example, the seller's estate is unable to pay the contract purchaser's claim and a plan is confirmed in the seller's chapter 11 case providing for the continuation of the lien after the closing of the case, will the purchaser be entitled to the appointment of a receiver in a foreclosure action? Will the rehabilitated seller be obligated to maintain insurance, pay taxes on the property, and keep the property in good condition? Will the seller be entitled to place junior liens or even senior liens on the property?^{n9a} What will be the priority of the section 365(j) lien with respect to mechanics liens on the property?^{n9b} It is suggested that if in significant real estate transactions the seller's viability is in question, clauses be included in the contract of sale, effective upon the entry of an order for relief on the seller's filing under the Bankruptcy Code, that set forth mortgage-style rights and remedies in accordance with standard

local forms of mortgages or deeds of trust. Although there can be no assurance that the bankruptcy courts will honor such provisions, there may be a predilection towards enforcement if the clauses are in general use in the local security forms and are not inconsistent with the provisions of the Bankruptcy Code. Moreover, the mere possibility of enforcement by a court might be sufficient to permit for a settled resolution of the matter that allows the disappointed purchaser to obtain the property or at least a large portion of the deposit.

The customary technique employed to ensure return of a purchaser's contract deposit in the event of a seller's default is to place the deposit into escrow. In residential sales contracts, the escrow agent is most often the seller's attorney or the broker. In the event of a pre-closing filing of a Bankruptcy Code petition by or against the seller, the escrow mechanism should ensure that the downpayment will not become part of the seller's estate notwithstanding the rejection of the sales contract by the seller's trustee.ⁿ¹⁰ The critical determinant in this case is whether the contract deposit constitutes property of the seller's estate under section 541(a) or instead belongs to the purchaser. If the deposit belongs to the seller's estate, then the purchaser is not entitled to return of the deposit, and will be relegated to the status of a secured creditor under section 365(j) with a lien on the subject premises in the amount of the deposit. (In addition, the purchaser may have a claim for damages arising out of the rejection of the contract which will be a general unsecured claim against the seller's estate.) The resolution of the question whether the escrow deposit constitutes property of the estate will turn on the interpretation of the contractual provisions establishing the escrow in the first instance.ⁿ¹¹

Unfortunately, many contract escrow clauses are not conclusive as to the ownership of the funds deposited. A typical escrow clause may provide that:

the downpayment hereunder shall be deemed to be made to seller by payment thereof to , whose office is at , attorney for seller, to be held by said attorney in escrow until the earlier of (i) the delivery of the deed hereunder or (ii) such time as the purchaser may be entitled to a refund thereof, at which time said escrowee shall remit such downpayment to the party entitled thereto.

Under this clause, the seller's Bankruptcy Code trustee may argue that the downpayment is property of the seller's estate inasmuch as it is recited to have been "made to seller," and that the purchaser is entitled merely to a "refund" if the seller fails to convey title. However, if the contract contains other indicia of ownership on the part of the purchaser, the trustee's argument should not prevail. For example, if the contract is contingent upon the purchaser's obtaining certain mortgage financing, and provides for interest on the contract deposit to be paid to the purchaser regardless of whether title closes, the purchaser may assert that the downpayment was merely a contingent payment that did not vest in the seller at least until the financing condition was satisfied, and that the provision for payment of interest to the purchaser further evidences the parties' intention as to the ownership of the downpayment by the purchaser. Furthermore, if the contract does not contain a liquidated damage clause, the purchaser may argue that the seller's interest in the downpayment was always subject to defeasance even if the *purchaser* breached the contract but the seller could not prove damages. Thus, the purchaser would maintain, the seller's link to the downpayment was tenuous at best until an actual closing took place. The purchaser would also assert that the very existence and purpose of the escrow clause demonstrate that the seller was not to have dominion over the downpayment until closing, that the seller's interest in the escrow fund was, therefore, contingent, and became the seller's property only upon performance or tender of performance by seller.

A similar situation is present in the case of land developers who are often required by state law to place funds received from consumer lot purchasers in escrow pending the receipt of certifications regarding the completion of required sewer and water lines. In *In re Atlantic Gulf Communities Corp.*,^{n11a} a debtor (Atlantic) sought to obtain turnover of a large escrow account set up for such purpose without completing the relevant construction. The debtor asserted that because it was the actual settlor of the escrow, using funds provided to it in monthly payments by lot purchasers, rather than funds deposited directly by the purchasers, and was entitled to the receipt of the funds after satisfaction of the conditions it had a superior interest as compared to the consumers. In deciding against the debtor, the court concluded that the debtor

was only a contingent grantee of the fund since it would only receive the funds upon satisfaction of the conditions and that the lot purchasers had a superior equitable interest in the funds. Although the escrow funds themselves were not property of the estate, the right to receive those funds upon meeting the construction requirements would remain property of the estate. The court in *Atlantic Gulf* seemed swayed by the equities of the case given the fact that as a result of subsequent events it was clear that the contractual conditions for release of the escrow to Atlantic could never occur and the structure of the escrow itself was mandated by the consumer protection authorities of the state for the stated purpose of protecting consumers. Nonetheless, as the deposit may be a significant potential asset to the bankruptcy estate, ambiguous contract escrow clauses may be subject to litigation claims by an aggressive debtor, particularly where the subject real property is already subject to a mortgage lien and the benefits of a lien in favor of the purchaser under *section 365(j) of the Code* may be questionable. Thus, the competition for contract escrow deposits may be eliminated by clear contractual delineation of the ownership of the fund. This may be accomplished by a declaration in the contract that the escrow agent is holding the deposit in trust for the seller or purchaser (as negotiated) or as agent for the seller or purchaser, or by a recitation that title to and ownership of the fund is in the seller or purchaser until the closing or occurrence of another specified event.

An example of such a declaration would be the following:

The parties to this Escrow Agreement acknowledge and agree that the funds deposited herein are being held in trust by agent for the benefit of purchaser and seller in accordance with the release provisions in Section _____ of this Escrow Agreement, and that until such funds are required to be released to seller or purchaser as provided in said Section _____ of this Escrow Agreement, the funds shall not be considered property of either purchaser or seller.

[2] The Purchaser as Debtor

If the purchaser under a contract for sale of real property becomes a debtor under the Bankruptcy Code, the trustee will have the option to reject or, in certain circumstances, assume the contract. If the contract is rejected, the seller will have a claim for damages in an amount allowable under state law.ⁿ¹² In contrast to the claim of a real estate lessor arising from the rejection of a lease by the lessee's trustee, there is no limitation in the Bankruptcy Code on the allowed amount of the claim of the aggrieved seller.ⁿ¹³ It has been held that the damages cap under *section 502(b)(6) of the Bankruptcy Code* is inapplicable to such a damages claim even if the real property purchase contract arose from the debtor's exercise of a purchase option contained in a lease.^{n13a} The claim will be a general unsecured claim against the debtor's estate.ⁿ¹⁴

If the seller has received a downpayment under the contract, and the contract contains a liquidated damage clause valid under applicable state law, it appears that the seller, upon rejection by the purchaser's trustee, may retain the downpayment in full satisfaction of its claim.^{n14a} It should be noted, however, that if the seller's actual damages are nonexistent or substantially less than the retained downpayment, the trustee may assert that: (1) the liquidated damage provisions of the contract have been rejected along with the balance of the agreement; (2) the retention of the downpayment by the seller constitutes a windfall to the seller and a forfeiture by the purchaser's estate; (3) the retention of the downpayment by the seller is in the circumstances analogous to a fraudulent conveyance for the benefit of the seller, inasmuch as the relinquishment by the seller of its actual claim for damages (which in the hypothetical are nonexistent) is not reasonably equivalent value for the purchaser's loss of the downpayment; and (4) the downpayment accordingly should be returned by the seller to the purchaser's trustee.ⁿ¹⁵ The seller will resist the trustee's argument on the grounds that (1) the bankruptcy court must give effect to a liquidated damage clause enforceable under state law, (2) the seller took the risk in accepting the liquidated damage clause that its actual damages could have been substantially higher than the downpayment, and (3) the bankruptcy court should not employ hindsight in evaluating the clause in the light of subsequent changes in the market for the property.

If the seller has received a downpayment under the contract, and the contract does not contain a liquidated damage

clause, the seller will seek to offset the downpayment against its claim for damages arising out of the rejection of the contract by the purchaser's trustee.^{n15a} If the contract provides that the downpayment is the seller's property *ab initio*, with the seller being obligated to return to the purchaser an amount equal to the downpayment in the event of the seller's inability to convey title, then the seller may assert in defense of its right to retain the downpayment that the downpayment was not property of the estate under *section 541(a) of the Code* as of the filing and therefore need not be turned over to the purchaser's trustee under *section 542(a)*. (In these circumstances, the property interest of the estate in the contract consists not of its right to the downpayment, but of its right to obtain specific performance of the seller's obligations under the contract. This right is, of course, relinquished when the purchaser's trustee rejects the contract.) In any event, the seller will be required to prove actual damages resulting from the rejection.

If the contract is silent as to the "ownership" of the downpayment, and the seller claims actual damages arising from the rejection by the purchaser's trustee, the seller will seek to retain the downpayment as an offset against such damages. The seller will base its right of retention on the traditional offset rights recognized under the bankruptcy laws, including *section 553 of the Bankruptcy Code*, in that the seller's right to damages and the purchaser's right to return of the downpayment are "mutual" prepetition obligations arising under the same transaction.ⁿ¹⁶ Thus, notwithstanding the fact that the contract was rejected after the filing of the purchaser's petition and the contract deposit was paid prior to the filing, the seller can argue with substantial merit that under *sections 365(g) and 502(g) of the Code* a post-petition rejection of an executory contract is deemed to have occurred immediately prior to the filing of the petition, and that the traditional mutuality requirement therefore has been satisfied.ⁿ¹⁷ If the downpayment does not satisfy the seller's claim for damages, the seller may in addition file a proof of claim for the balance.

The exercise of the seller's right of offset cannot occur until the seller demonstrates that it has suffered actual damages as a consequence of the rejection of the contract. Moreover, the automatic stay set forth in the Code will prevent the application by the seller of a specifically identifiable contract deposit to the seller's own use until the seller has obtained relief from the stay.ⁿ¹⁸ During the time lapse between the rejection of the contract and the time of proof by the seller of its actual damages, the seller may be ordered under *section 542(a) of the Code* to relinquish possession of the downpayment to the trustee. If the seller is unable to successfully resist an action brought against it under *section 542(a)*, and loses its ability to effect the offset, then under *section 506(a)* the seller will have a secured claim to the extent of the amount that could have been offset,^{n18a} and under *section 542(a)* should receive adequate protection for the recovery of the amounts turned over to the trustee if it is ultimately determined that the seller is entitled to damages arising out of the rejection of the contract.ⁿ¹⁹

The issues are even more complex if the downpayment has been placed in escrow pending the closing or satisfaction of some intermediate event. If the contract clearly provides that the downpayment belongs to the seller and that the escrow agent is holding the fund as seller's agent or trustee, then the seller should prevail on its argument that the downpayment is not property of the purchaser's estate and should be remitted to the seller. If, however, the contract does not specify the ownership of the downpayment and under state law the seller may be obligated to return the downpayment and pursue an action for damages, then the existence of the escrow arrangement may vitiate the seller's offset rights inasmuch as the seller is not in possession of any fund to employ for purposes of offset. The escrow agent, on the other hand, may be compelled to turn over the downpayment to the purchaser's trustee under *section 542(a)*. The seller may, of course, seek to prevent the turnover, but will be subject to the difficulties inherent in obtaining a judicial determination to prevent the turnover by a third party rather than compelling the trustee to take affirmative action against the seller as holder of the fund. Of course, if the seller is unable to convey title free of encumbrances in accordance with the contract for sale, the escrow deposit should be returned to the trustee for the purchaser.^{n19a}

As noted above, the degree of unpredictability may be diminished, although by no means eliminated, by clear delineation in the contract of the property interests in the downpayment, whether with or without an escrow provision.ⁿ²⁰

An avenue of attack available to the trustee notwithstanding the existence of properly drafted downpayment and damage

provisions may arise under the fraudulent conveyance provisions of the Code. If the trustee can demonstrate under section 548(a) (or under applicable state fraudulent transfer laws available to a trustee under *section 544(b) of the Code*) that the consideration payable by the purchaser under the contract was not reasonably equivalent to the value of the property to be conveyed to the purchaser, and can satisfy the other requirements of section 548(a), the trustee may be able to recover any downpayment as part of a rescission of the entire transaction.ⁿ²¹ The outcome of such an effort by purchaser's trustee is of course contingent on the facts developed in the course of litigation, and cannot be controlled by contract drafting.

If the purchaser's trustee seeks to assume a contract for sale of real property there are a number of issues that will arise in the context of the seller's opposition to the assumption. If the contract provides for a cash payment by the purchaser at the closing, and does not contemplate any continuing financial relationship between the seller and purchaser after the closing, there appears to be no reason why the trustee cannot assume the contract (with court authorization pursuant to section 365(a)) and proceed to closing.ⁿ²² If no default has occurred under the contract, the trustee is not required to provide adequate assurance of future performance under the contract as a condition to assumption.ⁿ²³ If a default has occurred, the trustee must cure the default and demonstrate the wherewithal to produce the cash required for closing.ⁿ²⁴ This demonstration will constitute adequate assurance of future performance.

If, however, the contract provides for purchase money indebtedness to be incurred by the debtor-purchaser at the closing, the trustee's right to assume the contract is subject to question. If there has been no default under the contract, the trustee need not provide adequate assurance of future performance as a condition to assumption. However, under section 365(c)(2), the trustee may not assume or assign a contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."ⁿ²⁵ This language appears to cover the extension to the debtor of "debt financing" in the form of purchase money debt, and therefore should enable the seller to argue successfully against assumption by the purchaser's trustee of a contract providing for such debt. In *In re Easebe Enterprises, Inc.*, the Court of Appeals for the Ninth Circuit held that a purchase option which required the seller to provide a purchase-money mortgage to the debtor-purchaser at the closing was nonassumable by operation of section 365.^{n25a} Nevertheless, the question may not be free from doubt if the purchase money debt is to be nonrecourse. Under this transaction structure, the debtor's financial capacity is arguably unrelated to the likelihood of payment of the purchase money debt, which is to be paid only out of the income and proceeds of the property.^{n25b} It could also be argued that nonrecourse debt is of a different risk profile from the point of view of the estate itself and other general creditors of the debtor, inasmuch as the estate will benefit from the property in the form of enhanced value to the creditor body if the project succeeds, but the estate will not have to share other assets of the estate with the seller creditor in the event of failure because of the nonrecourse nature of the indebtedness. The seller will maintain, on the other hand, that the debtor's creditworthiness is an indication of the likelihood of a future default, of the possibility of a subsequent Bankruptcy Code filing by the same debtor, and of the debtor's ability generally to develop or manage the property properly. It may be further argued that nothing in section 365(c) distinguishes between recourse and nonrecourse indebtedness, whereas the distinction is recognized elsewhere in the Code.ⁿ²⁶ Of course, if there has been a default under the contract, section 365(b)(1)(c) requires that the trustee provide adequate assurance of future performance under such contract, and the seller could strongly argue that this requires that the trustee demonstrate that the future obligations under the mortgage will be satisfied in accordance with its terms.^{n26a}

Similar issues arise in the context of the assumption and assignment of a contract of sale by the purchaser's trustee. Under section 365(f), the trustee may assign an executory contract notwithstanding any anti-assignment provisions if the trustee assumes the contract and adequate assurance of future performance by the assignee is provided. Notably, in the case of an assignment, the requirement of adequate assurance of future performance applies whether or not there has been a default under the contract.^{n26b} In the case of a contract providing for a cash payment at the closing, and no postclosing financial relationship between the seller and purchaser, the trustee need only demonstrate the assignee's ability to make the cash payment due at the closing in order to satisfy the requirement for adequate assurance of future performance. If the contract contemplates that purchase money indebtedness of the purchaser will be incurred at closing, there is a question as to whether section 365(c), discussed above, would render the contract nonassignable or

whether the trustee would be permitted to show adequate assurance of future performance by the assignee--to wit, the assignee's financial capacity to service the debt. The seller would argue in opposition to the proposed assumption and assignment transaction that section 365(c) describes a number of categories of contracts that cannot be *assumed or assigned* notwithstanding the contrary provisions of section 365. Thus, if a contract of sale contemplating purchase money debt cannot be assumed and retained by the trustee, then *a fortiori* the contract cannot be assumed and also assigned by the trustee. The argument to the contrary is that section 365(c) renders nonassumable a contract to extend debt financing to or for the benefit of the *debtor*, that, upon assignment, the debt financing would be for the benefit of the assignee rather than the debtor, and that the trustee should be given the opportunity to demonstrate the proposed assignee's ability to service the debt. Further, in the case of lease assignments, the landlord is obligated to accept a new assignee if the trustee can establish the assignee's financial and other capabilities to perform the lease, and hence in the case of a contract assignment the trustee should be accorded the opportunity to provide similar proof with respect to the assignee's ability to service the purchase money debt.ⁿ²⁷ Moreover, if the trustee is entitled to sell real property subject to existing liens,ⁿ²⁸ the debtor may argue that it should be empowered to assign a contract to a new purchaser who at the closing will encumber the property with the new mortgage lien contemplated in the contract.

FOOTNOTES:

(n1)Footnote 1. *In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982), holds that a contract for deed under which the vendee is a Bankruptcy Code debtor will be treated as a mortgage rather than an executory contract. This treatment permits the vendee to protect its equity in the property instead of requiring a complete assumption (and immediate cure of defaults) or total rejection of the contract (with a possible forfeiture of amounts theretofore paid under the contract). The *Booth* opinion contains a comprehensive list of articles and cases dealing with assumption and rejection of contracts for sale of real property. *Id.* at 67 note 3. The definitional issues are also reviewed in Quittner, *Franchises in Bankruptcy: Termination, Rejection and Assumption*, 89 Commercial L.J. 83 (Feb. 1984), and in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043, 12 C.B.C.2d 310 (4th Cir. 1985).

Although some courts have rejected the *Booth* approach and rigidly characterized contracts for deed as executory contracts under the Countryman definition and applicable state law. *See, e.g., Sipes v. Atlantic Gulf Communities Corp.* (In re General Dev. Corp.), 84 F.3d 1364 (11th Cir. 1996) (affirming the district court decision, at 177 B.R. 1000, 1995 U.S. Dist. LEXIS 1893). Other courts have preferred the *Booth* result where the debtor is the contract vendee. *In re Walker*, 227 B.R. 870 (Bankr. S.D. Ind. 1998) (state law applied, contract treated as secured transaction); *In re Speck*, 798 F.2d 279 (8th Cir. 1986) (rejects *Booth* because state law characterization governs); *In re Kane*, 248 B.R. 216 (1st Cir. B.A.P. 2000) (state law governs characterization, case-by-case analysis required, transaction deemed to be sale and financing arrangement); *In re Vacation Village Ltd. P'ship*, 49 B.R. 590 (Bankr. N.D. Iowa 1985) (rejects *Booth*, contract forfeited); *Shaw v. Dawson*, (D. N. Mex. 1985) (same); *Eugene Squire Motel v. Thurmond* (In re Thurmond), 46 B.R. 723 (D. Or. 1985) (follows *Booth*); *In re Bertelsen*, 65 B.R. 654 (Bankr. C.D. Ill. 1986) (same); *Chapman v. Britton* (In re Britton), 11 C.B.C.2d 1455, 43 B.R. 605 (Bankr. E.D. Mich. 1984) (same); *In re McCallen*, 13 C.B.C.2d 39 (Bankr. D. Or. 1985) (accepts *Booth* but holds that rehabilitative purpose better served if contract viewed as executory because debtor will have more time to cure); *cf. In re Moreggia & Sons, Inc. Walsh*, 852 F.2d 1179 (9th Cir. 1988) (refuses to apply state law to determine whether an agreement constituted a real property lease under section 365(d) (4) of the Code).

(n2)Footnote 2. H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977) ("House Report"), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). This language in the House Report was cited by the United States Supreme Court in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 533 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984); see also *COR Route 5 Company, LLC v. Penn Traffic Co.* (In re Penn Traffic Co.), 524 F.3d 373, 59 C.B.C.2d 1205 (2d Cir. 2008) (whether contract is executory is determined at the date of the petition).

(n3)Footnote 3. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439 (1973).

(n4)Footnote 3f. *In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982) , holds that a contract for deed under which the vendee is a Bankruptcy Code debtor will be treated as a mortgage rather than an executory contract. This treatment permits the vendee to protect its equity in the property instead of requiring a complete assumption (and immediate cure of defaults) or total rejection of the contract (with a possible forfeiture of amounts theretofore paid under the contract). The *Booth* opinion contains a comprehensive list of articles and cases dealing with assumption and rejection of contracts for sale of real property. 19 B.R. 53, 54 n.3 .

Although some courts have rejected the *Booth* approach and rigidly characterized contracts for deed as executory contracts under the Countryman definition and applicable state law. See, e.g., *Sipes v. Atlantic Gulf Communities Corp.* (In re General Dev. Corp.), 84 F.3d 1364 (11th Cir. 1996) (affirming the district court decision at 177 B.R. 1000, 1995 U.S. Dist. LEXIS 1893), other courts have preferred the *Booth* result where the debtor is the contract vendee. *In re Walker*, 227 B.R. 870 (Bankr. S.D. Ind. 1998) (state law applied, contract treated as secured transaction); *In re Speck*, 798 F.2d 279 (8th Cir. 1986) (rejects *Booth* because state law characterization governs); *In re Kane*, 248 B.R. 216 (1st Cir. B.A.P. 2000) (state law governs characterization, case-by-case analysis required, transaction deemed to be sale and financing arrangement); *In re Vacation Village Ltd. P'ship*, 49 B.R. 590 (Bankr. N.D. Iowa 1985) (rejects *Booth*, contract forfeited); *Shaw v. Dawson*, 48 B.R. 857 (D. N. Mex. 1985) (same); *In re Thurmond*, 46 B.R. 723 (D. Or. 1985) (follows *Booth*); *In re Bertelsen*, 65 B.R. 654 (Bankr. C.D. Ill. 1986) (same); *Chapman v. Britton* (*In re Britton*), 11 C.B.C.2d 1455, 43 B.R. 605 (Bankr. E.D. Mich. 1984) (same); *In re McCallen*, 13 C.B.C.2d 39, 49 B.R. 948 (Bankr. D. Or. 1985) (accepts *Booth* but holds that rehabilitative purpose better served if contract viewed as executory because debtor will have more time to cure).

(n5)Footnote 3g. *In re Heward Bros.*, 210 B.R. 475 (Bankr. D. Idaho 2007) (citing cases and holding that whether installment land sale contract was a security device would have to be decided on a case-by-case basis).

(n6)Footnote 3h. See *TKO Props., LLC v. Young* (In re Young), 214 B.R. 905 (Bankr. D. Idaho 1997) .

(n7)Footnote 4. Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1973). *In re Aslan*, 65 B.R. 826 (Bankr. C.D. Cal. 1986) . When a state court has entered a specific performance decree prior to the filing of a debtor-vendor's Bankruptcy Code petition, some courts have denied motions to reject the sales agreements and have enforced the specific performance orders. *In re Roxse Homes, Inc.*, 74 B.R. 810 (Bankr. D. Mass. 1987) ; *In re Pribonic*, 16 C.B.C.2d 626, 70 B.R. 596 (Bankr. W.D. Pa. 1987) ; *Kendall Grove Joint Venture v. Martinez-Estevé* (In re Kendall Grove Joint Venture) 59 B.R. 407 (S.D. Fla. 1986) ; *In re Meehan*, 12 C.B.C.2d 113, 46 B.R. 96 (Bankr. E.D.N.Y. 1985) .

(n8)Footnote 5. 11 U.S.C. § 101(4)(B).

(n9)Footnote 6. 124 Cong. Rec. H11,090 (Sept. 28, 1978) (remarks of Rep. Edwards); 124 Cong. Rec. S17,406 (Oct. 6, 1978) (remarks of Sen. DeConcini); *contra Lewis v. Maloon* (In re Lewis), 18 B.C.D. 969 (Bankr. D. Mass. 1988) . In *In re TKO Props. LLC*, 214 B.R. 905 (Bankr. D. Idaho 1997) , the court held that the sole remedy of the contract vendee was a claim for damages, but stated that the result might have been different if specific performance had been the only remedy available to the vendee rather than an alternative remedy to damages.

(n10)Footnote 6a. The court in *In re Taylor*, 103 B.R. 511 (D.N.J. 1989) , *aff'd*, 913 F.2d 102, 23 C.B.C.2d 1035 (3d Cir. 1990) , engaged in a similar analysis in upholding a trustee's right to reject a personal service contract of an individual debtor.

(n11)Footnote 7. 11 U.S.C. § 365(i).

(n12)Footnote 8. *House Report*, H.R. Rep. No. 595, 95th Cong., 1st Sess. 349 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(N13)Footnote 8a. See *In re Silberkraus*, 253 B.R. 890, 906 (C.D. Cal. 2000) ; *In re Maier*, 127 B.R. 325 (Bankr.

W.D.N.Y. 1991) ; *In re Smith*, 71 B.R. 754 (Bankr. M.D. La. 1987) .

(n14)Footnote 8b. *In re Fahnders*, 66 B.R. 94 (Bankr. C.D. Ill. 1986) ; cf. *Horton v. Rehbein* (*In re Rehbein*), 15 C.B.C.2d 46, 60 B.R. 436 (B.A.P. 9th Cir. 1986) .

(n15)Footnote 8c. *In re Fahnders*, 66 B.R. 94 (Bankr. C.D. Ill. 1986) .

(n16)Footnote 8d. It should be noted that once a seller has actually commenced a Bankruptcy Code case, termination provisions relating to the insolvency or financial condition of the seller, the commencement of such a case, or the appointment of or taking possession by a Bankruptcy Code trustee or a custodian before such commencement, are not enforceable. 11 U.S.C. § 365(e)(1). Thus, it is critical both that the default provision be triggered and the termination occur before the Bankruptcy Code case is commenced.

(n17)Footnote 8e. In cases under chapter 9, 11, 12 or 13 of the *Bankruptcy Code*, section 365 provides no statutory time limit for the debtor's decision to assume or reject most types of executory contracts, including contracts for the sale of real property. 11 U.S.C. § 365(d)(2). One notable exception relates to unexpired leases of nonresidential property, which must be assumed or rejected within 60 days after the date of the order for relief, or within such additional time as the court, for cause, fixes within such 60-day period. 11 U.S.C. § 365(d)(4).

(n18)Footnote 9. *In re New York Investors Mut. Group, Inc.*, 143 F. Supp. 51 (S.D.N.Y. 1956) . See also *Countryman, Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 471 (1973).

(n19)Footnote 9a. See *Aetna Bank v. Dvorak*, 176 B.R. 160 (N.D. Ill. 1994) (lien not entitled to priority over prior recorded mortgage); *Delta Energy Res., Inc., v. Damson Oil Corp.*, 72 B.R. 7 (W.D. La. 1985) (section 365(j) lien not entitled to adequate protection or administrative priority).

(n20)Footnote 9b. See *In re Thompson Designs*, 213 B.R. 725 (Bankr. S.D. Ind. 1997) (lien is subordinate to mechanics liens).

(n21)Footnote 10. *Gulf Petroleum, S.A. v. Collazo*, 316 F.2d 257 (1st Cir. 1963) .

(n22)Footnote 11. *Gulf Petroleum, S.A. v. Collazo*, 316 F.2d 257, 261 (1st Cir. 1963) ; *TTS, Inc. v. Citibank, N.A.* (*In re TTS, Inc.*), 158 B.R. 583 (D. Del. 1993) ; *In re ANR Advance Transp.*, 247 B.R. 771 (Bankr. E.D. Wisc. 2000) (holding that escrow established at third party bank for purpose of paying costs of remediating environmental damages was true escrow not included in property of the estate, given that escrow was not revocable by creators); *In re Pelc, Bank. L. Rep. P 69,497* (Bankr. D. Ore. 1983). See *In re O.P.M. Leasing Servs., Inc.* 46 B.R. 661 (Bankr. S.D.N.Y. 1985) (transfer by escrow agent during prepetition preference period did not constitute transfer of property of estate).

(n23)Footnote 11a. 369 B.R. 156 (Bankr. D. Del. 2007) .

(n24)Footnote 12. See *Robertson v. Pierce* (*In re Chi-Feng Huang*), 7 C.B.C.2d 639, 23 B.R. 798 (B.A.P. 9th Cir. 1982) .

(n25)Footnote 13. See P 3.03[2] *supra*.

(n26)Footnote 13a. *In re Leslie Fay Cos., Inc.*, 166 B.R. 802 (Bankr. S.D.N.Y. 1994) .

(n27)Footnote 14. 11 U.S.C. §§ 365(g), 502(g).

(n28)Footnote 14a. Cf. *Sullivan v. Willock* (*In re Wey*), 854 F.2d 196 (7th Cir. 1988) (contract downpayment forfeited by debtor-purchaser during prepetition period is not a preferential payment or fraudulent transfer); *but see In re Leslie Fay Cos., Inc.*, 166 B.R. 802, 811 (Bankr. S.D.N.Y. 1994) (concluding that forfeiture of entire downpayment may no longer be the law in Pennsylvania).

(n29)Footnote 15. *Cf. Florence St. Elec. & Mech., Inc. v. Cummins Mohawk Diesel, Inc. (In re Florence St. Elec. & Mech., Inc.)*, No. 81-11517 (N.D.N.Y. Nov. 8, 1982); *In re Davies*, 8 C.B.C.2d 760, 27 B.R. 898 (Bankr. E.D.N.Y. 1983) .

(n30)Footnote 15a. In *In re Leslie Fay Cos., Inc.*, 166 B.R. 802, 811 (Bankr. S.D.N.Y. 1994) , the court described the measure of damages in such a situation as the contract price minus the fair market value at the time of the breach (which the court noted was the time of the bankruptcy filing) less any payments received.

(n31)Footnote 16. *See generally 5 Collier on Bankruptcy*, ch. 553 (Matthew Bender 15th Ed. Revised).

(n32)Footnote 17. *5 Collier on Bankruptcy at P 553.10* (Matthew Bender 15th Ed. Revised).

(n33)Footnote 18. *5 Collier on Bankruptcy at P 553.08 [4]* (Matthew Bender 15th Ed. Revised). *Section 362(a)(7) of the Code* specifically stays "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7).

(n34)Footnote 18a. Significantly, *section 506 of the Code* specifically treats a claim that is subject to setoff under section 553 as a secured claim to the extent of the amount subject to setoff. 11 U.S.C. § 506(a).

(n35)Footnote 19. Although section 542(a) does not expressly provide for adequate protection of an interest in property upon a turnover to the trustee, the reference therein to property that the trustee may use, sell or lease under section 363 incorporates the section 363(e) adequate protection requirement for persons having an interest in property used, sold or leased by the trustee.

(n36)Footnote 19a. *In re Berkley Multi-Units, Inc.*, 69 B.R. 638 (Bankr. M.D. Fla. 1987) .

(n37)Footnote 20. *See P 4.01[1] supra*.

(n38)Footnote 21. *Cf. Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980) ; *P 2.04 supra* ; *see also McCannon v. Marston*, 679 F.2d 13, 6 C.B.C.2d 875 (3d Cir. 1982) , with respect to the effect of *section 544(a) of the Code*--the "strong-arm" avoidance provision--on unrecorded contracts for sale.

(n39)Footnote 22. Under 11 U.S.C. § 365(c)(2), a trustee may not assume a contract to extend financial accommodations to the debtor.

(n40)Footnote 23. 11 U.S.C. § 365(a), (b); *see P 3.01[5] supra*, for a discussion of the rules concerning assumption of leases. These rules are equally applicable to contracts of sale and other executory contracts.

(n41)Footnote 24. 11 U.S.C. § 365(b).

(n42)Footnote 25. 11 U.S.C. § 365(c).

(n43)Footnote 25a. 900 F.2d 1417 (9th Cir. 1990) . The *Easebe* case was overruled by *Unsecured Creditors' Comm., of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)*, 139 F.3d 702 (9th Cir. 1998) (*en banc*) with respect to whether an option agreement is an executory contract subject to rejection or assumption. The court rejected the *Easebe* implication that all option contracts were executory contracts. The court held that resolution of the issue requires a determination of whether there are outstanding obligations on both sides remaining unperformed at the time of the bankruptcy petition, and that the contract will not be deemed executory if the option holder has not exercised the option at that time. If the option holder has not exercised the option, there are no obligations of the parties to be performed. 139 F.3d 702, 705-06 . *Helms* did not overrule the holding of *Easebe* as it applied to contracts to extend financial accommodations.

(n44)Footnote 25b. This argument was made by the debtor and rejected by the court in *Easebe*, 900 F.2d 1417,

1420 (9th Cir. 1990) .

(n45)Footnote 26. 11 U.S.C. § 1111(b).

(n46)Footnote 26a. 11 U.S.C. § 365(b)(1)(c).

(n47)Footnote 26b. 11 U.S.C. § 365(f).

(n48)Footnote 27. See P 3.01[5] *supra*.

(n49)Footnote 28. See 11 U.S.C. § 363(b), (k).

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.02

P 4.02 Option Agreements

[1] Introduction

Options to purchase real property are frequently employed in parcel assemblage transactions, in sale-leaseback transactions in which the lessee requires the continued use of a facility subsequent to the expiration date of the lease, and in many other instances involving the acquisition of real property. Option contracts may be embodied in separate agreements or may be set forth in leases. In the case of sale-leaseback transactions, it is fair to generalize that most seller-lessees would not enter into such transactions in the absence of an enforceable purchase option. The principal creditors' rights issues in the case of option contracts are whether the party obligated to sell upon the exercise of the option (the optionor) may, as a debtor under the Bankruptcy Code, reject its obligation to convey the property, and, assuming the power to so reject, whether the party entitled to exercise the option (the optionee) may obtain a decree of specific performance against the debtor-optionor or its trustee.

[2] Option Contracts Separate From Leases

The threshold issue with respect to the rejectability of an option contract by the trustee for the optionor is whether the agreement is an executory contract for the purposes of section 365(a). If at the time of filing of the optionor's Bankruptcy Code petition the optionee has not exercised the option, and the optionor's trustee thereafter seeks to reject the contract, the optionee may assert that the contract cannot be rejected inasmuch as (1) the non-debtor optionee, not having exercised the option, has no obligations, and the debtor-optionor has no corresponding duties under the contract, (2) the contract therefore is not executory because no unperformed material obligations on the part of both parties exist as of the date of filing of the optionor's petition, and (3) accordingly, the contract cannot be rejected inasmuch as only executory contracts may be rejected under the Code.ⁿ¹

The optionor's trustee will argue in opposition that the optionee's contention misconstrues the nature and legal effect of the option contract. The contract is a binding agreement when executed and delivered and when the consideration for the option itself is paid. After that time, the optionor is under a legal disability that prohibits it from conveying the property to anyone else unless such conveyance is effected subject to the option. The optionee has therefore purchased an offer from the optionor irrevocable during the option term, as well as a power of acceptance of the offer that may be exercised by the exercise of the option.ⁿ² Under this analysis, the optionor is under a disability pursuant to the contract from and after the date of execution and delivery of the contract--the negative duty not to sell the property to anyone else during the term of the option contract other than subject to the option, and the affirmative duty to keep its offer

open during the option term.^{n2a} These duties can be breached outside of the Bankruptcy Code context by the optionor's selling the property to a third party purportedly free of the option or by its renunciation of the contract. If the optionor can breach the contract in this manner outside of a Bankruptcy Code case, there is no apparent reason why the optionor's trustee cannot likewise breach the contract by rejecting it under section 365(a).

The optionee will argue in response to the foregoing that even assuming that there is an obligation on the optionor's part that may be breached, the definition of "executory contract" alluded to in the House Report and promulgated by Professor Countryman requires the existence of unperformed obligations by *both* parties to the contract and that the optionor has no such obligations unless it exercises the option.ⁿ³ The answer to this contention is twofold: *first*, that the purpose of the trustee's rejection is to avoid the consequences of the eventual exercise of the option by the optionee, and that upon such exercise the contract becomes bilateral, with the optionee obligated to pay the balance of the purchase price and the optionor obligated to convey; and *second*, that the Countryman definition is subject to challenge on the grounds that the existence or nonexistence of an unperformed obligation on the part of the non-debtor party to a contract is irrelevant to the determination of whether a trustee is entitled to reject an unperformed obligation of the debtor if such rejection would be in the best interests of the unsecured creditors of the estate.ⁿ⁴

The option cases generally arise in the context of the debtor-optionor's desire to reject the option agreement in order to be free to dispose of its asset at a price higher than it would receive were the option to be exercised by the nondebtor optionee and the transaction performed. If a court declines to classify an option agreement as an executory contract, and the obligation is not otherwise avoidable under the Code, then there is no mechanism for dealing with the option agreement with the debtor's case under the Code, and the agreement will remain an obligation of the debtor.^{n4a} If the option involves an agreement to purchase real property, the parties may have recorded a memorandum of the option, which, in the absence of rejection, will remain an encumbrance on the property.

Alternatively, if an option contract were not an executory contract, but simply a unilateral obligation in the nature of a debt (*i.e.* an obligation on the part of the debtor to repay borrowed funds), the debtor could argue that in the exercise of business judgment, it decided to breach the option contract, giving rise to a claim by the optioner for damages arising from such breach. In fact, the debtor could effectively bring a motion under section 363(b)(1) to repudiate the contract on the grounds that a repudiation was not in the debtor's ordinary course of business and that approval for such a non-ordinary course transaction was warranted by the benefit to the estate of selling the asset to another person. Such a characterization is complicated, however, by the possible availability of the remedy of specific performance.^{n4b}

The argument that an option agreement is not an executory contract in the absence of unperformed obligations on the part of both parties may be tested by positing that the optionee--the party with the right to exercise the option--is the debtor rather than the optionor--the party that is subject to the option. If the optionee is the debtor and desires to exercise the option, it will most likely move to assume the agreement in order to exercise it. However, if the option agreement is not an executory contract, there is no authority under *section 365(a) of the Code* to assume the instrument, and it will not become an obligation or an asset of the estate.^{n4c} If the agreement does not become an obligation and asset of the estate, then arguably the agreement and the value to be realized from its exercise remain the property of the debtor and do not go into the estate. Although this may be conceptually correct in the case of an individual debtor and a chapter 7 or chapter 11 trustee, it is difficult to accept this result in the case of a debtor that is an entity and becomes a debtor in possession under chapter 11 *of the Code*.

The difficulties posed under the foregoing hypothetical situations may be avoided by revisiting the Countryman definition of an executory contract, and by focusing on the obligations of the debtor to be discharged through the breach of a contract and the allowance and discharge of claims resulting therefrom (in the case of rejection), and the benefits to be realized through acceptance by the estate of the subject contractual obligations (in the case of assumption).^{n4d} This approach appears to foster clearly articulated policy of bringing finality to the settlement of obligations through the expansive definition of a "claim" set forth in the Code^{4e} and the related discharge mechanisms. The Countryman definition of an executory contract was articulated prior to enactment of the Code, and may not provide the correct

methodology for finalizing the adjustment of the contractual relationships of Code debtors.

Assuming therefore, that an option contract is rejectable by the optionor's trustee, can the optionee take any steps to counter the effects of a rejection?

If the optionee is in possession of the property, whether under a lease or otherwise, it may be helpful to structure the option contract as a purchase and sale agreement within the ambit of section 365(i). As discussed earlier,ⁿ⁵ under section 365(i) a contract purchaser in possession may, notwithstanding a rejection of the contract by the seller's trustee, elect to remain in possession, make the payments required under the contract (less an offset for any damages arising out of the seller's nonperformance of its obligations under the contract) and compel the seller's trustee to deliver a deed on the scheduled date.ⁿ⁶ An option contract may be converted to a purchase and sale agreement by providing for a downpayment instead of a payment in consideration of the grant of the option, a liquidated damage clause limited to the amount of the downpayment instead of the forfeiture of the option consideration if the option is not exercised, and a clear provision to the effect that the liquidated damages are the seller's exclusive remedy. The principal difference between the two types of contracts is that under the purchase and sale agreement the purchaser's failure to close constitutes a breach of the contract, whereas under the option contract the optionee's failure to exercise the option does not constitute a breach. If the possibility of a breach (with the damage limitation described above) is acceptable, then the specific performance provisions of section 365(i) should be helpful to an optionor in possession.

A second approach utilizes a prophylactic theory under which the rejection of the option contract would be so onerous as to make assumption the better course of action for the trustee. One possibility, although difficult to achieve in the course of most negotiations, is to create some degree of personal liability on the part of the principals of the optionor in the event of a breach or rejection of the option contract. This may be particularly objectionable with respect to involuntary proceedings against the optionor under the Code because the principals may have no control over the trustee's election to reject the option contract. Another less effective but more acceptable approach is to secure the payment of damages arising from rejection of the option contract with a mortgage on the property. Although some jurisdictions may hold such a mortgage to be invalid for indefiniteness as to the amount secured, others will probably recognize the mortgage. The benefits of such a mortgage are that the trustee, upon rejection, will be constrained to deal with the optionee as a secured party rather than as an unsecured creditor, and to deal with the mortgage even in the case of a cramdown under section 1129(b). These considerations may at least give rise to negotiations between the trustee and the optionee prior to the rejection of the contract, with the optionee's bargaining power enhanced by the existence of the mortgage. A form of mortgage securing the payment of such damages is provided at the end of this chapter.ⁿ⁷ Another variant of the same approach is to bargain for a letter of credit to be furnished by the optionor, drawable upon a breach or rejection of the option contract. It should be reiterated that the personal guarantee, mortgage and letter of credit approaches do not directly address the problem that the optionee in all likelihood cannot obtain specific performance of the agreement, and are merely intended to deter rejection.

If the transaction involves a sale-leaseback of real property, consideration may be given to inclusion in the deed to the optionor of a provision for an automatic reverter or other automatic disposition of title to the optionee if the optionor breaches or rejects the option agreement. If the reversionary rights of the grantor-optionee are recognized under applicable state law, a bankruptcy court may view such rights as "property interests" which, unlike contractual rights, cannot be impaired by the bankruptcy court.ⁿ⁸ The self-operative feature of the reverter, together with the inclusion of the reverter in the deed itself, may create a distinction between a contractual obligation on the part of the optionor to convey title and a limitation on the estate's title to the property that must be respected in the same manner as any other title encumbrance (such as an easement or covenant).^{n8a} This degree of protection is ordinarily difficult to obtain in the absence of substantial bargaining power on the part of the optionee. The deed limitation may be particularly difficult to obtain in a tax-oriented sale-leaseback transaction, in which the owner- lessor must evidence substantial indicia of ownership to qualify for the tax benefits attendant upon such ownership.

[3] Option Contracts Contained in Leases

A purchase option contained in a lease will be impaired if the lessor rejects the lease under section 365. If the purchase option is viewed as an integral part of the lease, and is deemed rejected as part of the rejection of the lease, the lessee-optionee will be relegated to the remedies prescribed in section 365(h).ⁿ⁹ If the lessee treats the lease as terminated under 365(h)(1)(A)(i), it will surrender possession of the premises and have a claim arising out of the rejection of the lease. Any damages allowable under state law arising from the loss of the purchase option may be added to the claim. If, on the other hand, the nondebtor lessee elects under section 365(h)(1)(A)(ii) to retain its lease rights, the rejection of the lease appears to mean that the lessor will have breached its affirmative obligations thereunder, including its obligation to convey title to the lessee upon exercise of the embedded purchase option.^{n9a} Section 365(h)(1)(A)(ii) provides that the nondebtor lessee may elect to retain its rights under the lease, including rights appurtenant to the real property. The rights of such a lessee in respect of a purchase option contained in the lease may be considered to be appurtenant to the real property.^{n9b} However, *section 365(h)(1)(B) of the Code* provides that the exclusive remedy for a nondebtor lessee that retains its rights under section 365(h)(1)(A)(ii) for damages arising from the nonperformance by the debtor of its obligations under the lease is the offset of such damages from succeeding installments of rent. Thus section 365(h)(1)(B) appears to deny to such a lessee the remedy of specific performance.^{n9c}

If on the other hand the court determines to sever the option provisions from the lease, section 365(h) will be inapplicable with respect to the rejection of the option, and the optionee will be relegated to claim for damages under *section 365(g) of the Code* as if a separate option contract had always been in effect.ⁿ¹⁰ The severance of the purchase option will not enhance the lessee's ability to obtain specific performance of the lessor's obligation to convey title, unless the purchase option is deemed not to constitute an executory contract and is therefore unaffected by the debtor's case under the Code.^{n10a}

Moreover, if the option is severed from the lease, the court may then conclude that the option holder is only in possession of the premises solely by virtue of its status as lessee under the lease and deny the purchaser the benefits of section 365(i) that is only available to purchaser's in possession.^{n10b} It may be desirable for lessees in such situations to include language describing their right of possession and quiet enjoyment under the lease as being derived from their status as both lessees and purchasers.

It has been suggested above that option contracts should when possible be cast as contracts of purchase and sale within the purview of *section 365(i) of the Code* in an effort to realize the benefits of the specific performance provisions of that section.ⁿ¹¹ In the case of leasing transactions involving a purchase option for the benefit of the lessee, it is suggested that the use of a separate contract be considered whenever a strict characterization of an "option" rather than a contract with a liquidated damage clause is not essential. Even for transactions in which option characterization is important, consideration should be given to the utilization in certain circumstances of a separate option contract rather than inclusion of the option in the lease. The principal consideration in determining whether a separate option contract is desirable is whether the value of the section 365(h)(1)(B) rental offset for aggregate damages arising out of the lessor's rejection of the lease and option is greater than the value of a separate claim for damages caused by the breach of the option alone. If, for example, an option is not exercisable until shortly before the expiration of the lease, there may be little value in the right of offset against the ensuing rental payments. In different circumstances, the dollar-for-dollar worth of the rent offset may outweigh the potential benefit resulting from less than a 100 percent distribution on the allowed claim for damages, thus militating in favor of inclusion of the option in the lease. It should be noted, however, that the inclusion of an option provision in a lease will not necessarily ensure application of the section 365(h)(1)(B) offset rights in respect of option rejection damages if the court determines that the option provisions are in any event severable and should not be treated as part of the lease for Bankruptcy Code purposes.

In *In re Eldercare Properties Ltd.*,ⁿ¹² the failure to exercise an option to extend a lease was held to be "mere neglect that should be excused under Texas's narrow equitable exception to the rule of strict enforcement." In that case, the bankruptcy court allowed a nursing home debtor to extend its lease after it had inadvertently neglected to exercise the option to extend its lease. Holding that the failure to do so would result in great hardship, the court concluded that it was

"unconscionable to enforce literally the condition precedent of the lease."n13

FOOTNOTES:

(n1)Footnote 1. See PP 4.01[1] *supra*, and 4.07 *infra*, for discussions of the definition of the term "executory contract." *In re G-N Partners*, 48 B.R. 462 (Bankr. D. Minn. 1985), held that the option agreement in that case was an executory contract, and that section 108(b) extended the exercise period 60 days.

(n2)Footnote 2. 1A Corbin on Contracts § 259 (1963).

(n3)Footnote 2a. *In re Riodizio, Inc.*, 37 C.B.C.2d 868, 875, 204 B.R. 417, 422 (Bankr. S.D.N.Y. 1997).

(n4)Footnote 3. See P 4.01[1] *supra*. The Countryman test requires the existence of unperformed material duties on the part of both parties to the agreement, such that nonperformance of such a duty by a party would excuse performance by the other party. See *In re Riodizio, Inc.*, 37 C.B.C.2d 868, 871-73, 204 B.R. 417, 420-21 (Bankr. S.D.N.Y. 1997). Some courts have noted a difference between the Countryman test and the expression of that test set forth in the legislative history of the Code, which characterizes an executory contract as one in which "performance remains due to some extent on both sides." H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised), quoted in *In re Riodizio* 37 C.B.C.2d 868, 871-73, 204 B.R. 417, 420-21. This formulation appears to eliminate the materiality element of the Countryman definition, and is therefore regarded as more inclusive. *Id.* at 421. Still other courts take a so-called "functional approach" which bypasses the Countryman analysis and seeks to determine whether nonperformance of an agreement would provide benefits to the estate. *Id.* at 422. Under this formulation, the rejection of an option agreement under which the debtor is the optionor would be authorized when the option price is lower than the current market price for the asset subject to the option and the optionee's damage claim would be paid in less than one hundred cent dollars. The court in *In re Riodizio supra* appears to have been uncomfortable with the functional approach as being too policy oriented and adopted the test articulated in the House Report quoted above. See footnote 4 *infra* for further discussion of the functional approach to executory contracts.

(n5)Footnote 4. See P 4.07 *infra*; see also *In re Drexel Burnham Lambert Group, Inc.*, 26 C.B.C.2d 1128, 138 B.R. 687 (Bankr. S.D.N.Y. 1992) (adopting functional approach to determine whether contract is capable of rejection or assumption under section 365 such that analysis is not whether contract is "executory" but, rather, whether the estate will benefit from rejection or assumption). *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37 (D.R.I. 1999), contains a good review of the issues involved in the debate over whether the classic Countryman definition of an executory contract or the so-called "functional analysis" provides the proper standard for determining whether a contract is executory within the meaning of section 365 of the Code. The *Butler* court, in opting for the Countryman definition, argued that the functional analysis ignores the statutory mandate that the contract be executory. 241 B.R. at 44. However, it may be argued that the functional analysis presumes that there are unperformed obligations remaining under a contract, but only on the part of the debtor. To argue that for Bankruptcy Code purposes an executory contract must have material obligations unperformed on both sides assumes a conclusion nowhere mandated in the language of the Code.

The *Butler* court further characterized the functional analysis as merely an embodiment of the business judgment test relating to the trustee's decision to assume or reject a contract. *Id.* at 44. It may be argued, however, that the business judgment standard may be applied only after the functional analysis has determined that there are material obligations under a contract remaining to be performed by the debtor, and that assumption or rejection thereof will have an effect on the financial condition of the estate. The business judgment test will then apply to determine the court's scope of review of the trustee's decision to assume or reject the contract.

Options were dealt with as assumable or rejectable executory contracts in *In re Easebe Enters., Inc.*, 900 F.2d 1417 (9th Cir. 1990) (overruled by *In re Robert L. Helms Constr. Co.*, 139 F.3d 702, 39 C.B.C.2d 1055 (9th Cir. 1998)); *In re III Enters.*, 163 B.R. 453 (E.D. Pa 1994); *In re Hardie*, 100 B.R. 284 (Bankr. E.D.N.C. 1989); *In re Coordinated*

Fin. Planning Corp., 65 B.R. 711 (B.A.P. 9th Cir. 1986) ; *Santa Fe Dev. & Mortgage Corp. v. McCormack* (*In re Santa Fe Dev. & Mortgage Corp.*), 5 C.B.C.2d 1186, 16 B.R. 165 (B.A.P. 9th Cir. 1981) ; *In re A.J. Lane & Co., Inc.*, 107 B.R. 435 (Bankr. D. Mass. 1989) , *In re Waldron*, 36 B.R. 633 (Bankr. S.D. Fla. 1984) , and *Rivercity v. Herpel* (*In re Jackson Brewing Co.*), 567 F.2d 618 (5th Cir. 1978) but see *In re Giesing*, 96 B.R. 229, 232 (Bankr. C.D. Mo. 1989) (debtor paid option fee and contract was therefore deemed not executory); *In re Robert L. Helms Constr. Co.*, *infra* (unexercised option is not executory inasmuch as there are no unperformed obligations); *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (citing Robert Helms Construction Co., *infra*, and holding that a right of first refusal was not an executory contract, or, was not repudiated by any rejection).

(n6)Footnote 4a. See *COR Route Five Company, LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 59 C.B.C.2d 1205 (2d Cir. 2008) . See generally Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U. Colo. L. Rev. 845 (1988).

(n7)Footnote 4b. See P 4.01[1] *supra* for a general discussion of the argument that the Bankruptcy Code definition of "claim" severely limits if not eliminates the remedy of specific performance against a debtor if monetary damages can be calculated.

(n8)Footnote 4c. See generally Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U. Colo. L. Rev. 845 (1988). See also *Medical Malpractice Ins. Assoc. v. Hirsch* (*In re Lavigne*), 114 F.3d 379, 387, 38 C.B.C.2d 67, 76 (2d Cir. 1997) .

(n9)Footnote 4d. E.g., *Sipes v. Atlantic Gulf Cmty. Corp. (In re General Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996) , *aff'g*, 117 B.R. 1000 (S.D. Fla. 1995) ; *In re Drexel Burnham Lambert Group, Inc.*, 26 C.B.C.2d 1128, 138 B.R. 687 (Bankr. S.D.N.Y. 1992) . See the discussion in note 4, *supra*.

(n10)Footnote 4e. 11 U.S.C. § 101(5); see P 6.03 *infra*. See generally Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 Am Bankr. L.J. 223 (1981).

(n11)Footnote 5. See P 4.01[1] *supra*.

(n12)Footnote 6. Under section 365(h)(1), as in effect prior to the amendments pursuant to the Bankruptcy Reform Act of 1994, and dealing with the rights of a real estate lessee in "possession" to retain "possession" notwithstanding the rejection of the lease by the lessor's trustee, possession required something more than a right of entry for limited purposes. *In re Marina Enters., Inc.*, 5 C.B.C.2d 434, 14 B.R. 327 (Bankr. S.D. Fla. 1981) ; *Seidle v. Aeroservice Int'l, Inc. (In re Belize Airways, Ltd.)*, 12 B.R. 387 (Bankr. S.D. Fla. 1981) ; *In re J.H. Land & Cattle Co.*, 3 C.B.C.2d 695, 8 B.R. 237 (Bankr. W.D. Okla. 1981) . This analysis should remain relevant to interpreting the term "possession" under section 365(i), which was not amended by the Bankruptcy Reform Act of 1994.

(n13)Footnote 7. See P 4.51 *infra*. A further variant may be found in the option agreement considered in *Yates Dev., Inc. v. Old Kings Interchange, Inc. (In re Yates Dev., Inc.)*, 241 B.R. 247 (Bankr. Md. Fla. 1999) . The agreement provided for an increase in the purchase price of \$5,000 per day for every day after a specified date during which the exercise period was extended. The optionor filed a petition under the Code in an attempt to stop the running of the penalty period, but the court held that the increase in the purchase price had to be paid if the debtor were to assume the agreement and exercise the option. There were indications in the opinion that the purpose of the purchase price escalation provision was to deter a Bankruptcy Code filing by the optionor, but the court found that the provision was enforceable under applicable state law and did not constitute an unenforceable *ipso facto* provision under section 365(e)(1) of the Code.

(n14)Footnote 8. *In re 523 E. Fifth St. Housing Pres. Dev. Fund Corp.*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987) ; see P 4.04 *infra*, for a discussion of the distinction between "contractual rights" and "property interests" under the Bankruptcy Code. See generally Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 Am. Bankr. L.J. 223 (1981).

(n15)Footnote 8a. *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (treating right of first refusal as nonrejectable property right).

(n16)Footnote 9. *See P 2.01[4] supra*, for a discussion of the operation of section 365(h) upon the rejection of a real estate lease by the lessor's trustee. It appears that the issue of severability of the option from the lease is a question of state law. *See In re Beare Co.*, 177 B.R. 879 (Bankr. W.D. Tenn. 1994) (holding that under Tennessee law option to purchase assets of debtor was not severable from management agreement). *Compare In re Harrison*, 117 B.R. 570 (Bankr. C.D. Cal. 1990), holding that lease of motor fuel station combined with dealer agreement, automobile care agreement, warranty agreement and other matters would not be deemed a lease of real property for the purposes of the automatic rejection provisions of section 365(d)(4).

(n17)Footnote 9a. *See P 2.01[4] supra*.

(n18)Footnote 9b. Under common law, an easement appurtenant is a right arising by reason of ownership of a dominant estate in real property, and is assignable and inheritable as a part of such rights of ownership. An easement in gross is a right held independently of the ownership of real property, and is often deemed to be personal to the holder and not transferable. *See, e.g., Banach v. Home Gas Co.*, 23 Misc. 2d 556, 199 N.Y.S.2d 858 (Sup. Ct., Schuyler Co., 1960).

(n19)Footnote 9c. It should be noted that section 365(h)(1)(C), dealing with shopping center leases, provides to a nondebtor lessee under a lease rejected by a debtor-lessor the right of "enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance." The term "enforceability" employed in this section may give rise to the inference that the remedy of specific performance or similar affirmative relief is available to nondebtor lessees in respect of the types of provisions specified in section 365(h)(1)(C). Thus when section 365(h)(1)(C) is read in juxtaposition with section 365(h)(1)(B), which does not employ the term "enforceability," and which appears to provide for a rental offset as an exclusive remedy, the argument against the availability of affirmative relief for a nondebtor lessee under sections 365(h)(1)(a)(ii) and 365(h)(1)(B) in respect of a purchase option appears even stronger.

(n20)Footnote 10. *See P 4.02[2] supra*. The severance of purchase options contained in leases is a recognized method of preserving for the lessee the benefits of the option based upon the judicial determination that the parties intended the lease and option to be independent. *Bado Realty Co. v. Oetjen*, 5 Misc. 2d 914, 161 N.Y.S.2d 780 (Sup. Ct. 1957). *See generally* Annotation, *Holding Over Under Lease, or Renewal or Extension Thereof, as Extending Time for Exercise of Option to Purchase Contained Therein*, 15 A.L.R.3d 470 (1967). Bankruptcy cases that have considered severability include *In re Beare Co.*, 177 B.R. 879 (Bankr. W.D. Tenn. 1994) (option to purchase debtor's assets not severable from management agreement); *In re Myklebust*, 26 B.R. 582 (Bankr. W.D. Wis. 1983); *In re Fontaine Janitorial Supply & Service, Inc.*, 17 B.R. 322 (Bankr. M.D. Fla. 1982); cf. *In re Gardinier, Inc.*, 831 F.2d 974 (11th Cir. 1987), *reh'g en banc denied*, 849 F.2d 1480 (11th Cir.), *cert. denied*, 488 U.S. 853, 109 S. Ct. 140, 102 L. Ed. 2d 112 (1988) (brokerage provision in contract of sale may be rejected although contract of sale is being assumed); *In re Moskovic*, 77 B.R. 421 (S.D.N.Y. 1987) (same); *see also In re Cafe Partners/Washington* 1983, 90 B.R. 1 (Bankr. D.D.C. 1988), refusing to sever from a lease the lessee's obligation to repay a loan from the lessor.

(n21)Footnote 10a. *See P 4.02[2] supra*.

(n22)Footnote 10b. *In re Nickels Midway Pier, LLC*, 341 B.R. 486 (D.N.J. 2006).

(n23)Footnote 11. *See P 4.02[2] supra*.

(n24)Footnote 12. 568 F.3d 506 (5th Cir. 2009).

(n25)Footnote 13. 568 F.3d 506, 523.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.03

P 4.03 Nondisturbance Agreements

A nondisturbance agreement between a prime lessor and a sublessee typically provides that notwithstanding a default under or termination of the prime lease, the sublease will remain undisturbed as a lease between the prime lessor and sublessee if the sublessee is paying and performing its obligations under the sublease. One of the protections afforded to a sublessee by a nondisturbance agreement is that if the sublessor becomes a debtor under the Bankruptcy Code, and rejects the prime lease, the sublease will not fall inasmuch as it will be taken up by the prime lessor. If the prime lessor, but not the sublessor, becomes a debtor in a Bankruptcy Code case, and rejects the prime lease, the sublessor under *section 365(h) of the Code* should be empowered to elect to retain its rights under the lease and thus remain in possession of the premises *vis-a-vis* the prime lessor, and therefore the sublease will once again be protected so long as the sublessor exercises its rights under section 365(h).¹ If, however, both the prime lessor and the sublessor become debtors under the Bankruptcy Code, and (1) the prime lessor rejects the prime lease, (2) the sublessor elects under section 365(h) to treat the prime lease as terminated, and (3) the sublessor rejects the sublease, can the sublessee elect under section 365(h) to remain in possession and rely upon the nondisturbance agreement with the prime lessor?² Will the prime lessor's trustee be able to reject the nondisturbance agreement itself?

The bankruptcy of both the prime lessor and sublessor is of course an unlikely event, and would probably occur only if the prime lessor and sublessor were affiliated. This has happened in certain large retail company insolvency cases in which separate subsidiaries had been established to own or lease each store location, and for internal tax (particularly state tax) or financing purposes the stores had been leased or subleased to other entities in the consolidated group.³ When the enterprise encountered financial difficulties, substantially all of the subsidiaries and affiliates became debtors under the former Bankruptcy Act or Code notwithstanding the viability of a particular store or entity. Thus, in this context a prime lessor and sublessor could both become debtors in a Bankruptcy Code case.

Another example of a potential dual bankruptcy arises in the case of a sale-leaseback transaction involving a partnership as fee owner, a corporate sublessor, and the original seller as sublessee. In this structure, the sublessor may be affiliated with a tax-shelter syndicator that is also the sponsor of the fee owner partnership, and the general partner of the partnership may also be affiliated with the sponsor. The partnership will ordinarily incur nonrecourse mortgage debt to acquire the property, and the sublease rentals will be passed through to service the mortgage. It is generally asserted that there can be no bankruptcy of the sublessor and prime lessor as long as the sublessee continues to pay and perform its obligations under the sublease, so that the sublessee need not be concerned with the possibility of a rejection of the prime lease, the sublease and the related nondisturbance agreement. Although this position has substantial merit,

counsel for the prospective sublessee may consider the possibilities that (a) the fee owner may independently encounter financial difficulties if anticipated tax benefits are ultimately held to be unavailable, (b) the sublessor may encounter financial difficulties if the limited partners of the fee owner, having been denied anticipated tax benefits, seek recovery from the tax-shelter sponsor and its affiliates, including the sublessor, and (c) the tax-shelter sponsor, for reasons unrelated to the sale-leaseback transaction, files a petition under the Bankruptcy Code for itself and its affiliates, including the general partner of the prime lessor partnership and the sublessor. It is of course important to assess the probabilities of occurrence of these events on a pragmatic basis, taking into account the identity of the sponsor, its history and current financial capacity, and the nature of the particular transaction.

With respect to the rejectability of a nondisturbance agreement as a matter of bankruptcy law, it appears that such agreements fall within the Countryman definition of an executory contract and are therefore rejectable by the trustee of a prime lessor under *section 365(a) of the Bankruptcy Code*.ⁿ⁴ The agreement ordinarily will require performance of obligations by both parties. The prime lessor will be required to recognize the sublease and to accept the sublessee as the tenant of the prime lessor, and the sublessee will be required to attorn to the prime lessor. Thus, a nondisturbance agreement may be breached by the prime lessor by refusing to accept the sublease and the sublessee. The sublessee may have a claim for damages against the estate of the prime lessor (as well as a separate claim against the estate of the sublessor arising out of the sublessor's election to treat the rejected prime lease as terminated), but will encounter difficulty if it seeks to specifically enforce the nondisturbance agreement.ⁿ⁵

In the so-called "sandwich lease" structure described above, the holder of the nonrecourse debt incurred by the fee owner partnership will require assurance of the continued flow of rental from the sublessee through the sublessor to the fee owner for the purpose of servicing the debt, and the fee owner partnership will also require such assurance to avoid a loss of the property with attendant adverse tax consequences. Thus, the lender and fee owner will ordinarily insist upon a "hell or high water" sublease under which the sublessee agrees to pay rent notwithstanding a loss of possession of the premises or any other event. However, a loss of possession of the property by the sublessee can conceivably result from the bankruptcy of both the fee owner partnership and the sublessor in the circumstances discussed above and the rejection of the nondisturbance agreement by the fee owner's trustee. Accordingly, the sublessee should consider bargaining for an exception to its unconditional obligation to pay the sublease rental relating to the rejection of the nondisturbance agreement, although most prospective lenders and prime lessors will resist this request. It should be emphasized again that the likelihood of a bankruptcy of both the prime and sublessor is highly remote and should be a source of concern only in appropriate circumstances.

The critical importance of obtaining a nondisturbance agreement from the prime lessor in the case of a sublease with a financially distressed sublessor is highlighted by a decision by the United States Bankruptcy Court for the District of Arizona. In *In re BCE West L.P.*,^{n5a} a sublessee, Einstein Noah Bagel Corporation (ENBC), entered into a sublease with its majority owner, Boston Chicken, Inc. (BCI), that contained a covenant requiring BCI, the sublessor, to use its best efforts to obtain a nondisturbance agreement in favor of ENBC from an unaffiliated prime lessor. BCI failed to obtain the nondisturbance agreement. After BCI filed for protection under the Bankruptcy Code, it rejected its prime lease with the prime lessor, thereby forcing ENBC to relocate. ENBC subsequently filed an administrative expense claim against the debtor BCI for damages (moving, relocation and related expenses) incurred by reason of the debtor's postpetition failure to obtain for it a nondisturbance agreement, arguing that the failure constituted a breach of the sublease and that such damages were entitled to administrative expense priority under section 365(d)(3), which requires the trustee to timely perform all obligations of the debtor under a lease that arise after the entry of an order for relief against the debtor and until such lease is assumed or rejected.ⁿ⁶ Notably, ENBC argued that the language of the first sentence of section 365(d)(3) required a debtor to perform its obligations under a lease whether the debtor was the lessee or the lessor under the subject lease.ⁿ⁷ On the other hand, BCI argued that the statute was intended to protect landlords only, rather than lessees such as ENBC, and cited the last sentence of section 365(d)(3), as well as the legislative history of the provision to support its position.ⁿ⁸ Ultimately, the court rejected ENBC's argument and held that section 365(d)(3) only protects lessors and that ENBC's claim for breach of the nondisturbance covenant was a general unsecured claim. Thus, the BCE West case is significant not only for highlighting the importance of obtaining a

nondisturbance agreement at the time of entering into a sublease, but also for the proposition that the sole protection available to a nondebtor lessee under the Bankruptcy Code is under section 365(h), and that prior to the assumption or rejection of a sublease or any other lease in which the debtor is the lessor, the lessee has no rights under section 365(d)(3) and may, as a practical matter, have little ability to force a debtor to perform any of its obligations under the lease during the period prior to rejection or assumption.

FOOTNOTES:

(n1)Footnote 1. *See P 3.06[11] supra*. This argument appears to have been strengthened by reason of the amendments to section 365(h) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), which provides that the term "lessee" "includes any successor, assign, or mortgagee permitted under the terms of [the] lease." *11 U.S.C. § 365(h)(1)(D)*.

(n2)Footnote 2. It may be questioned why it is necessary to posit the bankruptcy of the sublessor and rejection of the sublease, inasmuch as under section 365(h) the sublessor can accept the rejection of the prime lease regardless of whether the sublessor is a debtor under the Bankruptcy Code. There is considerable authority to the effect that a sublessor may not voluntarily accept the surrender or rejection of a prime lease and destroy the subleasehold. 1 Friedman, *Leases* § 7.703 (2d ed. 1983). If, however, the sublessor is a Bankruptcy Code debtor, it cannot be said with certainty that the powers of the trustee to deal with obligations of the debtor will not prevail over the sublessee's common law rights in the absence of supervening equitable considerations. *Cf. Commercial Trading Co. v. Lansburgh (In re Garfinkle)*, 577 F.2d 901, 17 C.B.C. 635 (5th Cir. 1978) ; *In re Penn Cent. Transp. Co.*, 458 F. Supp. 1346 (E.D. Pa. 1978) .

(n3)Footnote 3. The proceedings of Interstate Stores, Inc. in the Southern District of New York (Nos. 74 B 614-802 inclusive, filed May 22, 1974) under Chapter X of the former Bankruptcy Act involved the parent and 188 subsidiaries, many of which held store leases and subleases. More recently, the bankruptcy case of K-Mart under the Bankruptcy Code involved the parent and 37 subsidiaries, many of which held store leases and subleases. *In re K-Mart Corp.* (Case No. 02-0274, N.D. Ill.) (case commenced Jan. 22, 2002). *See also In re Best Prods. Co., Inc.*, 157 B.R. 222 (Bankr. S.D.N.Y. 1993) which treated a real property sublease lease between a subsidiary and its parent as a financing lease rather than a true lease.

(n4)Footnote 4. *See PP 4.01[1], 4.02[2] supra* .

(n5)Footnote 5. *See P 4.01[1] supra*.

(n6)Footnote 5a. 257 B.R. 304 (Bankr. D. Az. 2000) .

(n7)Footnote 6. *11 U.S.C. § 365(d)(3)*.

(n8)Footnote 7. 257 B.R. 304, 308 .

(n9)Footnote 8. 257 B.R. 304, 308 . The last sentence of section 365(d)(3) provides that "[a]cceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title." (emphasis added). BCI argued, and the court ultimately agreed, that the emphasized language in the last sentence of the statutory provision indicated that the first sentence was intended to apply only to debtors in their capacities as lessors.

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

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P 4.04 Operating and Easement Agreements

It is common practice in shopping center developments to divide the ownership of the center between the developer and one (or more) anchor department stores. Under this arrangement, the developer ordinarily will own the portion of the center to be leased to smaller, or "satellite" tenants, together with appurtenant parking and other common areas, and the department store will own its site and the necessary parking facilities relating thereto. The developer and department store, in order to cause the shopping center to function as an integrated unit, will frequently enter into an operating agreement providing for, among other things, (a) hours of operation in the center, (b) cross-easements with respect to the various parking and other common areas and (c) maintenance of the parking and other common areas. Many of these provisions, including the cross-easements, will be recorded in the local real estate records. If the department store or the developer becomes a debtor under the Bankruptcy Code, what is the effect on the non-debtor party of a rejection of the operating agreement?

The resolution of this seemingly straightforward issue involves some of the most difficult areas of creditors' rights law. Although a complete exposition of the underlying issues is beyond the scope of this book, a brief discussion may be helpful in connection with the preparation of operating agreements.

The principal issue relating to the rejection of an operating agreement containing cross-easement provisions is whether rejection will terminate the easement rights of the beneficiary, thus impairing the unitary nature of the shopping center operation. The traditional formulation of the position opposing termination of the easement rights as a consequence of rejection is that (a) the grant of the easement creates a "property right" in the beneficiary, (b) a trustee under the bankruptcy law may reject and therefore impair "contractual rights," but may not divest another party of a property right created by the debtor, and (c) therefore, the grant of easement may not be impaired by rejection of the operating agreement.ⁿ¹ This argument would take note of the fact that a non-preferential and non-fraudulent conveyance of a fee interest in real property by the debtor prior to the filing of the petition is not subject to defeasance, and that a grant of easement is merely another subcategory of estates in property that likewise should not be subject to defeasance once created in accordance with law. It would be further noted that a mortgage lien on real property, and indeed any valid security interest, may be subject to delay in enforcement, modification, or even substitution of collateral under the bankruptcy law, but cannot constitutionally be eliminated or materially impaired. In each instance, a property right in a non-debtor party has been created and recorded, and runs with the land, hence divesting the debtor of the particular property interest created for the benefit of a non-debtor party, to such extent that the property interest cannot become property of the estate under *section 541 of the Code*. Since it was not property of the debtor prepetition, it does not

become part of the estate created by section 541.

The trustee may assert in opposition to the foregoing that:

- (a) so-called property rights are merely a group of legal rights and powers created by agreement generally enforceable in the courts,
- (b) so-called contractual rights are also merely a group of legal rights and powers generally enforceable in the courts,
- (c) the distinction between property rights and contractual rights is therefore without substance, and
- (d) the proper analysis should relate not to "labels" but to the effect of rejection of the so-called property right upon the non-debtor party, the degree of reliance by the non-debtor party upon the continued existence of the right, the degree of damage to the non-debtor party that may result from the elimination of the right, the extent of the benefit to the estate of the elimination of the right, and the general effect upon commercial expectations if such rights may be eliminated.ⁿ²

Under this theory, there is no absolute due process or other constitutional limitation upon the impairment in bankruptcy of the rights and expectations of non-debtor parties, and the determination of the degree of impairment will be governed by judicial consideration of the equitable and social consequences of the rejection.ⁿ³ In the case of an operating agreement containing easement provisions, the analysis would be relatively straightforward in view of the continuing nature of the easement provisions, and the ability of the court to weigh the detriment suffered by the non-debtor party in the event of rejection and termination against the detriment to the estate that would arise if rejection and termination were prohibited. It should be noted in this connection that courts have engaged in this type of analysis for many years with respect to executory contracts, collective bargaining agreements and real estate leases, and are well qualified to perform the same analysis for easement agreements and similar "vested rights."

The issue is further complicated when the easement provisions of the operating agreement are viewed in the context of the other provisions of the operating agreement that the trustee desires to reject. If, for example, the debtor is a department store operator, and provisions of the operating agreement unrelated to the cross-easements set forth obligations that are burdensome to the estate (such as requirements for maintenance of common areas, hours of operation and shopping center promotional fees), will the debtor's trustee be empowered to reject these obligations if it cannot also reject the cross-easement provisions of the operating agreement? The traditional doctrine of assumption and rejection is that an agreement may be assumed or rejected in whole but not in part, and that a trustee may not "cherry-pick" an agreement by eliminating certain burdens while retaining the benefits.ⁿ⁴ Will this doctrine work to prevent rejection of any part of an operating agreement, however burdensome, if the easement provisions of the agreement are held to be unrejectable?

Although nothing herein purports to constitute a resolution of the "property rights"-"contractual rights" dilemma, one suggested approach is offered with respect to the rejectability of operating agreements containing easement provisions. If this type of operating agreement is viewed as a conveyance (of the easement) and a contract (with respect to other matters in the agreement), a close analogy may be drawn to real estate leases which the trustee of the lessor desires to reject. *Section 365(h) of the Code*, which governs the rejection of real estate leases by the lessor's trustee, appears to recognize the real estate lease as a conveyance (of the leasehold) and a contract (with respect to the continuing rights and obligations of lessor and lessee). In both situations, the interests of the debtor in relieving itself of burdensome obligations is counter-balanced by the heightened interest of the nondebtor that is indicated by its possession of the subject premises--as a lessee in the case of a lease rejection and as a developer or co-tenant in the case of an operating agreement. Under section 365(h), if the lessor's trustee rejects the lease and the lessee elects to retain its rights under the lease in respect of the demised premises, the lessor (1) is relieved of the obligation to perform the affirmative covenants

on its part to be performed under the lease, (2) remains subject to the passive obligation not to disturb the lessee's possession of the premises and (3) is subject to a claim (recoverable only by means of rental offset) for damages suffered by the lessee with respect to the nonperformance by the lessor of its affirmative obligations under the lease. In other words, the conveyance to the lessee of the leasehold estate is not impaired by rejection of the lease, but the distinct contractual elements of the lease are impaired by the rejection. Thus, under section 365(h) the lease insofar as it is a contract is rejectable in its entirety, and insofar as it constitutes a conveyance is not rejectable at all. The breach of the contractual elements of the lease, as in the case of rejection of any executory contract, gives rise to an allowable claim for damages.

The above lease analysis is readily applied to operating agreements, under which the easement provisions may be viewed as non-rejectable conveyances, and the contractual elements binding upon the debtor may be deemed to be rejectable for the purpose of relieving the estate of burdensome contractual obligations.ⁿ⁵ The preservation of the easements for the nondebtor beneficiary, like the preservation of the leasehold estate for the lessee under a rejected lease, will at least maintain a substantial part of the benefits of the original instrument for the party that may have expended substantial sums and otherwise acted in reliance thereon. With respect to the rejected elements of the agreement, such as the provisions for the hours of operation of the debtor's department store, and the debtor's obligation to contribute towards the cost of common area maintenance, the nondebtor party may be able to prove actual damages on the basis of experience and expert testimony (with respect to hours of operation) and out-of-pocket costs (with respect to common area maintenance), and may thus recover under a proof of claim filed in the debtor's Bankruptcy Code case.

Perhaps an analogy may be found in the series of cases holding that rejection of a contract or lease does not terminate the contract or lease in all respects but instead constitutes an election by the trustee not to assume the agreement as an obligation of the estate.^{n5a} Under these cases, certain elements of the subject contract or lease, such as a covenant not to compete affecting the debtor, survive rejection inasmuch as the contract or lease has conceptually survived rejection.^{n5b} The import of these cases with respect to operating agreements may be that the real estate conveyance elements of an operating agreement may be viewed as severable and as surviving rejection of such agreements.

In one analogous situation, a court held that a right of first refusal is not an executory contract and could not be rejected by a trustee, at least in situations in which there was no sale pending at the time of the commencement of the Bankruptcy Code case.^{n5c} Notably, however, the court held that even if a right of first refusal could be treated as an executory contract, the rejection would not repudiate the holder's property right with respect to the underlying asset thus preserving the right of first refusal even after rejection.^{n5d} Citing extensively to the scholarly articles by Professors Andrew and Westbrook,^{n5e} the court concluded that rejection of a contract is not analogous to terminating the contract, but merely constitutes the exercise of the trustee's business judgment that the estate should not assume the burden of an executory contract as an administrative expense; thus, rejection simply has the effect of providing the nondebtor party to an executory contract with an unsecured claim for nonperformance instead of an administrative expense claim.^{n5f}

If operating agreements are viewed in part as a conveyance or other grant of a property right that cannot be rejected or otherwise revoked, and in part as a contract subject to rejection, they should be drafted with a view towards the potential consequences of rejection. Assuming that the nondebtor party desires to have as much of the operating agreement as possible survive a rejection, the easement provisions of the agreement should be integrated with as much related matter as possible in the hope that the related matter will survive as an integral part of the easement. For example, in an operating agreement between a developer and a department store owner providing for an easement from the developer's parcel onto the department store's parcel for purposes of parking and vehicular and pedestrian access, the easement may also include (1) an easement for the developer to enter onto the department store parcel for the purpose of maintaining the parking areas in the event of the department store's rejection of its obligations to maintain the parking area, and (2) an easement for the developer to connect into or otherwise operate the lighting system in the department store's parking area in the event of a rejection of the department store's agreement as to hours of operation. The agreement may also provide for a setoff by the developer against any sums owing by the developer to the department store owner of

amounts expended by the developer in the exercise of the self-help remedies described in the preceding sentence. Although the setoff should not constitute the developer's exclusive remedy in view of the uncertainty as to the existence of a debt from the developer to the department store owner, the setoff right may be justified by analogy to the setoff provisions of section 365(h)(1)(B) and may lend support to the argument that rejection of the operating agreement should be handled in the same manner as a rejection of a real estate lease under section 365(h).

Another area of difficulty relates to the assumption and assignment of operating agreements. The Bankruptcy Code provisions dealing with assumption and assignment of executory contracts and leases are discussed elsewhere in this book.ⁿ⁶ Operating agreements are specifically tailored to the needs of each shopping center, and often contain detailed requirements for hours of operation, the types of merchandise to be sold, and the name or names under which a particular operator is to conduct its business at the center. If such an operator becomes a Bankruptcy Code debtor and seeks to sell a shopping center store location and to assume and assign to the purchaser the related operating agreement, the court may be called upon to consider whether the prospective purchaser-assignee can provide adequate assurance of future performance with respect to all of the relevant provisions of the operating agreement.

In the bankruptcy cases involving Federated Department Stores and Allied Stores, the debtors sought to transfer to Mervyn's a Jordan Marsh store located in the Town Center in Boca Raton, Florida, and to assume and assign the related operating agreement.ⁿ⁷ The operating agreement required, among other things, the continuous operation of the store under the name "Jordan Marsh" or "such other name used by Allied for substantially all of its stores of the same type generally being operated on the east coast of the State of Florida."ⁿ⁸ The court found that Mervyn's had provided adequate assurance of future performance with respect to all provisions of the operating agreement other than the "nameplate" requirement, and held the nameplate requirement to be unenforceable under the Bankruptcy Code as a *de facto* anti-assignment clause.ⁿ⁹ The court also held that the more stringent shopping center lease assignment provisions set forth in section 365(b)(3) applied only to leases and not to operating agreements.ⁿ¹⁰ Similarly in the bankruptcy case involving Rickel Home Centers,^{n10a} the Bankruptcy Court refused to enforce a lease provision that required that the subject premises be operated as a home improvement center and would have prevented an assignment by the debtor to an entity which intended to operate the premises as an office supply store.

FOOTNOTES:

(n1)Footnote 1. See Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 Am. Bankr. L.J. 223 (1981); cf. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 Harv. L. Rev. 973 (1983); *Gouveia v. Tazbir*, 37 F.3d 295, 299 (7th Cir. 1994) .

(n2)Footnote 2. Rogers, 96 Harv. L. Rev. 973, 1023-30 (1983); cf. 11 U.S.C. § 363(h).

(n3)Footnote 3. Rogers, 96 Harv. L. Rev. 973, 1023-30; cf. 11 U.S.C. § 363(h).

(n4)Footnote 4. E.g., *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951) , cited with approval in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531-32, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482, 499, 9 C.B.C.2d 1219, 1230 (1984) . *Steffan v. McMillan (In re Coordinated Fin. Planning Corp.)* 65 B.R. 711 (B.A.P. 9th Cir. 1986) holds that a recorded right of first refusal between co-owners of real property is rejectable as an executory contract. The court found that the right of first refusal, as a covenant running with the land, was merely a contractual provision binding upon successor owners but was not a "property right." 65 B.R. at 712 . But see *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (treating right of first refusal as nonrejectable property right in favor of nondebtor). The court in *In re 523 E. Fifth St. Housing Pres. Dev. Fund Corp.*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987) held a restrictive use covenant in a deed from a municipality not to constitute an executory contract and to be nonrejectable by the debtor. See *Net Realty Holding Trust v. Franconia Props., Inc.*, 544 F. Supp. 759 (D. E.D.Va. 1982) for treatment of a continuous operation provision as a covenant running with the land. See generally Kahn, *What Happens to the OREA If an Anchor Goes Under?*, 6 Real Estate Fin. 33 (1989).

(n5)Footnote 5. *Cf. Leasing Serv. Corp. v. First Tenn. Bank N.A.*, 826 F.2d 434 (6th Cir. 1987) (rejection by debtor-tenant of lease that also granted security interest to lessor does not impair security interest); *In re Don & Lin Trucking Co.*, 110 B.R. 562 (Bankr. N.D. Ala. 1990) (rejection by debtor-lessee of equipment lease containing noncompetition covenant does not relieve debtor of its obligations under the covenant). In *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994), a chapter 7 trustee sought to relieve the estate of the burden of a restrictive covenant that limited real estate development to residential structures. The debtor had constructed a retail store on the affected property. The court held that the covenant constituted a property right of the benefited parties and could not be rejected as an executory contract. The court stated:

Like many other real-property interests, the Lincoln Covenant establishes an ongoing right of present (not merely future) enjoyment--the present right to have a commercial-free neighborhood. As noted by the bankruptcy court, restrictive covenants like restrictive easements, traditionally have been recorded on the title of the encumbered property. While distinguishing between contracts and property rights may seem elusive, the neighbors' present enjoyment of the right, their completion of performance noted by both the bankruptcy and district court, and the traditional treatment of their rights as running with the land, all indicate to us that the Lincoln Covenant is an interest in real property. As such s 365 of the bankruptcy code is inapplicable.

The trustee also sought to sell the asset free and clear of the covenant under *section 363(f)(5) of the Code*, under the argument that the beneficiaries of the covenant could be compelled to accept a money satisfaction of their interests under the covenant. The court rejected this argument on the grounds that the beneficiaries had the option to accept money damages or to receive equitable relief, and therefore could not be compelled to accept a money satisfaction. 37 F.3d at 299. The court also rejected the argument that the beneficiaries' interests under the covenant constituted a dischargeable claim under *section 101(5)(B) of the Code* inasmuch as the covenant provided for money damages as well as equitable relief. *Id.* at 300.

(n6)Footnote 5a. *Medical Malpractice Ins. Assoc. v. Hirsch (In re Lavigne)*, 114 F.3d 379, 38 C.B.C.2d 67 (2d Cir. 1997) (holding that debtor's rejection of a medical malpractice insurance policy did not bar subsequent chapter 7 trustee's right under policy to purchase tail-end insurance); *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (holding that rejection of right of first refusal did not terminate nondebtor's rights thereunder). *Couture v. Burlington Hous. Auth. (In re Couture)*, 225 B.R. 58 (D. Vt. 1998); *In re Steaks To Go, Inc.*, 40 C.B.C.2d 1391, 226 B.R. 35 (Bankr. E.D. Mo. 1998); *In re Bacon*, 38 C.B.C.2d 839, 212 B.R. 66 (Bankr. E.D. Pa. 1997).

(n7)Footnote 5b. *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir. 1994); *In re Steaks To Go, Inc.*, 226 B.R. 35 (Bankr. E.D. Mo. 1998); *Cf. Medical Malpractice Ins. Assoc. v. Hirsch (In re Lavigne)*, 114 F.3d 379 (2d Cir. 1997); *In re Hughes*, 30 C.B.C.2d 2010, 166 B.R. 103 (Bankr. S.D. Ohio 1994); *Fellerman & Cohen Realty Corp. v. Clinical Plus Inc. (In re Hirschhorn)*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993). Another approach is exemplified by *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001), in which the court held that a noncompete covenant requiring the debtor to refrain from the practice of chiropractic for a specified time and within a specified radius survived both the rejection of the contract that contained the covenant and the discharge of the debtor under chapter 7 of the Code. The court determined that the rejection of the agreement gave rise to a dischargeable claim under the Code, except for the provision requiring the debtor to refrain from practicing. The action called for under the covenant did not require the debtor to expend money, and the breach of the covenant was found not to give rise to an equitable remedy for breach of performance resulting in a right to payment within the meaning of *section 101(5) of the Code* (setting forth the definition of a "claim"). Inasmuch as the breach of the covenant could not give rise to a claim under the Code, there would be no discharge of the debtor's obligation under the covenant.

(n8)Footnote 5c. *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999).

(n9)Footnote 5d. 241 B.R. 17, 36.

(n10)Footnote 5e. M. Andrew, *Executory Contracts in Bankruptcy: Understanding 'Rejection,'* 59 U. Colo. L. Rev. 84 (1988) and M. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook,* 62 U. Colo. L. Rev. 1 (1991); J. Westbrook, *A Functional Analysis of Executory Contracts,* 74 Minn. L. Rev. 227 (1989).

(n11)Footnote 5f. 241 B.R. 17, 22 .

(n12)Footnote 6. See PP 3.01[5], 4.01[1], 4.02[2] *supra* .

(n13)Footnote 7. *In re Federated Dep't Stores, Inc.*, Case No. 1-90-00130, Slip Opinion, October 9, 1991 (Bankr. W.D. Ohio) (hereinafter "Federated Opinion").

(n14)Footnote 8. *In re Federated Dep't Stores, Inc.*, Case No. 1-90-00130, Slip Opinion, October 9, 1991 (Bankr. W.D. Ohio).

(n15)Footnote 9. *Federated Opinion*, Case No. 1-90-00130, Slip Opinion, October 9, 1991 (Bankr. W.D. Ohio) at 10; *cf.*, *In re Ames Dep't Stores*, 136 B.R. 357 (Bankr. S.D.N.Y.) (court refused to allow separate damage claim for breach of going dark provision in lease). *Net Realty Holding Trust v. Franconia Props. Inc.*, 544 F. Supp. 759, 768 (E.D. Va. 1982) (thirty continuous operation provisions upheld but provision for operation under specific name stricken under rule of impossibility of performance).

(n16)Footnote 10. *Federated Opinion*, Case No. 1-90-00130, Slip Opinion, October 9, 1991 (Bankr. W.D. Ohio) at 5-6.

(n17)Footnote 10a. *In re Rickel Home Ctrs.*, 240 B.R. 826 (D. Del. 1998) , *aff'd*, 209 F.3d 291 (3d Cir. 2000) .

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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 4 Miscellaneous Transactions *

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P 4.05 Mortgage Participation Transactions

[1] Characterization

In a typical participation transaction involving a mortgage loan, the lead lender will originate the loan, receive and hold a note, mortgage, assignment of rents and other related documents, and sell participations to other financial institutions under a participation agreement. The participation agreement will ordinarily recite the purchase by a participant of an undivided interest in the mortgage loan, provide for distributions to the participant out of the proceeds of the payments made by the mortgagor, exculpate the loan originator from any liability in respect of the repayment of the loan other than to remit proceeds actually collected from the mortgagor or the mortgaged property, and provide for the administration of the loan by the originator.ⁿ¹ In a so-called "true" participation, the participants do not have privity of contract with the underlying borrower, and the participants may look solely to the lead for satisfaction of their claims because they are not creditors of the borrower.^{n1a} If the originator--sometimes referred to as the "lead lender"--becomes insolvent, there are a number of creditors' rights considerations that will dictate whether the participant will continue to receive its allocable share of the mortgage loan proceeds or will be relegated to the status of a general creditor of the lead with a claim for the unpaid balance of the purchase price of its participating interest.

If the participant is deemed to have made a loan to the lead, and has not perfected a security interest in the underlying mortgage loan to secure repayment from the lead, the participant will be relegated to general creditor status for the outstanding amount of its investment, and may be required to repay to the lead's estate as a preference any amounts received under the participation agreement on or within 90 days before the date of filing of the lead's petition.^{n1b} If the participation transaction is viewed not as a loan but an investment of the participant held in trust by the lead, the participant will be entitled to receive its allocable share of the payment stream from the underlying loan free of any claim by the general creditors of the lead's estate.ⁿ² Within these two interpretations of a participation transaction lie several subsidiary but important issues, including: (1) the manner of perfection of a security interest in a note and mortgage;ⁿ³ (2) the binding effect of a valid trust arrangement upon the Bankruptcy Code trustee of the lead lender;ⁿ⁴ and (3) if the lead is a bank or other financial institution not eligible to be a debtor under the Bankruptcy Code, the determination of whether state or federal law will govern the characterization of the participation transaction.ⁿ⁵

The argument for holding that a participation transaction gives rise to a creditor-debtor relationship may be stated as follows: The participation agreement does not vest in the participant an undivided share in the underlying mortgage loan. Under Article 3 of the Uniform Commercial Code, which governs the transfer of negotiable instruments, a party

claiming an undivided share in a mortgage note must be a holder of the note.^{n5a} A participant who has received neither an endorsement of the mortgage note nor possession of the note is not a holder because a holder must receive the instrument through negotiation and have physical possession of it. Indeed, given that a participant purports to hold less than the entire interest in the underlying mortgage loan, an endorsement of a partial amount of the mortgage note cannot under the Uniform Commercial Code confer holder status on the transferee. Moreover, a participant is without power to enforce the mortgage note directly against the mortgagor, or to transfer the note to another party. The lead lender rather than the participant retains such powers and therefore retains ownership in full of the note. If the lead lender retains ownership of the note, it retains ownership of the entire mortgage loan, and the loan is included in the property of the estate of the lead lender under *section 541(a) of the Bankruptcy Code* upon the filing of a petition by the lead lender under the Code.ⁿ⁶

The argument in favor of the creditor-debtor characterization further asserts that if the participant is not a holder of the mortgage note under the Uniform Commercial Code, neither is it an assignee in whole or in part of the note. An assignment is a present transfer of the right to performance by the obligor under the note, relieves the assignor from all obligations and powers in respect of the note, and empowers the assignee to directly enforce the note against the obligor. Participation agreements generally do not effect an assignment of the underlying loan because (1) they do not divest the lead lender of its powers and obligations in respect of the mortgage loan and (2) they do not empower the participant to directly enforce the mortgage note against the mortgagor. Thus, under common law principles applicable outside the context of the Uniform Commercial Code, a participant is not an assignee of the mortgage loan and therefore cannot claim an ownership interest therein.ⁿ⁷

The creditor-debtor advocates will conclude that if the participant is neither a holder nor an assignee of the mortgage note, then no other formulation describes the participant's relationship to the lead lender better than the creditor-debtor characterization.

Having concluded that the participant is a creditor of the lead, the advocate will then seek to determine whether the participant is a secured or unsecured creditor. If the participant is a secured creditor, with the collateral consisting of the underlying mortgage loan, the participant will under the Bankruptcy Code be entitled either to collect the payments made on the underlying loan or receive adequate protection of its interest therein.ⁿ⁸ Moreover, as a secured creditor (if fully secured), the participant will be immune to preference attack with respect to prepetition distributions received under the participation agreement. Thus, the lead's trustee will seek to demonstrate that the participant has not perfected a security interest in the underlying loan.

The determination of nonperfection will perforce require an analysis of the proper method of perfecting a security interest in a mortgage note and mortgage. A security interest in the mortgage note, or pledge of the note, is governed by the perfection requirements of the Uniform Commercial Code.ⁿ⁹ The pledge of the mortgage note, apart from consideration of the mortgage, may be perfected by delivery of possession of the note to the pledgee.ⁿ¹⁰ With respect to the mortgage securing the note, the method of perfection is somewhat more problematical. There are at least five possibilities for perfection: *first*, that the mortgage as a matter of law follows the note, so that a valid pledge of the note automatically constitutes a valid and perfected pledge of the mortgage under the Uniform Commercial Code without reference to local real estate law;ⁿ¹¹ *second*, that the mortgage falls into the basket category of general intangibles under the Uniform Commercial Code, and therefore the filing of a Uniform Commercial Code financing statement is required for perfection of a security interest in the mortgage;ⁿ¹² *third*, that the mortgage may constitute an instrument within the meaning of the Uniform Commercial Code, so that possession of the original mortgage is required for perfection;ⁿ¹³ *fourth*, that perfection of a security interest in the mortgage is not governed by the Uniform Commercial Code inasmuch as the mortgage represents an interest in real property, and perfection of a security interest requires recordation of a security document in the real property records;ⁿ¹⁴ and *fifth*, that perfection of a security interest in a mortgage is governed by local real estate law, but local real estate law does not require the recordation of an assignment or other security document in respect of the mortgage, and delivery of the mortgage note will constitute perfection of the lien on both the note and mortgage.ⁿ¹⁵ Case law and commentary strongly support the *fifth* alternative, with special

emphasis on the adverse impact upon secondary mortgage market transactions involving the pledge of residential mortgage pools if local real estate recordation or even possession of the mortgage document were required for perfection.ⁿ¹⁶ This argument is further strengthened by Revised Article 9, which provides that if a secured party assigns a perfected security interest, a further filing is not required to continue the perfected status of the security interest against creditors of an transferees from the original debtor.^{n16a}

In the case of mortgage loan participations, however, the advocates of the creditor-debtor characterization for the participant-lead lender relationship can demonstrate that under any of the above perfection methods a participant ordinarily will be an unsecured creditor. In the participation transaction described at the beginning of this paragraph, the lead lender has retained possession of the mortgage note and mortgage, and there has been no Uniform Commercial Code or other recordation naming the lead as a debtor in the transaction. Thus, under any of the five formulations described above the participant has not taken the steps required for perfection of a lien on the underlying mortgage loan.

The opposing school of thought would have no need to determine the proper method of perfecting a security interest in a note and mortgage in the participation context because it would emphatically dispute the existence of a creditor-debtor relationship and therefore the relevance of the security and perfection discussions. It asserts that mortgage participation transactions have been and should continue to be recognized as (a) express trusts in which the lead lender is trustee for the participant, (b) implied trusts having the same effect as express trusts, (c) present assignments coupled with an agency permitting the lead lender to collect, or (d) present assignments coupled with a trust to collect.ⁿ¹⁷

The effect of a trust characterization is to remove the trust *res* from the general assets of the estate of the lead, and to segregate this property for the exclusive benefit of the participant. Moreover, the trust characterization eliminates any issue of preference with respect to prepetition distributions to the participant because the participant, as beneficiary, will have received funds owned by it rather than by the lead lender and will not have diminished the assets of the lead's estate.

The Bankruptcy Code appears to have embodied the rule maintained under the former Bankruptcy Act to the effect that if the debtor held legal but not equitable title to an asset, the debtor's estate generally will succeed only to such legal title and be subject to the claims of the beneficiaries.ⁿ¹⁸ *Section 541(d) of the Code* provides:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.ⁿ¹⁹

The legislative history accompanying section 541(d) strongly supports the conclusion that this section subjects the estate to the rights of trust beneficiaries. Representative Edwards, in his statement on the House floor, addressed this matter as follows:

Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. Examples of this are mortgages sold for which legal title has been retained for servicing. Similarly, if the debtor holds an equitable interest in property without legal title, the estate would acquire only the equitable interest of the debtor in property and not the legal title. Thus, as section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate except to the extent that defenses which are personal against the debtor are not

effective against the estate.ⁿ²⁰

Thus, notwithstanding that there is no public notice of the beneficiary's interest in the trust property in the hands of the lead lender, and the potential danger of successive participation transactions with respect to the same underlying mortgage loan, it is clear that the Bankruptcy Code will recognize and permit enforcement of participants' rights without requiring delivery of the underlying loan documents or other steps to "perfect" a participant's interests in the loan. Indeed, the legislative history strongly indicates that this result will obtain, even if the participant-lead relationship is characterized as something other than that of beneficiary and trustee. Senator DeConcini, in referring to the effect of section 541(d) on secondary mortgage market transactions, stated in his Senate floor presentation that "[i]t makes no difference whether the servicer and the purchaser characterize their relationship as one of trust, agency or independent contractor."ⁿ²¹ Although the statement clearly deals with the problem of the bankruptcy of a mortgage servicer, rather than that of a lead lender, the issues of possession, perfection and recognition of beneficial claims are the same in both types of transactions.ⁿ²²

The exclusion of the trust *res* from the category of "property of the estate" does not mean that a participant's access to the payment stream from the underlying loan will not be delayed by the lead's bankruptcy case. The lead's trustee may seek to delay remission of the participant's share while the trustee views the applicable agreements and law. A participant seeking to obtain possession of its share of the underlying loan proceeds will be constrained to obtain a bankruptcy court order modifying the automatic stay to permit access to property in the possession of the estate.ⁿ²³ Indeed, the holder of beneficial rights in a fund has been held subject to the section 542(a) requirement to turn over to the estate property that the trustee may use under *section 363 of the Code*, even if the estate has only bare legal title to such property.ⁿ²⁴ Nevertheless, the participant should ultimately prevail in its efforts to obtain release of its participating share and of the payment stream which will thereafter follow on the underlying loan.ⁿ²⁵

As noted above, a similar result should obtain if the participation arrangement is characterized as a present assignment coupled with a trust or agency. A valid prepetition assignment constitutes a disposition of property comparable to the sale of an item of tangible personal property, thus divesting the debtor's estate of any right or claim to the property. The payment stream to the participant arising from the mortgage loan payments are owned by the participant, and not the debtor under the Bankruptcy Code, and should not be subject to permanent impairment because the trustee or agent has become a debtor under the Code.

[2] Bank Participation Agreements

The Bankruptcy Code does not govern the liquidation of a domestic bank, savings and loan association, building and loan association, homestead or credit union.ⁿ²⁶ In the case of national banks, liquidation is effected under the National Bank Act,ⁿ²⁷ which preempts state law either in whole, or in certain circumstances, to the extent state law is inconsistent with the National Bank Act.ⁿ²⁸ It is therefore necessary to examine separately the participant-lead lender issue if the insolvent lead is a national bank.

The provisions of the National Bank Act that deal with creditors' rights are, unfortunately, merely skeletal. In the words of the Supreme Court:

Congress has seen fit not to anticipate by specific rules solution of problems that inevitably arise in national bank liquidations. Instead, it chose achievement of a "just and equal distribution" of an insolvent bank's assets through the operation of familiar equitable doctrines evolved by the courts.ⁿ²⁹

Section 194 of the National Bank Act mandates a "ratable dividend" on claims approved by the Comptroller of the Currency or adjudicated in a court of competent jurisdiction.ⁿ³⁰ But notwithstanding the rule of ratable distribution and the absence of statutory authority for deviations from that rule, the law has long recognized that all claimants against the receivership estate of a national bank are not treated alike. For example, rights of secured creditors are recognized.

Indeed, the Supreme Court has held that under Section 194 a secured creditor is entitled to a general dividend on the entire amount owed to it, and may then resort to its collateral to satisfy any deficiency.ⁿ³¹ Yet another illustration of the flexibility of the ratable distribution concept is its accommodation of the equitable notion of setoff of mutual obligations. Definitively upheld in *Scott v. Armstrong*,ⁿ³² the rule of setoff--allowing one who is both indebted to an insolvent national bank and a depositor therein to reduce his debt by the amount held on deposit--affords the depositor a preferred distribution to the extent of the amount set off. Thus, both secured creditors and indebted depositors of an insolvent national bank may receive a more-than-ratable distribution on their claims.

A third class of claimants has been deemed by case law construing Section 194 to merit preferential treatment: claimants who can show that the bank holds a specific, identifiable fund or asset that can be impressed with a trust in their favor and which fund or asset has "augmented" the receivership estate. Cases are uniform in requiring a fiduciary relationship, but an express trust is not required. Constructive trusts and other fiduciary relationships, such as bailor-bailee, suffice.ⁿ³³ The finding of a debtor-creditor relationship between bank and claimant is, however, fatal to the contention that a trust exists.ⁿ³⁴

The few reported cases to have considered the relationship between lead lender and loan participant when the lead is an insolvent national bank appear to have perpetuated the "trust relationship" prerequisite to preferred status, and to have assumed *sub silentio* the existence of this relationship.

Thus, in *Federal Deposit Insurance Corporation v. Mademoiselle of California* ⁿ³⁵ (receivership of San Francisco National Bank), the requirements for a preferred claim were said to consist of an identifiable fund or payment, augmentation of the estate, and facts "such that the court must say in equity that the property is not that of the bank but rather that of the claimant."ⁿ³⁶ The last-mentioned requirement may appear to supplant the traditional trust-relationship characterization, but closer examination demonstrates that this requirement is employed coextensively with the requirement of a trust relationship. Moreover, in *Chase Manhattan Bank, N.A. v. Federal Deposit Ins. Corp.*, ⁿ³⁷ (receivership of Penn Square Bank, N.A.), *Mademoiselle* is described as having held that establishment of a preferred claim requires augmentation, a traceable *res*, and a "constructive trust."ⁿ³⁸ In neither *Mademoiselle* nor *Chase Manhattan* did the participant bank succeed in establishing preferred status, for reasons described below. But both cases held that proof of identifiable payments by an obligor on a participated note, not remitted to the participant, might establish a preferred claim if the estate were shown to be augmented thereby. Each case thus seems to have assumed the existence of the requisite trust relationship. Indeed, in *Chase Manhattan*, the F.D.I.C. assured the district court that it would pay over to the participant bank the latter's share of the proceeds of the participated loan as they were paid in.ⁿ³⁹

The lead-participant relationship has also been described as an agency.ⁿ⁴⁰ Though there is little case law directly on point, the most satisfactory statement of the nature of the relationship may be that furnished by *Coffey v. Lawman* ⁿ⁴¹ in which the relationship between the bank (organizing a mortgage pool) and the participation certificate holders was described as being:

of a hybrid nature, having some characteristics of agency, some of debtor and creditor and some of trust... . Whether termed "trustee" or "agent" the bank occupied a trust relationship to them in the collection of interest on the mortgages and the other duties resting on it and its liability must be measured by the law applicable to trusteeship.ⁿ⁴²

The second indispensable element of a preferred claim--augmentation of the estate--was the element found lacking in both the *Mademoiselle* and *Chase Manhattan* cases. The receivership estate is augmented only if its assets are increased. When, as in both *Mademoiselle* and *Chase Manhattan*, the fund alleged to have augmented the estate was merely the cancellation of a debt (the result of exercise by the obligor of his right of setoff), no preferred claim attaches. In other cases, preferred claims have been denied on the similar ground that depositing with the now-insolvent bank a check drawn on that very bank effects a mere bookkeeping transaction--a shifting of credits on the books of the bank without increasing the fund available to the receiver.ⁿ⁴³

It is clear that the national bank cases recognize and enforce, in the absence of competing claims of a kind generally restricted to bank cases, that a loan participant has a preferred status in distribution of the lead's assets and is not merely a general creditor.

[3] Conclusion

In the absence of contractual variation of a typical participation agreement, the arguments for the beneficiary-trustee characterization of the participant-lead relationship appear stronger than the arguments favoring the creditor-debtor relationship. A participant's decision to invest in a given loan transaction will ordinarily be based upon its determination of the (a) creditworthiness of the underlying borrower, (b) the quality of the collateral, (c) the terms of the underlying loan, such as amortization, interest rate and fees, (d) the financial terms of the proposed participation arrangement, (e) the recommendation of the transaction by the lead lender and (f) the experience and reputation of the lead lender. The transaction will not be perceived by the participant as a credit transaction with the lead lender in a typical nonrecourse participation arrangement, and the lead lender instead will be viewed primarily as a servicer and, if required, collection facility with respect to the underlying transaction. The participant will relinquish to the lead all rights of enforcement in respect of the underlying loan inasmuch as (1) the lead ordinarily will have developed the business relationship with the borrower and (2) the participant is relinquishing to the lead lender a portion of the yield on the loan transaction to place on the lead and eliminate for the participant the burdens of servicing and enforcing the underlying loan. If, therefore, it is viewed through the perspective of the parties, the transaction appears to be better described by the trust formulation than the creditor-debtor formulation.

Apart from the legal analysis of the relationship, it is difficult to identify any policy considerations that would militate in favor of the creditor-debtor characterization. If through application of the creditor-debtor theory the payment stream from a mortgage loan was captured by the lead's trustee and held as an asset of the estate, then the participant's original investment in a specific loan transaction would have been converted into a general investment in the lead lender. It is doubtful that the general creditors of the lead had relied upon the participation transaction as an investment in the lead, but such creditors would be accorded an unanticipated benefit as a consequence of the diversion into the estate of the mortgage loan proceeds theretofore payable to the participant. On the other hand, the threat of such a diversion could conceivably deter investment by participants in good loans through the medium of a less-than-top-credit lead lender, thereby denying the lead lender the opportunity to make the loan and to enhance its own profitability.

With respect to the preparation of participation agreements, it seems advisable from the participant's viewpoint to include express declarations of trust or present assignment in language most strongly supporting the desired characterization under applicable state law, and to disclaim expressly the existence of a loan transaction or creditor-debtor relationship between the participant and the lead. If for some reason it is necessary to characterize the participation transaction as a loan, and if the credit of the lead lender is subject to question, then the participant should seek to have the transaction described as a secured loan, and should receive a written collateral assignment of the mortgage as well as physical possession of the mortgage note. Although the better view is that recordation of the assignment in the real property records is not required to perfect the participant's security interest in the mortgage, recordation should be effected if possible to eliminate any issue as to perfection.ⁿ⁴⁴ Similarly, in order to deal with the argument as to the requirement for a Uniform Commercial Code financing statement covering the participant's lien on the mortgage (apart from its lien on the note), financing statements should be filed in addition to the real estate recordation of the mortgage assignment.

Departures from the typical participation structure may of course evidence a participant's intention to rely at least in part on the credit of the lead lender and result in a finding of a creditor-debtor relationship between the participant and the lead. The cases dealing with the characterization of the relationship tend to classify the transactions involving nonrecourse participations as "true participations," and transactions involving recourse participations as loan or credit transactions between the participant and the lead. In most instances, characterization of a nonrecourse participation

transaction as a true participation will result in the exclusion of the participating share of the underlying loan and its proceeds from the Bankruptcy Code estate of the lead lender. Characterization of a recourse participation transaction as a credit transaction will generally result in the inclusion of the participating share of the underlying loan and its proceeds in the Bankruptcy Code estate of the lead lender and the classification of the participant as general unsecured creditor of the lead lender.

The operation of this approach may be illustrated by *In re Coronet Capital Company*,ⁿ⁴⁵ in which the court found that a participation agreement that included an interest guarantee by the lead lender as well as subordination of the lead's right to principal constituted a credit transaction between the participant as creditor and the lead lender as debtor. Accordingly, the chapter 7 trustee of the lead lender was able to establish that the underlying loan constituted property of the estate, and that the automatic stay should not be lifted to permit the participant to proceed against the underlying borrower. At the conclusion of its opinion, the court set forth succinctly its definition of a true participation agreement, stating:

A true participation agreement is one that: a) money is advanced by participant to a lead lender; b) a participant's right to repayment only arises when a lead lender is paid; c) only the lead lender can seek legal recourse against the borrower; and d) the document is evidence of the parties[sic] true intentions.ⁿ⁴⁶

This recitation has sometimes been referred to in subsequent cases as the "Coronet Capital factors."ⁿ⁴⁷

Although the issues arising in connection with the proper characterization of a participation transaction are most clearly presented in the context of the bankruptcy of the lead lender and the efforts of a participant to demonstrate a property interest in the underlying loan separate from the other creditors of the lead's estate, the issues may also arise in the context of the bankruptcy of the underlying borrower and the efforts of a participant to be accorded a direct claim and remedy against the borrower as a debtor under the Bankruptcy Code. In these circumstances, the participant will seek to demonstrate that the participation agreement should be recharacterized as a loan agreement between the participant and the underlying borrower or as a joint loan agreement among the participant and the lead, as co-lenders, and the underlying borrower.

An important precedent in this area is *In re Yale Express System, Inc.*,ⁿ⁴⁸ which arose under the former Bankruptcy Act. In this case, the participant, a commercial bank, held certain deposit accounts of the underlying borrower, who was a debtor under the Act. The participant sought an order permitting it to set off the funds in the accounts against its exposure as a participant in loans to the debtor. The court held that (a) the participation agreement before it evidenced a true participation transaction, (b) the participant had no creditor-debtor relationship with the debtor, (c) the participant's sole right to payment derived from actions taken by the lead lender, and (d) accordingly the participant held no claim against the debtor with respect to which it could effect a setoff.ⁿ⁴⁹

Following *Yale Express* is the case of *In re Okura & Co.*,^{n49a} in which on the date of a closing of a letter of credit facility from a lender (Fuji) to the borrower (Okura), the lender sold to another institution (Bank of Tokyo) pursuant to a participation agreement "an undivided interest and participation to the extent of 22.5% (your 'Percentage Share') in and to the Letters of Credit and the obligations of the [Debtor] in respect of the Letters of Credit and under the Letter of Credit Agreement." The participation agreement explicitly provided that Fuji would have the right in its sole discretion to agree to any amendment, modification or waiver of the letter of credit facility and the sole power "to exercise or refrain from exercising any powers or rights which we may have under or in respect of the Letter of Credit Agreement, the Depository Agreement, the Letters of Credit or any agreement or document related thereto or any collateral therefore, including, without limitation, the right to enforce the obligations of [the Debtor]." The only exceptions to Fuji's rights in respect of the loan to borrower was that Fuji could not alter the times for any payment of principal or interest, the principal amount and the rate of interest or fees. When Okura commenced a chapter 11 case, the participant, Bank of Tokyo, sought to enforce directly against the debtor its portion of the Fuji claim.^{n49b} The court, citing *Yale*

Express and Mason & Dixon Lines, Inc. v. First Nat'l Bank of Boston,^{n49c} and concluded that the clearly expressed intent of the participation agreement was that only Fuji would have a direct claim against the debtor, and declined to characterize the relationship between Bank of Tokyo and Fuji as one of a joint tenancy in common.

The *Okura* decision reflects the common understanding of the treatment of participations in connection with the bankruptcy of the underlying borrower. In most large syndicated loan transactions, the credit agreement will typically contain restrictions and conditions on assignments, including provisions limiting the assignee to other financial institutions of a certain net worth, and providing the syndicate agent, or sometimes even the borrower itself, with limited consent rights to assignments, often subject to a reasonableness standard (i.e. such consent not to be unreasonably withheld or delayed). These provisions can be explained by the desire of both agents and borrowers to know and be comfortable with the identity of its direct lenders and the parties with whom they will share confidential information and reach out to in the event that a waiver or modification is required. By contrast, participation provisions in syndicated loan credit agreements are usually very permissive in recognition of the risk allocation function of the participation agreement with typically no consent rights on the part of the agent or borrower. In situations where it is important for the participant to have a direct claim against the ultimate borrower, and avoid some of the risks of participation--for example, the insolvency of the lead lender or the effect of possible equitable subordination of a lead lender's entire claim because of asserted misconduct by the lead lender, it is critical for the participant to bargain directly for assignment status as an initial matter or to seek the insertion in the participation agreement of a provision allowing the participant to "elevate" its claim upon notice or other circumstances such as in the case of voting on a plan of reorganization.

Although the cases are generally consistent in denying recourse by the participant to the underlying borrower,ⁿ⁵⁰ there are cases in which a participant is able to convince the court that the transactional context evidences the parties' intention to effect a direct loan from the participant to the underlying borrower, in effect a refinancing or purchase of the original loan from the lead lender to the borrower. Thus in *Tax Investments, LTD. V. FDIC*,ⁿ⁵¹ the court found that a participant who funded 95 percent of the loan, and whose existence (although not expressly named) was contemplated by the underlying loan agreement, would be deemed a third party beneficiary of the loan agreement entitled to enforce its provisions against the borrower. The court looked to the circumstances and expectations that preceded the transaction and determined that the lead lender acted as such solely as an accommodation to the borrower and that the parties always contemplated that the participant would be the primary lender.ⁿ⁵²

FOOTNOTES:

(n1)Footnote 1. See *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 1999 U.S. Dist. LEXIS 21362 (W.D. Mich. 1999) .

(n2)Footnote 1a. *In re Okura & Co. (America), Inc.*, 249 B.R. 596, 608 (S.D.N.Y. 2000) . *Okura* contains an extensive analysis of the status of participations in bankruptcy cases of underlying borrowers and a comprehensive review of the leading cases and articles on the subject.

(n3)Footnote 1b. Simpson, *Loan Participations: Pitfalls for Participants*, 31 *Bus. Law.* 1977, 1985 (1976)(former Bankruptcy Act); 11 *U.S.C. § 547(b)*.

(n4)Footnote 2. Simpson, 31 *Bus. Law.* 1977, 1992-2003 (1976); MacDonald, *Loan Participations as Enforceable Property Rights In Bankruptcy--A Reply to the Trustee's Attack*, 53 *Am. Bankr. L.J.* 35 (1979).

(n5)Footnote 3. Krasnowiecki, Miller & Ziff, *The Kennedy Mortgage Co. Bankruptcy Case: New Light Shed on the Position of Mortgage Warehousing Banks*, 56 *Am. Bankr. L.J.* 325, 329-39 (1982) [hereinafter *Mortgage Warehousing*]; MacDonald, 53 *Am. Bankr. L.J.* 35, 67-72 (1979); Simpson, 31 *Bus. Law.* 1977, 2004-19 (1976).

(n6)Footnote 4. See Simpson, 31 *Bus. Law.* 1977, 1992-2003 (1976); MacDonald, *Loan Participations as Enforceable Property Rights In Bankruptcy--A Reply to the Trustee's Attack*, 53 *Am. Bankr. L.J.* 35 (1979).

(n7)Footnote 5. See P 4.05 [2] *infra*. There are additional possible characterizations of the participant-lead relationship, including (1) assignee-assignor, (2) tenants in common, (3) joint venturers or partners, and (4) principal-agent. Hutchins, *What Exactly is a Loan Participation?*, 9 *Rut.-Cam. L.J.* 447, 458-75 (1978). In *Deutscher v. Tennesco, Inc. (In re Southern Indus. Banking Corp.)*, 45 B.R. 97 (Bankr. E.D. Tenn. 1984), the court found that the sale of 100 percent of the loans as participations constituted sales under Tennessee law. Nevertheless, in the absence of a 100 percent disposition, the debate has largely focused on the creditor-debtor/trust dichotomy. MacDonald, 53 *Am. Bankr. L.J.* 35, 54-66 (1979); see *In re Columbia Pacific Mortg., Inc.*, (Bankr. W.D. Wash. 1981).

(n8)Footnote 5a. *Uniform Commercial Code* § 3-301 (holders of instruments may discharge instruments or enforce payment in their own names).

(n9)Footnote 6. Drake & Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 *Am. Bankr. L.J.* 23, 26-35 (1978).

(n10)Footnote 7. Drake & Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 *Am. Bankr. L.J.* 23, 35-43 (1978).

(n11)Footnote 8. *In re Columbia Pacific Mortg., Inc.*, (Bankr. W.D. Wash. 1981).

(n12)Footnote 9. Simpson, 31 *Bus. Law.* 1977, 2004-07 (1976); *Mortgage Warehousing*, 56 *Am. Bankr. L.J.* 325, 329-33 (1982).

(n13)Footnote 10. Revised *Uniform Commercial Code* § 9-313. Under Revised Article 9 of the Uniform Commercial Code, which went into effect in most states on July 1, 2001, a security interest in an "instrument" (a negotiable note is an "instrument" under the UCC) may also be perfected by filing. See Revised *Uniform Commercial Code* § 9-312(a). This represents a significant change from former Article 9, under which the secured party's taking possession was the only method of achieving long term perfection in an instrument. According to the official comments to the new provision, the availability of perfection by filing "is likely to be particularly useful in transactions involving a large number of notes that a debtor uses as collateral but continues to collect from the makers." Official Comment 2 to Section 9-312. Nevertheless, under Revised *Uniform Commercial Code* § 9-330(d), a security interest in a note perfected by filing is subordinate to the rights of a purchaser or secured party for value who takes possession of the note without knowledge that the purchase or secured transaction violates the rights of the original secured party. Moreover, under Revised *Uniform Commercial Code* § 9-331, the filing of a financing statement to perfect a security interest in a note will not preclude a subsequent purchaser of the note from becoming a holder in due course and taking the note free of all claims, including those of the secured party.

(n14)Footnote 11. Simpson, 31 *Bus. Law.* 1977, 2007 (1976); *Mortgage Warehousing*, 56 *Am. Bankr. L.J.* 325, 329 (1982). The 2001 revisions to Article 9 of the Uniform Commercial Code referred to in note 11 *supra* provide in Section 9-203(g) that the attachment of a security interest in a right to payment that is itself secured by a lien or security interest on real or personal property also constitutes attachment of the security interest to the underlying "security interest, mortgage, or other lien." Official Comment 9 to Section 9-203 states that "Subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien." Section 9-308(d) of Revised Article 9 provides conversely that perfection of a security interest in collateral also perfects a security interest in the supporting obligation for the collateral.

(n15)Footnote 12. *Mortgage Warehousing*, 56 *Am. Bankr. L.J.* 325, 329 (1982); Drake & Weems, 52 *Am. Bankr. L.J.* 23, 43-51 (1978). Under Revised Article 9, as under the former Article 9, perfection in general intangibles may only be perfected by filing. Revised Article 9 § 9-310(a).

(n16)Footnote 13. *Mortgage Warehousing*, 56 *Am. Bankr. L.J.* 325, 329-30 (1982). But see note 11, *supra*.

(n17)Footnote 14. Simpson, 31 *Bus. Law.* 2007, 2013-19 (1976); *Mortgage Warehousing*, 56 *Am. Bankr. L.J.*

325, 330 (1982).

(n18)Footnote 15. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 333-39 (1982).

(n19)Footnote 16. *E.g.*, *In re Cambridge Mortgage Corp.*, 92 B.R. 145 (Bankr. D.S.C. 1988) ; *In re Columbia Pacific Mortg., Inc.*, (Bankr. W.D. Wash. 1981) . *First Nat'l Bank of Boston v. Larson (In re Kennedy Mortgage Co.)*, 17 B.R. 957 (Bankr. D.N.J. 1982) ; see *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325 (1982); see also P 4.06 *infra*, dealing with sales of mortgages in secondary market transactions.

(n20)Footnote 16a. Revised Article 9 § 9-310(c). Under Revised Article 9 § 9-203(g) and § 9-308(e), the attachment of a perfected security interest in an obligation also constitutes the attachment of a perfected security interest in the security interest, mortgage or lien securing the underlying obligation.

(n21)Footnote 17. MacDonald, 53 Am. Bankr. L.J. 35 (1979). See *In re Columbia Pac. Mortgage, Inc.*, 20 B.R. 259 (Bankr. W.D. Wash. 1981) , holding that participation arrangement gave rise to express trust for benefit of the participant; *Deutscher v. Tennesco, Inc. (In re Southern Indus. Banking Corp.)*, note 5 *supra* , holding the disposition of 100 percent of the participating shares in a package of loans constituted a sale or gave rise to a trust.

(n22)Footnote 18. 4A Collier on Bankruptcy, P 70.25 (Matthew Bender 14th ed. 1978). See also 5 Collier on Bankruptcy, P 541.LH[3][a].

(n23)Footnote 19. 11 U.S.C. § 541(d).

(n24)Footnote 20. 124 Cong. Rec. H11,096 (Sept. 28, 1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(i) (Matthew Bender 15th Ed. Revised). To the same effect is the Senate floor statement of Senator DeConcini reported in 124 Cong. Rec. S17,413 (Oct. 6, 1978) *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(iii) (Matthew Bender 15th Ed. Revised) and set forth in P 1.06 *supra* .

(n25)Footnote 21. 124 Cong. Rec. S17,413 (Oct. 6, 1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(iii) (Matthew Bender 15th Ed. Revised).

(n26)Footnote 22. See P 4.06 *infra*.

(n27)Footnote 23. 11 U.S.C. § 362(a)(3).

(n28)Footnote 24. *Georgia Pac. Corp. v. Sigma Serv. Corp.*, 712 F.2d 962, 9 C.B.C.2d 379 (5th Cir. 1983) .

(n29)Footnote 25. *In re Columbia Pacific Mortg., Inc.*, 20 B.R. 259 (Bankr. W.D. Wash. 1981) .

(n30)Footnote 26. 11 U.S.C. § 109(b)(2).

(n31)Footnote 27. 12 U.S.C. §§ 21 *et seq.*

(n32)Footnote 28. See *Argonaut Sav. & Loan Ass'n v. Federal Deposit Ins. Corp.*, 392 F.2d 195 (9th Cir.) , *cert. denied*, 393 U.S. 839, 89 S. Ct. 115, 21 L. Ed. 2d 109 (1968) ; *Tompkins v. Bender*, 42 F. Supp. 211 (M.D. Pa. 1941) .

(n33)Footnote 29. *American Sur. Co. v. Bethlehem Nat'l Bank*, 314 U.S. 314, 316, 62 S. Ct. 226, 228, 86 L. Ed. 241, 243 (1941) .

(n34)Footnote 30. 12 U.S.C. § 194.

(n35)Footnote 31. *Merrill v. National Bank of Jacksonville*, 173 U.S. 131 (1899) ; see *American Surety Co. v. Bethlehem Nat'l Bank*, 314 U.S. 314, 62 S. Ct. 226, 86 L. Ed. 241 (1941) .

(n36)Footnote 32. 146 U.S. 499, 13 S. Ct. 148, 36 L. Ed. 1059 (1892) .

(n37)Footnote 33. *State Y.M.C.A. v. Picher*, 8 F. Supp. 412, 416 (D. Me. 1934) ; *John L. Walker Co. v. Alden*, 6 F. Supp. 262 (E.D. Ill. 1934) .

(n38)Footnote 34. *John L. Walker Co. v. Alden*, 6 F. Supp. 262 (E.D. Ill. 1934) .

(n39)Footnote 35. 379 F.2d 660 (9th Cir. 1967) .

(n40)Footnote 36. *Federal Deposit Ins. Corp., v. Mademoiselle of California*, 379 F.2d 660, 664 (9th Cir. 1967) (quoting *John L. Walker Co. v. Alden*, 6 F. Supp. 262 (E.D. Ill. 1934) . The same language was approved in *Hibernia Nat'l Bank v. Federal Deposit Ins. Corp.*, 733 F.2d 1403 (10th Cir. 1984) .

(n41)Footnote 37. 554 F. Supp. 251 (W.D. Okla. 1983) .

(n42)Footnote 38. 554 F. Supp. 251, 254 (W.D. Okla. 1983) .

(n43)Footnote 39. 554 F. Supp. 251, 253 (W.D. Okla. 1983) .

(n44)Footnote 40. *Franklin v. Commissioner*, 683 F.2d 125 (5th Cir. 1982) .

(n45)Footnote 41. 99 F.2d 245 (6th Cir. 1938) .

(n46)Footnote 42. 99 F.2d 245, 247-48. (6th Cir. 1938) .

(n47)Footnote 43. *Hoffman v. Rauch*, 300 U.S. 255, 57 S. Ct. 446, 81 L. Ed. 629 (1937) , and cases cited therein.

(n48)Footnote 44. See P 4.06 *infra*.

(n49)Footnote 45. 142 B.R. 78 (Bankr. S.D.N.Y. 1992) .

(n50)Footnote 46. 142 B.R. 78, 82 (Bankr. S.D.N.Y. 1992) .

(n51)Footnote 47. See *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 1999 U.S. Dist. LEXIS 21362 (W.D. Mich. 1999) ; *Corporate Fin. v. Fidelity Nat'l Title Ins. Co. (In re Corporate Fin.)*, 221 B.R. 671 at 678 (Bankr. E.D.N.Y. 1998) ; *European Am. Bank v. Sackman Mortgage Corp., (In re Sackman Mortgage Corp.)*, 158 B.R. 926 at 933 (Bankr. S.D.N.Y. 1993) . A loan participation transaction has been defined as a true participation "if there is a pro rata sharing of market risk and credit risk between the seller and the participant." Interpretive Letter of Brian W. Smith, Chief Counsel, Office of Comptroller of the Currency, reported in [1983] Control of Banking Rep. (P-H) P39999.104 (Apr. 4, 1983). The existence of an interest rate differential between the lead and participating shares, and the lead's agreement to repurchase a participating share if the underlying loans do not satisfy eligibility standards provided for in the agreement, do not violate the test of a true participation. However, a repurchase obligation arising upon an underlying loan default, and a "first-out" provision for a participation, will result in loan characterization. *Interpretive Letter of Brian W. Smith, supra* ; see MacDonald, *Loan Participations as Enforceable Property Rights In Bankruptcy--A Reply to the Trustee's Attack*, 53 Am. Bankr. L.J. 35, 39 (1979), for references to Internal Revenue Service Rulings concerning the participation characterization of mortgage participation pools. A debtor-creditor relationship was found to exist under the facts presented in *In re Woodson Co.*, 813 F.2d 266 (9th Cir. 1987) .

Notwithstanding the fairly clear distinctions between participation and credit transactions in respect of a participant and lead lender, some courts will hold that even in the true participation context equitable considerations dictate that the underlying loan or loans should remain property of the lead's estate for the benefit of all creditors. *Corporate Fin., Inc. v. Fidelity Nat'l Title Ins. Co. of New York (In re Corporate Fin., Inc.)*, *supra*. Conversely, under facts involving a participation agreement that included a repurchase obligation on the part of the lead lender, the court held that equitable

considerations mandated a holding that notwithstanding the existence of a credit obligation on the part of the debtor-lead lender, the participant would be given a priority in distribution over other creditors of the lender. *Savings Bank of Rockland County v. FDIC*, 668 F. Supp. 799 (S.D.N.Y. 1987) . For a discussion of cases involving the recharacterization of sale-leaseback and lease transactions, see P2.02[3], *supra*.

(n52)Footnote 48. 245 F. Supp. 790 (S.D.N.Y. 1965) .

(n53)Footnote 49. 245 F. Supp. 790, 792 (S.D.N.Y. 1965) . The Yale Express holding was followed under the facts presented in *In re Pearson Bros. Co.*, 787 F.2d 1157 (7th Cir. 1986) and in *Mason & Dixon Lines, Inc. v. First Nat'l Bank of Boston*, 86 B.R. 476 (M.D.N.C. 1988) .

(n54)Footnote 49a. 249 B.R. 596 (Bankr. S.D.N.Y. 2000) .

(n55)Footnote 49b. The rationale for this attempt was that, pursuant to a settlement agreement relating to a different transaction with the debtor, Bank of Tokyo was entitled to a better recovery on the other claim if it was able to assert a direct claim against Okura pursuant to the letter of credit agreement with Fuji.

(n56)Footnote 49c. 86 B.R. 476, 480 (M.D.N.C. 1988) , *aff'd*, 883 F.2d 2 (4th Cir. 1989) .

(n57)Footnote 50. See cases cited note 47 *supra*. Although a participant in a true participation transaction ordinarily is without a direct claim against the underlying borrower, the participant will be entitled to payment from the borrower's assets ahead of a guarantor whose right of subrogation would arise only upon payment in full of the guaranteed indebtedness. *Natwest USA Credit Corp. v. Alco Standard Corp.*, 858 F. Supp. 401 (S.D.N.Y. 1994) .

(n58)Footnote 51. 763 F. Supp. 1452 (N.D. Ill. 1991) .

(n59)Footnote 52. 763 F. Supp. 1452, 1457 (N.D. Ill. 1991) .

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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.06

P 4.06 Secondary Mortgage Market Transactions

Secondary mortgage market transactions entail the sale by a mortgage loan originator, such as a savings and loan association, of a portfolio of mortgage loans. Such sale programs enable loan originators to maintain liquidity, and provide new cash that may in turn be employed to make still more mortgage loans and create more loan portfolios. This process makes available greater amounts of mortgage money to prospective home buyers and facilitates the growth of the residential construction industry.ⁿ¹ The secondary mortgage market functions through a number of different instrumentalities, including the issuance by the Government National Mortgage Association (GNMA) of guarantees of mortgage-backed securities purchased by non-government investors, and the outright purchase of mortgage pools by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).ⁿ² Inasmuch as the GNMA, FNMA and FHLMC programs deal with large pools of residential mortgages, and in view of the originators' requirements for liquidity during the period when the pools are being formed, there are so-called mortgage warehousing banks that will make interim loans to the originators against the security of the mortgage pools in formation.

The sale, guarantee and warehousing loan transactions often have in common the fact that the originator will retain the functions of servicing the mortgages in the pools, receiving and remitting to the investors the payments made under the mortgages, ascertaining that required insurance coverage on each home is being maintained, dealing with prepayments and enforcing rights upon default. Given the requirements of the servicers to retain and use a large part of each mortgage file, and the substantial number of mortgages involved in each transaction, it is apparently the practice of many warehousing lenders to receive physical delivery of the mortgage notes and to take a written assignment of a security interest in the mortgages against which the interim loan is being made, but not to record this assignment in the real property records.ⁿ³ Similarly, the GNMA, which as guarantor of securities backed by pools of mortgages takes a security interest in the pooled mortgages, will take an unrecorded assignment of the mortgages and have the mortgage notes held by an outside bank as custodian.ⁿ⁴ With respect to the sale of portfolios to FNMA and FHLMC, it also appears that substantial portions of the mortgage files remain in the possession of the servicers of the mortgages, and that mortgage assignments are not recorded in the real estate records.ⁿ⁵

With respect to the outright sale of mortgage pools with retention of mortgage documents by the servicer and nonrecording of the mortgage assignments, the creditors' rights issue is whether upon the bankruptcy of the servicer the servicer's trustee can successfully assert that the mortgages are property of the estate, or otherwise avoid the transfer of the mortgages to the purchaser. *Section 541(d) of the Code* and its accompanying legislative history clearly provide

that the mortgage documents in the hands of the debtor, as servicer, do not constitute property of the estate. Section 541(d) provides:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.ⁿ⁶

It may be noted that section 541(d) does not deal with the question of recordation in the real property records of an assignment of mortgages, and assumes a valid transfer. However, the legislative history expressly provides that nonrecordation and indeed failure of the purchaser to take possession of the mortgage notes do not change the result that the mortgage pool does not constitute property of the servicer's estate:

Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. The purpose of section 541(d) as applied to the secondary mortgage market is identical to the purpose of section 541(e) of the Senate amendment and section 541(d) will accomplish the same result as would have been accomplished by section 541(e). Even if a mortgage seller retains for purposes of servicing legal title to mortgages or interests in mortgages sold in the secondary mortgage market, the trustee would be required by section 541(d) to turn over the mortgages or interests in mortgages to the purchaser of those mortgages.

The seller of mortgages in the secondary mortgage market will often retain the original mortgage notes and related documents and the seller will not endorse the notes to reflect the sale to the purchaser. Similarly, the purchaser will often not record the purchaser's ownership of the mortgages or interests in mortgages under State recording statutes. These facts are irrelevant and the seller's retention of the mortgage documents and the purchaser's decision not to record do not change the trustee's obligation to turn the mortgages or interests in mortgages over to the purchaser. The application of section 541(d) to secondary mortgage market transactions will not be affected by the terms of the servicing agreement between the mortgage servicer and the purchaser of the mortgages. Under section 541(d), the trustee is required to recognize the purchaser's title to the mortgages or interests in mortgages and to turn this property over to the purchaser. It makes no difference whether the servicer and the purchaser characterize their relationship as one of trust, agency, or independent contractor.

The purpose of section 541(d) as applied to the secondary mortgage market is therefore to make certain that secondary mortgage market sales as they are currently structured are not subject to challenge by bankruptcy trustees and that purchasers of mortgages will be able to obtain the mortgages or interests in mortgages which they have purchased from trustees without the trustees asserting that a sale of mortgages is a loan from the purchaser to the seller.ⁿ⁷

Notwithstanding *section 541(d) of the Code* and its legislative history, there is an argument that an unrecorded transfer of a mortgage pool may be avoided by the seller's trustee.ⁿ⁸ Under *section 544(a)(3) of the Code*, which is part of the "strong-arm" avoidance provision, the trustee is deemed to have, "without regard to any knowledge of the trustee or of any creditor," the rights and powers of, and may avoid any transfer of property of the debtor that is voidable by, "a bona fide purchaser of real property from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser at the time of the commencement of the case, whether or not such a purchaser exists."ⁿ⁹ Assuming an unrecorded mortgage pool transfer with physical delivery to the purchaser of the mortgage notes, the seller's trustee may assert avoidance rights under the theory that (a) the mortgages represent interests in real

property, (b) the mortgage transfer could have been recorded and therefore perfected against subsequent purchasers of the debtor's interest in the mortgages, (c) the mortgage assignment was not so recorded and therefore does not bind a subsequent bona fide purchaser, and (d) the transfer is accordingly voidable by the trustee who is given the status of a hypothetical bona fide purchaser.

There are at least four responses that dispose of the trustee's argument:

(1) The trustee's employment of section 544(a)(3) in the mortgage transfer context is totally at odds with the clearly articulated policy of section 541(d), expressed in the legislative history, that sales of mortgage pools without recordation of the transfer and even without delivery of the mortgage notes divests the trustee of all claim to and control over this property; indeed, nothing in the legislative history accompanying section 544(a) purports to deal with transfers of mortgages, which would certainly be the case if there were an intention to limit the scope of section 541(d).

(2) The transfer of the mortgages does not as a matter of state law require recordation to be perfected as against subsequent purchasers inasmuch as the state recording acts were intended to deal with transfers of the underlying real estate but not transfers of interests in mortgages.ⁿ¹⁰

(3) The transfer of the mortgage notes automatically carries with it the transfer of the security--the mortgages--as a matter of law and the absence of the notes in the debtor's files constitutes notice to any prospective purchaser of the mortgage pool that it must inquire as to the status of the mortgages supporting the notes.ⁿ¹¹

(4) To require recordation of the assignment of every residential mortgage included in a mortgage pool will result in substantial expense, require the enlargement of the bureaucracies dealing with the secondary mortgage market and generally impair the system of secondary mortgage market transactions vital to the housing market.ⁿ¹²

With respect to the third argument, the trustee will respond that *section 544(a)(3) of the Code* expressly provides for avoidance powers "without regard to any knowledge of the trustee," and that the trustee is therefore not bound by any constructive notice arising from the absence of the mortgage notes. The rejoinder to this assertion is that the section 544(a) language was intended and should be construed to absolve the trustee of any actual and personal knowledge that he may have gained by coincidence or otherwise, but was not intended to eliminate the doctrine of constructive notice in real estate transactions.ⁿ¹³

The principles discussed above have come into the fore as a result of the bankruptcies of several mortgage originators in connection with the so-called subprime mortgage crisis. One published decision highlights the importance that courts have given to the legislatively expressed purpose of section 541(d) in limiting the rights of a debtor-originator to assets arising from a mortgage pool that was subject to servicing by the debtor. That decision squarely addresses the argument discussed above regarding the relationship between *section 541(d) of the Code* and the strong-arm provisions of *section 544(a)(3) of the Code*.

In *Mortgage Lenders Network USA, Inc. v. Wells Fargo Bank, N.A. (In re Mortgage Lenders Network USA, Inc.)*,^{n13a} the debtor, MLN, had, prior to its bankruptcy filing, been in the business of originating and purchasing residential mortgage loans that were pooled together and sold to three separate trusts. In a typical mortgage securitization structure, the trusts sold securities secured by the assets of the trust, including the mortgages. Wells Fargo was the indenture trustee for the holders of the asset-backed securities issued by the trusts. MLN had also entered into servicing agreements with each of the trusts that provided for the following services: (1) the receipt and processing of mortgage payments from underlying borrowers; (2) effort to collect past due payments; and (3) the foreclosure on mortgage loans that had gone into default.^{n13b}

According to the court, the servicing agreements had a number of provisions that the court viewed as clearly showing that the intended relationship between MLN and the trusts was one of agency and express trust. Those provisions included (1) acknowledgments that Wells Fargo "remains the sole and absolute record holder of the [mortgage loans] and all rights related thereto," (2) provisions that upon foreclosure, MLN was to hold title to the foreclosed properties on behalf of the trusts and the security holders and that MLN "shall manage, conserve, protect and operate each [owned property obtained upon foreclosure (REO Properties)] for the [security holders]," (3) an acknowledgment and agreement that MLN would service and administer the mortgage loans and REO Properties for the benefit of the security holders for whom Wells Fargo acted as trustee and (4) provisions for MLN to forward to Wells Fargo the proceeds of the sale of any REO Properties, less any closing costs and advances made by MLN for foreclosure costs and other related expenses.^{n13c}

The dispute in the case arose from the fact that there was a lag between the time of a foreclosure taken in MLN's name and the time of an actual sale to produce proceeds to be turned over to the trusts. As a result, when MLN filed for bankruptcy, it held a number of foreclosed properties in its name. MLN commenced an adversary proceeding to assert that the trusts had no rights to these foreclosed properties. MLN, as debtor, essentially argued that because the trusts' ownership of the properties was unrecorded, a bona fide purchaser of the properties could purchase the properties free of the trusts' interests, and accordingly, under the avoidance provisions of section 544(a)(3), the debtor should also take free and clear and title to the properties.^{n13d} Wells Fargo, as trustee, argued that MLN could not benefit from section 544(a)(3) because Wells Fargo had an equitable interest in the properties and such interest was entitled to the protections of section 541(d).^{n13e}

Although the defenses provided by section 541(d) might, at first blush, have seemingly decided the matter, MLN responded by pointing out that the protections of section 541(d) do not apply *broadly* to all property that comes into the estate under section 541(a). Rather, by its terms, section 541(d) only relates to assets that would otherwise be estate property under either paragraph (1) or paragraph (2) of subsection 541(a). According to the debtor, the foreclosed properties came into the estate, not under either of those two provisions, but, rather, under subsection 541(a)(3), which encompasses "any interest in property that the trustee recovers under section ... 550." According to MLN, section 544(a)(3) is an avoidance statute and the property interests avoided under that provision come into the estate under section 550, which provides that "to the extent that a transfer is avoided under section 544, 545, 547, 548, 540, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred."^{n13f}

Although the court acknowledged that section 544 was not a model of clarity, it rejected the debtor's argument by construing section 541(a)(3), including the reference to section 550, as applying only to property that comes into the estate following the petition date as a result of action taken by the court or a debtor. According to the court, section 544(a)(3), the statute relied upon by the debtor to bring the foreclosed properties into the estate, encompassed a different type of right--one that automatically vested property in the estate as of the petition date by deeming the debtor to be a hypothetical bona fide purchaser--and this type of right was intended to be subject to the limitations of section 541(d):

MLN is not avoiding a lien or conveyance, it is exercising the right of a hypothetical bona fide purchaser of real property to defeat an unrecorded ownership interest arising out of an express trust. But this application has nothing to do with a trustee recovering property as contemplated by § 541(a)(3) and § 550(a). On the date the petition was filed MLN had legal title to the Foreclosed Properties. This fact falls squarely within § 541(a)(1) which, in relevant part, provides: "Such an estate is comprised of all of the following property, wherever located and by whomever held: ... all legal or equitable interests of the debtor in property as of the commencement of the case." Thus, the application of § 541(d): "Property in which the debtor holds, as of the commencement of a case, only legal title and not an equitable interest ... becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

... .

Section 541(d) identifies as an example of the kind of property coming into the estate "a mortgage secured by real property." But the application of § 541(d) is not limited to a mortgage secured by real property. The fact that MLN holds a deed rather than a mortgage is irrelevant. A mortgage or an interest in a mortgage as stated in § 541(d) is simply an example of "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest" As described above, for eight years MLN serviced the Wells Fargo mortgages in a manner fully cognizant of Wells Fargo's equitable interests and the absence of any MLN equitable interest, other than being compensated for the servicing, which it apparently has been so compensated. Since MLN had no equitable interest in the mortgages, it follows that it has no equitable interest in the Foreclosed Properties which are a product of the mortgages.

Other than the holding of a mortgage example set forth in § 541(d), I cannot imagine a more appropriate application of § 541(d) than the situation here. By its prepetition conduct MLN acknowledges that it held the Wells Fargo mortgages in the name of MLN but the fruits of those mortgages were enjoyed solely by Wells Fargo. Those fruits included ownership of real property upon foreclosure. The Foreclosed Properties are the product of Wells Fargo's mortgages. MLN is in no better position to keep the Foreclosed Properties than it was entitled to an equitable interest in the Wells Fargo mortgages held in MLN's name.

If the foreclosures had not taken place and MLN held the mortgages in its name, then when the bankruptcy petition was filed Wells Fargo's equitable interest in the mortgages would clearly have been preserved pursuant to § 541(d). It is clear from the legislative history of § 541(d) that with respect to the mortgage servicing business, Congress intended to preserve the rights of mortgagees whose interests were not publicly recorded.^{n13g}

The court further cited the legislative history previously discussed in this chapter *supra* and the expressed "purpose of section 541(d) as applied to secondary mortgage market ... to make certain that secondary mortgage market sales as they are currently structured are not subject to challenge by bankruptcy trustees."^{n13h} The court then concluded that such purpose applied to the very situation before it--where MLN, a mortgage servicer in the secondary mortgage market, holds legal title to the foreclosed properties that it was servicing on behalf of the trusts, as equitable owner of the properties.ⁿ¹³ⁱ

Finally, the court distinguished a number of cases which had held that the trustee's rights to augment the estate under section 544(a) trumped the defense under section 541(d) available to the holder of an equitable interest in the property based on the fact that those cases involved constructive trusts rather than express trusts of the type created in the MLN transactions and that none of the conflicting cases involved secondary mortgage transactions.^{n13j}

Although the court in the *Mortgage Lenders Network* case faced a difficult question of reconciling and determining the relative priority of different statutory provisions, in the end, the court relied principally on the legislative history of section 541(d) and the fact that the case before it involved the secondary mortgage market transaction and a fact pattern (i.e., the ownership by the servicer of real property upon foreclosure) that was ancillary in the ordinary course to the servicing function, in order to protect the equitable owners of the properties. This case should lessen many of the concerns previously faced by purchasers of mortgages in situations where the servicer is financially challenged or may otherwise be a potential bankruptcy debtor.

It is important to note that a key element in the purchaser's defense against the trustee's attack arises from the fact that possession of the mortgage notes has been transferred to the purchaser of the pool, and that absent such transfer the third argument above is unavailable. Accordingly the better practice in mortgage pool sales is to transfer possession of the

notes to the purchaser.

Section 541(d) of the Code does not by its terms deal with the granting of security interests in mortgages, having been drafted in terms of sales of mortgages and interests in mortgages. As noted above, the practice of warehousing lenders and of the GNMA in making of loans against pools of mortgages is to take possession of the mortgage notes, to obtain a written assignment of the mortgages, but not to record the assignments. The creditors' rights issue in this context is whether the security interests in the mortgages have been perfected as against the trustee of the mortgage originator. It has been stated that this issue "is of vital importance not only to the commercial banking community, which annually advances millions of dollars to the mortgage companies, but also to the future of the entire home mortgage market."¹⁴

The issue was squarely before a bankruptcy court in *First National Bank of Boston v. Larson (In re Kennedy Mortgage Co.)*,¹⁵ a chapter 11 case involving as the debtor a mortgage company (the originator) which received a loan advance from a bank under a secured revolving credit agreement against delivery of certain mortgage notes and an unrecorded assignment of the related mortgages. The court held that the bank's security interest in the notes and mortgages was perfected by delivery of the notes and unrecorded assignments. The court found that (a) perfection of the security interest in the notes is governed by the Uniform Commercial Code, and that delivery to the secured party is required for perfection, (b) the security interest in the mortgages involves an interest in real property, and perfection of that security interest is governed by the local recording acts and not by the Uniform Commercial Code, (c) the local recording acts do not require recordation of the mortgage assignment for validity as against a subsequent assignee of the mortgages, and (d) the mortgages are merely adjuncts to the notes without independent force of their own so that transfer of each note carries with it the transfer of the related mortgage for perfection purposes. The court took notice of the substantial impact that a contrary holding may have upon the residential mortgage market, stating:

It was disclosed that mortgage brokers arrange for placing of mortgages throughout the entire United States in the hundreds of millions of dollars and they obtain funds for such purposes from banks and other lending institutions and only surrender possession of the notes and deliver unrecorded assignments of the mortgages upon completion of the mortgage settlement. The bank and lending institutions warehouse the loans and sell them to investors or to GNMA or governmental agencies in blocks of millions of dollars. The method now used for financing of the mortgages would be seriously affected if every assignment had to be recorded. It would require searches of title and delay in transfers as well as involve considerable expense for recording and the recording of assignments. The easy access that mortgage brokers now have for a source of funds would be disrupted and reduce the availability of funds in the mortgage market.¹⁶

The court added that business practices could not be the "sole and dominant factor" in its decision, but that the interpretation of commercial statutes should be effected in the light of such practices.¹⁷

It should be noted that the perfection issue relating to the financing of mortgage originators is identical to the perfection issue raised by the advocates of the creditor-debtor characterization of the relationship between a mortgage loan participant and its lead lender.¹⁸ In the case of mortgage loan participations, the creditor-debtor proponents must first establish the correctness of their characterization of the participant-lead lender relationship and then demonstrate that the participant failed to take the steps required to perfect a security interest in the underlying mortgage loan. In the case of loans to mortgage originators, there is no question as to the existence of a creditor-debtor relationship between the lender and originator, with the only issue being the manner of perfection of the lender's security interest in the underlying mortgage portfolio. Under the *Kennedy Mortgage* decision, perfection occurs by delivery to the lender of the mortgage notes and an unrecorded assignment of the mortgages. In participation transactions, the participant ordinarily does not take delivery of the underlying note, and would be deemed unperfected under the *Kennedy Mortgage* holding. Thus, the principal defense against a trustee's attack in the participation context will relate to the characterization of the relationship rather than the existence of secured creditor status of the participant.

It should also be noted that *section 541(d) of the Code* is not an all-encompassing carveout to the scope of the property in a debtor's estate. The statute only limits the rights of the debtor to property in which the legal and equitable interests have been separated. In relation to secondary mortgage transactions, the types of rights that may be limited under section 541(d) are only the property rights that have been sold "such as a mortgage secured by real property, or the interest in such a mortgage." In particular, in a recent notable case arising from the bankruptcy of a mortgage originator, it has been held that the servicing rights were severable from the mortgages themselves even where the servicing rights were contained in the same purchase agreement, and therefore the right of a debtor to service a mortgage was not an "interest in such a mortgage" for which the debtor's rights are limited under section 541(d).ⁿ¹⁹ In that decision, the court held that such servicing rights not only were property of the estate under section 541(a), but were severable from a related repurchase agreement for the underlying mortgages and, therefore, not subject to the special safe-harbor protections relating to repurchase agreements under *sections 555 and 559 of the Code*.ⁿ²⁰

FOOTNOTES:

(n1)Footnote 1. Krasnowiecki, Miller & Ziff, *The Kennedy Mortgage Co. Bankruptcy Case: New Light Shed on the Position of Mortgage Warehousing Banks*, 56 Am. Bankr. L.J. 325, 326-29 (1982) [hereinafter "Mortgage Warehousing"].

(n2)Footnote 2. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 326-29 (1982); see *In re Adana Mortg. Bankers, Inc.*, 12 B.R. 977 (Bankr. N.D. Ga. 1980) , for a description of the GNMA program.

(n3)Footnote 3. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 340-41(1982).

(n4)Footnote 4. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325 (1982).

(n5)Footnote 5. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325 (1982).

(n6)Footnote 6. 11 U.S.C. § 541(d). *In re Union Sec. Mortgage Co.*, 25 F.3d 338, 31 Collier Bankr. Cas. 2d (MB) 134 (6th Cir. 1994) .

(n7)Footnote 7. 124 Cong. Rec. S17,413 (Oct. 6, 1978) (statement of Senator DeConcini), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(f)(iii) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 342-43 (1982).

(n9)Footnote 9. 11 U.S.C. § 544(a)(3).

(n10)Footnote 10. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 333-39 (1982).

(n11)Footnote 11. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 337-39 (1982).

(n12)Footnote 12. See *Colin v. Fidelity Standard Mortgage Corp. (In re Fidelity Standard Mortgage Corp.)*, 36 B.R. 496 (Bankr. S.D. Fla. 1983) ; *First Nat'l Bank of Boston v. Larson (In re Kennedy Mortgage Co.)*, 17 B.R. 957, 961 (Bankr. D.N.J. 1982) .

(n13)Footnote 13. See *In re Sandy Ridge Oil Co., Inc.* 807 F.2d 1332, 15 C.B.C.2d 1234 (7th Cir. 1986) ; *McCannon v. Marston*, 679 F.2d 13, 6 C.B.C.2d 875 (3d Cir. 1982) ; *Walsh v. Saghi (In re Gurs)*, 10 B.C.D. 128 (B. A. P., 9th Cir. 1983) ; *In re Roman Crest Fruit, Inc.*, (Bankr. S.D.N.Y. 1983) ; *In re Hardway Restaurant, Inc.*, 31 B.R. 322 (Bankr. S.D.N.Y. 1983) . The section 541(d) exclusion from property of debtors' estates of beneficial interests in mortgage portfolios also renders the remission of mortgage loan payments from the debtor-servicer to the beneficial owner immune from preference attack under *section 547 of the Code*.

(n14)Footnote 13a. 380 B.R. 131 (Bankr. D. Del. 2007) .

(n15)Footnote 13b. 380 B.R. 131, 133 .

(n16)Footnote 13c. Section 544(a)(3) provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by--

...

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(n17)Footnote 13d. 380 B.R. 131, 134 .

(n18)Footnote 13e. 380 B.R. 131, 136 .

(n19)Footnote 13f. 11 U.S.C. § 550(a).

(n20)Footnote 13g. 380 B.R. 131, 136-138 .

(n21)Footnote 13h. 380 B.R. 131, 137 (quoting legislative history).

(n22)Footnote 13i. 380 B.R. 131, 138 .

(n23)Footnote 13j. 380 B.R. 131, 139 .

(n24)Footnote 14. *Mortgage Warehousing*, 56 Am. Bankr. L.J. 325, 325 (1982). Revised Article 9 of the Uniform Commercial Code, which went into effect in most states on July 1, 2001, provides in *Section 9-203(g)* that "The attachment of a security interest in a right to payment of performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien." Official Comment 9 to Section 9-203 characterizes Section 9-203(g) as codifying the common law, and cites to the Restatement (3d), Property (Mortgages) in support of this statement. It therefore appears that if a mortgage warehousing lender takes possession of the mortgage notes to perfect its security interest therein, it will have also perfected a security interest in the mortgages supporting the notes without further action in those jurisdictions that have adopted these amendments to the Uniform Commercial Code.

It should also be noted that the revisions to the UCC also include *section 9-312(a)*, which permits perfection of a security interest in an instrument by filing as an alternative to possession. However, *Section 9-330(d)* provides that the security interest in an instrument perfected by filing may be defeated by purchasers for value taking possession of the instrument without knowledge that the purchase violates the rights of the secured party. Under *Section 9-331*, the existence of the filing does not constitute such notice as would defeat the rights of a subsequent purchaser of the relevant note as a holder in due course that takes the note free of the earlier security interest.

(n25)Footnote 15. 17 B.R. 957, (Bankr. D.N.J. 1982) .

(n26)Footnote 16. *First Nat'l Bank of Boston v. Larson (In re Kennedy Mortgage Co.)*, 17 B.R. 957, 961 (Bankr. D.N.J. 1982) . Similar policy reasons apparently influenced the district court's decision in *In re Maryville Sav. & Loan Corp.*, 31 B.R. 597 (E.D. Tenn. 1983) , *aff'd in part, rev'd in part*, 743 F. 2d 413 (6th Cir. 1984) , *supp. op.*, 760 F.2d 119 (1985) , holding that recordation of an assignment of notes and trust deeds without possession by the secured

creditor of the notes and trust deeds nevertheless resulted in perfection of the lien. The Court of Appeals reversed on this point, finding that possession of the notes was required for perfection; *cf. In re Cambridge Mortgage Corp.*, 92 B.R. 145 (Bankr. D.S.C. 1988) . *But see* note 14, *supra*, for a discussion of changes to the Uniform Commercial Code that have codified the rule that possession of the mortgage notes constitutes perfection of a security interest in the underlying mortgages.

(n27)Footnote 17. *In re Cambridge Mortgage Corp.*, 92 B.R. 145 (Bankr. D.S.C. 1988) . The *Kennedy Mortgage* case has been characterized as part of a "growing consensus" that possession of a mortgage note for perfection purposes results in perfection of a security interest in the underlying mortgage without recordation of a mortgage assignment. *Stockschlaedder McDonald, Esqs. v. Kittay*, 145 B.R. 797, 808-09 (Bankr. S.D.N.Y. 1992) .

(n28)Footnote 18. *See P 4.05 supra*.

(n29)Footnote 19. *Calyon N.Y. Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.)*, 58 C.B.C.2d 1901, 379 B.R. 503 (Bankr. D. Del. 2008) .

(n30)Footnote 20. 379 B.R. 503, 518, 521-22 .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

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P 4.07 Partnership Agreements and Limited Liability Company Operating Agreements

[1] Introduction

The discussion in paragraph 4.07[2] *infra* deals principally with the effect on a partnership of the bankruptcy of a general partner. This issue has been addressed in numerous opinions and articles.ⁿ¹

The emergence of the limited liability company ("LLC") as a preferred entity for the ownership of real estate and other assets has given rise to the issue of the effect on the LLC of the bankruptcy of a managing member of the LLC. This issue has been addressed in a small number of opinions, which are considered in paragraph 4.07[3] *infra* .

[2] The Effect on a Partnership of the Bankruptcy of a General Partner

Although the formation of a partnership is not in itself a real estate transaction, the partnership form is a frequently employed method of real estate ownership. This was especially true in tax-shelter real estate transactions structured prior to enactment of the Tax Reform Act of 1986,^{n1a} wherein the partnership form permitted individual partners to receive certain tax benefits arising from the ownership of the property and the financing of the transaction. The partnership continues to be a favored form of ownership solution for real estate ventures notwithstanding the elimination in the Tax Reform Act of 1986 of many benefits theretofore associated with tax-sheltered transactions.

The ensuing discussion deals with the question of whether a Bankruptcy Code trustee of a general partner of a general or limited partnership may assume, or assume and assign, the general partner's interest in the partnership without the consent of the other partners.ⁿ² The resolution of this question affects the ability of the nondebtor partners of a nondebtor partnership to wrest from the trustee of the debtor partner the control rights in the partnership of the debtor partner, in view of potential or actual conflicts of interest between the trustee and the other partners. These conflicts may arise from:

- (1) the trustee's interest in liquidating the assets of the estate;
- (2) the debtor's unwillingness as a general partner to issue a capital call;
- (3) the debtor's general inability to honor its obligations for capital contributions; or

- (4) the debtor's unwillingness generally to enter into significant commitments relating to the future development of the partnership's property.

In addition, the debtor's financial difficulties may undermine the confidence of the other partners in the debtor's capacity, as the general partner of a limited partnership or as the managing partner in a general partnership, to manage the business and affairs of the enterprise. The desire of the nondebtor partners of a debtor general partner to remove the general partner from its position of control and management is counterbalanced by the provisions and policies of the Bankruptcy Code that generally render unenforceable provisions of state law and of executory contracts that would result in a modification or termination of a debtor's contractual rights by reason of the commencement of the debtor's case under the Code.

Before considering the difficult creditors' rights issues arising from the bankruptcy of a general partner of a general or limited partnership, it may be helpful first to consider the several types of relationships and rights arising from the partnership form of property ownership. A partnership agreement is, of course, a contract between the parties thereto, specifying the respective rights and obligations of the partners.ⁿ³ In addition, a partnership agreement evidences certain "property rights" of the partners, arising from their investment in the partnership and their expectations concerning income and distributions generated by the operation of the partnership's assets.ⁿ⁴ Moreover, the entry into a partnership agreement gives rise to a fiduciary relationship between the partners vested with the managerial or control rights of the partnership and the partners that are not vested with such rights.ⁿ⁵ The partnership relationship is also subject to the provisions of applicable partnership statutes, which may be varied in certain instances by overriding provisions in a partnership agreement.ⁿ⁶

The Bankruptcy Code, in section 365, provides a comprehensive system for the treatment of executory contracts of the debtor, including such matters as cure of contractual defaults, and assumption, assignment, rejection and termination. The Code, in other sections such as 363, 506, 541, 1111(b) and 1129(b), deals with the treatment of property rights of debtors and claimants. However, no section or series of related sections in the Code deals comprehensively with agreements--such as partnership agreements--that give rise to both contractual relations and property rights.ⁿ⁷

Certain provisions of the Code address the problem of interconnected contractual and property rights on an *ad hoc* basis. For example, under section 365(h), dealing with the rejection of a real estate lease by the trustee for a landlord, the trustee may reject the landlord's affirmative obligations and duties set forth in the lease, but may not, if the nondebtor tenant so elects, deprive the tenant of its right to possession and use and other rights under the lease that are in or appurtenant to the real property to the extent that such rights are enforceable under applicable nonbankruptcy law.^{n7a} Thus, section 365(h) operates to eliminate a landlord's contractual obligations under a lease, while preserving the covenant of quiet enjoyment binding upon the landlord and inherent in the creation of the tenant's leasehold estate. Similarly, under section 365(n), the trustee for a licensor under a license of intellectual property may reject the licensor's affirmative obligations under the agreement, but the licensee is entitled to continued enjoyment of its license under the terms of the governing document.

However, as noted above, no corresponding provisions in the Code deal specifically with the rights of nondebtor partners under partnership agreements. Therefore, it is necessary to address the creditors' rights issues arising from the bankruptcy of a general partner of a general or limited partnership by reference to the more general provisions of the Code dealing with executory contracts and property rights.

The creditors' rights issues include:

- (1) Does the filing of a general partner's petition under the Bankruptcy Code result in a dissolution of the partnership, thereby requiring the winding-up of the partnership's affairs?

- (2) If the Bankruptcy Code filing of the partner does not result in dissolution of the partnership, does the partnership agreement constitute an executory contract for the purpose of a Bankruptcy Code analysis of the trustee's rights *vis a vis* the nondebtor partners?
- (3) If the partnership agreement constitutes an executory contract for Bankruptcy Code purposes, does the filing of the general partner's petition give rise to a right of the nondebtor partners to enforce a bankruptcy termination or default provision in the partnership agreement?
- (4) If the partnership agreement cannot be terminated by the nondebtor partners under a bankruptcy termination or default provision in the agreement, may the general partner's trustee assume the general partner's rights and duties under the partnership agreement including the control rights of the general partner?
- (5) If the trustee may assume the general partner's rights and duties under the partnership agreement, may the trustee likewise assign those rights and duties to an outside party?
- (6) If the trustee may not assume the general partner's rights and duties under the partnership agreement, may the trustee be compelled to reject the partnership agreement and relinquish all of the debtor's economic rights in the partnership?

The resolution of these issues first requires a review of the applicable state law and Bankruptcy Code provisions.

State Law--Dissolution of a Partnership Upon the Bankruptcy of a General Partner--Section 31(5) of the Uniform Partnership Act of 1914 (UPA) provides that the bankruptcy of a partner is a cause of dissolution of the partnership. Section 31(5) speaks only of the "bankruptcy" of a partner, and does not refer to proceedings involving reorganization, rehabilitation, the appointment of a trustee or receiver, or other proceedings which do not necessarily contemplate a bankruptcy liquidation.ⁿ⁸ Under Revised Uniform Limited Partnership Act (RULPA) Sections 402(4), 402(5) and 801(3), if a general partner commits one or more enumerated acts of bankruptcy (including the filing of a voluntary bankruptcy petition, the filing of a voluntary petition or answer seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief, and the seeking of or consent to the appointment of a trustee, receiver or liquidator of all or a substantial part of the partner's properties), then the limited partnership is dissolved unless:

- (1) one or more other nondebtor general partners are present, the partnership certificate provides for continuation of the partnership in these circumstances, and the nondebtor general partner or partners carry on the partnership's business; or
- (2) all partners agree, in writing, within 90 days after the occurrence of the bankruptcy event specified in Section 402 of the RULPA, to continue the partnership business and to "the appointment of one or more additional general partners if necessary or desired."ⁿ⁹

The Uniform Limited Partnership Act (ULPA) is silent as to the effect of the bankruptcy of a general partner, but most limited partnership agreements governed by the ULPA include a bankruptcy termination clause with respect to the bankruptcy of the general partner and the dissolution of the partnership.ⁿ¹⁰ Similarly, the Revised Uniform Partnership Act of 1997 (RUPA), which, as of December 1, 2000, has replaced the 1914 Uniform Partnership Act in 30 states, has no automatic dissolution upon the bankruptcy or similar occurrence with respect to a partner, but does provide for dissolution upon an event agreed to in the partnership agreement.^{n10a} Moreover, upon an event agreed to in the partnership agreement, a partner may be "dissociated" from a partnership.^{n10b}

Before discussing the provisions of the Bankruptcy Code applicable to the resolution of the issues enumerated above, it may be helpful to consider certain differences in state law and Bankruptcy Code terminology that are relevant to the analysis. The term "dissolution" is a state law construct involving the departure from a partnership of one or more partners. A dissolution of a partnership does not necessarily mean that the business of the partnership must be discontinued. Upon a dissolution, the affairs of a partnership are to be "wound up." This may take the form of a liquidation of the partnership's business, but also may be accomplished by a reconstitution of the partnership as a new entity and the continuation of the business of the former partnership without the participation of the departed partner.^{n10c} Thus dissolution does not always adversely affect the remaining partners, but necessarily affects the rights and investment of the departing partner.

As more fully discussed below, the Bankruptcy Code appears to address the partnership termination issue not in terms of dissolution but rather in terms of the termination of a partnership agreement as an executory contract. As a matter of partnership law, an event of dissolution does not terminate a partnership agreement and instead constitutes the first step leading to the winding-up of the partnership's affairs. Nevertheless, in order to analyze the interplay between state law and the Bankruptcy Code in this area, it appears necessary to assume that the Code's anti- termination provisions in section 365 relate to the state law and partnership agreement dissolution provisions.

[a] Bankruptcy Code Provisions--Termination of a Partnership Upon the Bankruptcy of a General Partner

The relevant provisions of the Bankruptcy Code, which, under the supremacy clause of the United States constitution, supersede state law and partnership agreement provisions to the extent of any inconsistency between such provisions and the Code, are:

- (1) section 541(c), which provides that property of a debtor becomes property of the estate notwithstanding any "provision" that is conditioned on insolvency, the filing of a petition under the Code, or the appointment or taking of possession of a Bankruptcy Code trustee or a custodian, or which provides for a forfeiture, modification or termination of the debtor's interest in property;
- (2) section 365(e)(1), which provides that an executory contract of a debtor, and a particular right or obligation of a debtor under an executory contract, cannot be terminated or modified under any provision of law or of the contract that is conditioned on the debtor's insolvency or financial condition, the commencement of the debtor's case under the Code, or the appointment of or taking possession by a Bankruptcy Code trustee or a custodian; but subject to--
- (3) section 365(e)(2)(A), which provides that the section 365(e)(1) invalidation of bankruptcy termination and financial condition default clauses is inapplicable to contracts with respect to which "applicable law excuses a party, other than the debtor ... from accepting performance from or rendering performance to the trustee or to an assignee of such contract ..., whether or not such contract ... prohibits or restricts assignment of rights or delegation of duties,"ⁿ¹¹ and the nondebtor party or parties do not consent to such assumption or assignment.

In addition, consideration should be given to Section 5i of the former Bankruptcy Act, which provided that the bankruptcy of fewer than all of the general partners of a partnership required the nondebtor general partners to wind up the partnership business. Although no counterpart is in the Bankruptcy Code to Section 5i, it has been asserted that the same result may obtain in the case of a chapter 7 proceeding of a general partner.ⁿ¹² This assertion may find support in *section 704(1) of the Code*, which requires a trustee expeditiously to collect and reduce to money the property of the estate.

[b] State Law--Assumption and Assignment of the Partnership Agreement by the Trustee of a General

Partner

With respect to the power of the trustee of the debtor partner to assume the debtor's interest in the partnership, Section 35(3)(b) of the UPA provides that a debtor partner is without authority to bind the partnership after dissolution, and ULPA Section 9 and RULPA Section 403 each provides that the general partner of a limited partnership has all of the rights and powers and is subject to the duties and liabilities of a general partner of a general partnership. Section 702 of the RUPA provides that a "dissociated" partner can only bind the partnership under certain specified conditions. With respect to the trustee's power to assume and assign the debtor's interest in the partnership, Section 18(g) of the UPA provides that unless otherwise agreed in the partnership agreement, no person may become a partner without the consent of all existing partners, and Section 27 of the UPA provides that conveyance by a partner of its partnership interest does not dissolve the partnership, entitles the assignee to receive profits that the assigning partner would have otherwise received, but does not entitle the assignee to management rights, to obtain information concerning partnership transactions, or to inspect the partnership books. Similarly, section 603 of the RUPA provides that upon a partner's dissociation, the partner's right to participate in the management and conduct of the partnership business terminates, and section 701 provides that if a partner is dissociated from a partnership without resulting in a dissolution and winding up of the partnership business, the partnership shall cause the dissociated partner's interest in the partnership to be purchased for a buyout price determined in subsection (b), unless otherwise provided in the partnership agreement. The ULPA provides that a general partner may not admit another general partner without the written consent or ratification of all limited partners, but does not expressly deal with the assignment of a general partner's interest.ⁿ¹³ Under the RULPA, additional general partners may be admitted only with the consent of each existing partner, assignment of a partnership interest may be restricted under the partnership agreement, and an assignee cannot exercise the rights of a partner but is entitled to the distributions that the assignor would have received.ⁿ¹⁴ In sum, the UPA, the RUPA (assuming that insolvency is stated as an event of dissociation in the partnership agreement), ULPA and RULPA, without reference to the Bankruptcy Code, do not permit an insolvent general partner to continue to function as a general partner without the consent of the nondebtor partners, and in the absence of an event of dissolution, (1) restrict the admission of new general partners and (2) contemplate the assignment or purchase of a general partner's economic rights but not its management rights.

[c] Bankruptcy Code Provisions--Assumption and Assignment of a Partnership Agreement by the Trustee of a General Partner

The provisions of the Bankruptcy Code relating to assumption and assignment are:

- (1) Section 365(b), which permits the trustee to assume an executory contract if the trustee cures or provides adequate assurance of prompt cure of outstanding defaults and provides adequate assurance of future performance but does not require cure, adequate assurance of prompt cure, or adequate assurance of future performance with respect to financial condition or bankruptcy default clauses in executory contracts or with respect to the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract;ⁿ¹⁵
- (2) Section 365(f)(1), which renders unenforceable executory contract provisions and provisions of law prohibiting, restricting or conditioning the assignment by the trustee of an executory contract of the debtor;
- (3) Section 365(f)(3), which renders unenforceable executory contract provisions and provisions of law permitting termination or modification of an executory contract or of any right or obligation thereunder on account of an assignment of the contract in the context of an assumption or assignment by the trustee, all of which are subject to--

(4) Section 365(c), which provides that a trustee may not assume or assign an executory contract with respect to which applicable law excuses the nondebtor party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract prohibits or restricts the assignment of rights or the delegation of duties.

Section 541(c) is intended to effect the transfer from a debtor to its estate of the assets properly includable in the estate, with such assets to be undiminished and otherwise unaffected by the occurrence of the debtor's Bankruptcy Code case. Under the uniform laws discussed above, and under the view that a chapter 7 filing of a general partner requires dissolution of the partnership, the bankruptcy of a general partner may result in a dissolution of the partnership. If a dissolution of the partnership and a winding-up of the partnership business occurs, the remaining partners are required to distribute the partnership's assets and to account to the trustee for the debtor's share therein.^{n15a} If a dissolution and continuation of the partnership's business by the remaining partners occurs, the debtor's share must likewise be accounted for.ⁿ¹⁶ Thus, dissolution may affect the interest in the partnership of the debtor-general partner by converting an interest in a subsisting enterprise to a right to payment or distribution. If the partnership agreement provides for the payment or distribution without giving effect to going-concern value, and the remaining partners elect to continue the business, to the extent that the liquidation value of the partnership business is less than the going-concern value, the interest in the partnership of the debtor-general partner may be impaired by the dissolution.ⁿ¹⁷ Moreover, the debtor-general partner in a real estate partnership may suffer adverse tax consequences, such as recapture of depreciation deductions, upon dissolution and termination which would not occur in the absence of dissolution.ⁿ¹⁸ If one of the objectives of the Bankruptcy Code is to foster the preservation and marshalling of a debtor's assets for the benefit of the estate and its creditors, then a rule providing for automatic dissolution of the partnership in which the debtor is a general partner will not in all circumstances serve this objective. Indeed, even in the case of a chapter 7 liquidation of the general partner, the estate may, in some instances, be better served if the trustee is permitted to dispose of the debtor's interest in the partnership rather than to collect the proceeds of a partnership liquidation. In view of these considerations, it cannot be concluded that dissolution will be decreed in all instances. The absence of any specific provision in the Code dealing with this question, in contrast to the express directive contained in Section 5i of the former Bankruptcy Act, suggests that the issue should be resolved on a case-by-case basis.ⁿ¹⁹

Assuming for purposes of discussion that general and limited partnerships, in some circumstances, will not be deemed dissolved upon the filing of a Bankruptcy Code petition by a general partner, the analysis turns to the rights of the trustee to deal with the partnership interest of the debtor, and to the powers of the nondebtor partners to prevent short of dissolution the continued exercise by the trustee of the powers of the debtor as a general partner. Underlying this approach is the distinction between dissolution of a partnership and the termination of a partnership agreement.

As noted above, the dissolution of a partnership involves the change of the relationship between persons as partners, and is the first step in the process of winding-up a partnership's business.ⁿ²⁰ The occurrence of an event of dissolution does not necessarily result in termination of the governing partnership agreement, and ordinarily will instead bring into play the provisions of the partnership agreement and of state law prescribing the steps to be followed to effectuate the winding-up of the partnership's business. The termination of a partnership agreement, on the other hand, ends the contractual relationship as well as "extra-contractual relationship" between the partners, although in fact the process of and distributions resulting from the disposition of the partnership's business following a contractual termination probably will closely resemble the dissolution procedure prescribed in most partnership agreements.

The notion of the dissolution of a partnership is grounded in state law and is not addressed in the Bankruptcy Code, but the treatment and possible termination of the contractual elements of the partnership relationship appear to fall within the general provisions of the Code dealing with executory contracts. Therefore, in order to provide a framework for consideration of the issues within the context of the Bankruptcy Code, it is necessary to set aside the construct of a "dissolution" and to address the treatment of the debtor's general partnership interest as a set of rights and obligations arising under an executory contract. Thus, it must be determined whether a partnership agreement may fall within the definition of an "executory contract" for the purposes of the Bankruptcy Code.ⁿ²¹

The generally accepted definition of an "executory contract" for the purposes of the Bankruptcy Code is a contract with respect to which material obligations remain to be performed by both parties to the contract.ⁿ²² It has been held that a partnership agreement is not an executory contract under the generally accepted definition inasmuch as the nonperformance of a contractual obligation by one partner does not ordinarily excuse performance by the other partners, and merely gives to the performing partners a right of action, or preferential rights of return (depending on the provisions of the partnership agreement), as against the nonperforming partner.ⁿ²³

However, the generally accepted definition need not be accepted as the exclusive definition of an executory contract in circumstances under which the trustee would benefit from the rejection or assumption of a particular obligation in a contract that does not fall within that definition.ⁿ²⁴ Section 365(a) is the exclusive source of a trustee's authority to assume or reject executory contracts and unexpired leases. Thus, if a contract is deemed to be neither an executory contract nor an unexpired lease, then, under a strict interpretation of the Code, no methodology exists for a trustee to deal with that contract other than to breach it or to permit the contract to "ride through" the case.ⁿ²⁵ Although a contract may be dealt with in a Bankruptcy Code case apart from section 365, that section sets forth a series of rules and mechanisms that are intended to accommodate the interests of the debtor and nondebtor parties to a contract. Such rules and mechanisms should not become inapplicable to a contract by reason of a narrow definitional threshold, if application of section 365 would be workable and beneficial to the estate. The foregoing considerations, therefore, warrant a liberal definition of an executory contract. An executory contract may be defined more broadly as any unperformed obligation of a debtor, the assumption or rejection of which may benefit the estate.

If a Bankruptcy Code debtor is a general partner under a partnership agreement providing for substantial capital contributions or for burdensome management obligations to be performed by the general partner, the debtor's trustee may determine that rejection would benefit the estate. If, on the other hand, the debtor had prior to the filing invested substantial sums in the partnership and anticipated a reasonable return from the partnership business, the trustee would probably seek to retain such benefits. Although, as discussed above, section 365 does not expressly address a number of the issues arising from the intertwining of contractual and property rights within a typical partnership agreement, the section does provide a framework sufficient to permit the courts to resolve the questions left unanswered by the statute. Accordingly, section 365 should be held applicable to partnership agreements.^{n25a}

If partnership agreements are characterized as executory contracts and, if dissolution of a partnership is viewed as a step leading to the termination of the governing partnership agreement, section 365(e)(1) would render unenforceable any provision of partnership law or of a partnership agreement that provides for dissolution of the partnership or termination of the partnership agreement upon the bankruptcy of a general partner. Similarly, under section 365(b), a general partner's trustee may assume a partnership agreement notwithstanding any provision of partnership law or of the partnership agreement to the contrary, and under section 365(f)(1) and (f)(3) could assign its general partnership interest under the partnership agreement to an outside party notwithstanding restrictions on assignment set forth in partnership law or the partnership agreement.

However, section 365(b), (e)(1), (f)(1) and (f)(3) must be read in the light of section 365(e)(2)(A), which provides in substance that bankruptcy termination provisions of applicable law and of executory contracts are enforceable when:

(A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) such party does not consent to such assumption or assignment.ⁿ²⁶

Section 365(e)(2)(A) does not read easily. For example, although it is clear that section 365(e) deals solely with *ipso*

facto and other bankruptcy termination and modification clauses in executory contracts and unexpired leases, and not with restrictions on assignability, section 365(e)(2)(A)(ii) appears to refer to an assumption or assignment issue that is not dealt with in section 365(e). It may be suggested that as drafted in the Bankruptcy Reform Act of 1978, section 365(c), which does deal with certain types of executory contracts which cannot be assumed or assigned without the consent of the nondebtor party, contains in section 365(c)(i)(B) the same "consent" language as set forth in section 365(e)(2)(A)(ii), and that the consent language in that section is merely an erroneous drafting duplication that adds nothing to the substance of section 365(e)(2)(A).

In any event, it is clear that prior to the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA),ⁿ²⁷ which amended subsection (c) but not subsection (e)(2)(A), both of these subsections were construed to mean that bankruptcy termination and modification provisions and anti-assignment clauses in executory contracts involving personal services, personal relationships, nondelegable duties, fiduciary obligations and the like were enforceable.ⁿ²⁸ Under this interpretation, it can be readily demonstrated that partnership agreements and the partnership relationship give rise to nondelegable fiduciary duties and principal-agent functions in the hands of the general partner (as a fiduciary and agent for the other partners), and that the bankruptcy of the general partner, therefore, afforded the nondebtor partners the option of terminating the partnership agreement under section 365(e)(2)(A) or preventing assumption or assignment of the general partner's interest under section 365(c).ⁿ²⁹

This view of the language of sections 365(c) and 365(e)(2)(A), which was virtually identical prior to the amendment to section 365(c) effected in 1984 under BAFJA, was best exemplified by the opinion in *Skeen v. Harms (In re Harms)*,ⁿ³⁰ which became the leading case in the area.

In *Harms*, the general partner of seven limited partnerships filed a chapter 11 petition and commenced to function as a debtor in possession. The proceedings subsequently were converted from chapter 11 to chapter 7. The limited partners sought a declaration that the partnerships had been dissolved by reason of the filing of the debtor's petition under the Code. The court held that:

- (1) the limited partnership agreements were executory contracts;
- (2) the trustee could not assume the position of the general partner under the limited partnership agreements because he was not the person with whom the limited partners first contracted; and
- (3) the partnerships dissolved when the debtor-general partner assumed the status of a debtor in possession, inasmuch as the debtor in possession, like the trustee, is an entity separate from the debtor and, under section 365(c), cannot assume the partnership agreements without the consent of the limited partners. The court stated:

The Court is convinced that under the circumstances of this case, the debtor-in-possession is not the same entity as the pre-petition general partner of the seven limited partnerships. A general partner is in a fiduciary relationship with the limited partners. It is important that he have no conflict of interest. Moreover, an agreement among partners is unique in the law. It is not only a legal relationship, but is also a personal relation or status, somewhat as marriage is a relation or status. [Citation omitted] Partners may dissolve a partnership at will, even if the contract states otherwise (*Colo. Rev. Stat. § 7-60-131* (1973)). A partner must make full disclosure of all material facts within his knowledge in any way relating to the partnership affairs. [Citation omitted] The Uniform Partnership Act reinforces these rules by providing that partners must render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability (*Colo. Rev. Stat. § 7-60-120*). The duty imposed by the Uniform Partnership Act is owed by all partners, but the standard of rigid fair dealing required of a managing partner vis-a-vis the inactive partners is especially high [citation omitted]. It thus becomes clear that when the only general partner in a limited partnership becomes a debtor-in-possession, there is an inherent conflict of interest which

precludes him from remaining as the general partner. He is a different entity. Under *Section 365(c) of the Bankruptcy Code*, executory partnership agreements cannot be assumed by a debtor-in-possession without the consent of all the limited partners.

In the case now before the Court, the limited partners have not consented to the performance of the debtor-in-possession as their general partner. Therefore, the limited partnerships, having no general partner as of the day the debtor came into possession, ceased to exist (except for purposes of winding up which follows dissolution).ⁿ³¹

It is noteworthy that the "inherent conflict of interest" theory of *Harms* would have been equally applicable whether the court had regarded the debtor in possession as a separate entity or the same entity as the debtor. The conflict of interest perceived by the *Harms* court arose not because the debtor in possession was a different entity or even because a trustee was appointed, but instead existed because the financial condition of the enterprise represented by the estate was such that the original objectives of the partnerships could have been frustrated by the debtor's inability to function adequately--whether on a financial or managerial basis--as the sole general partner of the limited partnerships. Accordingly, the court's focus on section 365(c), dealing with the assumability of personal service and fiduciary relationship contracts, required it to subscribe to the legal fiction that a debtor in possession is an entity separate from the debtor, and that, under section 365(c), the debtor in possession could not assume the debtor's general partnership interests without the consent of the limited partners.ⁿ³² The court could have avoided the infirmities of the "different entity" theory by instead focusing on section 365(e)(2)(A), which, as noted above, involves only the enforceability of bankruptcy termination and modification provisions of state law and of executory contracts. Under section 365(e)(2)(A), the court could have decreed the dissolution of the partnerships by reason of the termination of the partnership agreements rather than by finding the partnership agreements to be nonassignable to a hypothetical third party under section 365(c).

Prior to enactment of BAFJA in 1984, section 365(c)(1) provided:

(c) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if--

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment. ...

After enactment of the 1984 Amendments and an additional amendment enacted in 1986, section 365(c)(1)(A) provides that:

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to, *an entity other than the debtor or the debtor in possession*, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and ...ⁿ³³

According to the brief legislative commentary, the amendment:

... makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal service

nature of the contract.ⁿ³⁴

As noted above, the 1984 Amendments changed section 365(c) but not section 365(e)(2)(A), notwithstanding that the two sections were theretofore virtually identical.ⁿ³⁵

The amendment to section 365(c)(1)(A) may be viewed as an effort to overrule that part of the holding in *Harms* that found the limited partnerships to have terminated by reason of the succession by the debtor in possession to the general partnership interests of the debtor.ⁿ³⁶ Accordingly, under section 365(c) as presently constituted, an executory contract involving personal services or, presumably, fiduciary obligations to be performed by a debtor may be assumed by a debtor in possession but not by a trustee for the debtor.ⁿ³⁷ Indeed, inasmuch as a chapter 7 trustee ultimately was appointed in *Harms*, the result in that case would not have been changed by reason of the amendment to section 365(c)(1)(A).

The amendment to section 365(c), which is referred to by some practitioners as the "*Harms* Amendment," appears to reject that part of the *Harms* opinion and rationale that finds an inherent conflict of interest between the objectives and requirements of the debtor, as a general partner, and the rights and expectations of the nondebtor partners. Perhaps the import of the *Harms* Amendment is that the conflict of interest between a debtor-general partner and the nondebtor partners is not inherent and may develop in some cases but not in others. In the cases in which a conflict of interest is recognized by the court, the debtor in possession could be precluded from assuming the partnership agreement under the provisions of section 365(b), which require a demonstration of adequate assurance of future performance as a condition to the assumption of an executory contract under which a default exists.^{n37a}

The *Harms* Amendment, as did the *Harms* opinion, failed to address the provisions of section 365(e)(2)(A). Therefore, under a literal reading of the Code, the filing of a petition by a general partner of a general or limited partnership will afford to the nondebtor partners the opportunity to enforce a provision of state law or of the partnership agreement permitting the termination or modification of the agreement by reason of such filing. Accordingly, under this approach to section 365(e)(2)(A), the issue of assumption of the partnership agreement by the debtor in possession under section 365(c) will not be considered by a court, inasmuch as the agreement must be terminated and thus cannot be assumed. This apparent inconsistency in the statute has been reconciled in *In re Cardinal Indus., Inc.*,ⁿ³⁸ which is perhaps the most significant opinion rendered in the area of partner bankruptcy since the enactment of the Code.

In *Cardinal*, the corporate debtor and its affiliates had engaged in the business of developing or acquiring hundreds of real estate projects through the formation of a separate limited partnership for each project, in which the debtor or its affiliate was the general partner. After the debtor-general partner filed a petition under chapter 11, a trustee was appointed, pursuant to section 1104(a), in the chapter 11 case.ⁿ³⁹ Under the contractual arrangements entered into at the inception of each partnership, the debtor was entitled to collect management fees for the management of the projects, and in many instances also held second mortgages on the projects securing the repayment of loans and advances to the partnership that owned the project. The court acknowledged that "[b]ecause these values cannot be realized for seven to ten years, it is important to the Debtor's estate that these Partnerships not be sold during this time period and that the Debtor continue to control selection of the operating entity."ⁿ⁴⁰

Limited partners in three of the partnerships moved under section 365(e)(2)(A) to terminate the debtor's management interests in the partnerships pursuant to *ipso facto* bankruptcy termination provisions in the partnership agreements and the RULPA. Among the reasons presented in support of the motion was a history of misapplication of the partnerships' funds to obligations of unrelated partnerships, and the difficulties encountered by the partnerships resulting from a general prepetition cash "sweep" by one of the debtor's banks. The movants argued that:

(1) section 365(e)(2)(A) requires enforcement of partnership agreements and state law bankruptcy termination provisions in any circumstance in which a hypothetical assignment by the debtor in possession or trustee of the general partner's management and control rights requires the consent of the

nondebtor partners; and

(2) in the instant case, the prohibited assignment was not in any event hypothetical inasmuch as a different entity--the chapter 11 trustee--had succeeded to the debtor's management and control rights without the consent of the nondebtor partners.

The court denied the motion and refused under the supremacy clause of the Constitution to enforce the partnership agreement termination provisions and the termination provisions of the applicable RULPA. The court assumed expressly that: (1) the partnerships had not been dissolved by reason of the filing of the debtor's chapter 11 petition;ⁿ⁴¹ and (2) the limited partnership agreements were executory contracts.ⁿ⁴² The holdings of the court were that:

(1) section 365(c)(1) applies only to executory contracts that are the subject of an actual proposed assignment rather than a hypothetical assignment;ⁿ⁴³

(2) under the facts before it, the language of section 365(c)(1) referring to an entity other than the debtor or debtor in possession did not refer to a chapter 11 trustee but only to a chapter 7 trustee, and, therefore, the partnership interest of the debtor-general partner remained in the hands of the estate;ⁿ⁴⁴

(3) by reason of the holding described in clause (2), no actual transfer of the debtor's partnership interest occurred within the meaning of section 365(c)(1);ⁿ⁴⁵ and

(4) section 365(e)(2)(A) "... is meant to reflect the same philosophy ..." as section 365(c)(1),ⁿ⁴⁶ and, therefore, section 365(e)(2)(A) does not preserve the enforceability of the partnership agreements' *ipso facto* bankruptcy termination provisions or the bankruptcy termination provisions of the RULPA when the debtor-general partnership is acting as a debtor in possession or is succeeded by a trustee.

The court further noted that, even if the debtor's economic interests in the partnerships were to be preserved by conversion of the debtor's general partnership interest into a financially equivalent limited partnership interest in accordance with the express provisions of the partnership agreements, the loss of management fees and of the right to control the disposition of the partnerships' properties to maximize any recoveries on second mortgages on such properties held by the debtor, would create an economic harm detrimental to the estate.ⁿ⁴⁷

The *Cardinal* decision warrants at least three observations:

First, if the court had decided in favor of the movants, the entire chapter 11 case would have been placed in jeopardy because the debtor's principal business was the management of approximately 900 real estate partnerships resembling the partnerships then before the court, and all such management rights could have been terminated had the appropriate limited partners elected to do so;

Second, the court reconciled the language discrepancies between section 365(c)(1) and section 365(e)(2)(A) by determining that section 365(e)(2)(A) is to be construed as though it were identical to section 365(c)(1); and

Third, under the *Cardinal* holdings, the determination of whether sections 365(c)(1) and 365(e)(2)(A) apply to certain types of contracts will take into account not only the characteristics of the contract (such as personal service or fiduciary relationship agreements), but also the type of assignment transaction involved (*i.e.*, "assignments" to a debtor in possession, chapter 11 trustee, chapter 7 trustee or third party). Thus, under *Cardinal*, transfers of the rights and interests of a debtor-general partner to a debtor in possession or to a chapter 11 trustee will not be affected by bankruptcy termination, dissolution or anti-assignment provisions of state partnership law or of partnership agreements, but transfers of such rights and interests to a chapter 7 trustee and to a third party remain subject to such termination,

dissolution and anti-assignment provisions.ⁿ⁴⁸

Cardinal also demonstrates that sufficient room exists in the Bankruptcy Code for a court to decide the partner bankruptcy issue on a reasoned and flexible basis. Many different types of partnerships and many different types of general partners exist. In certain circumstances, the identity of a general partner will be critical to the limited partners and to the prospects for a successful investment. Examples of such circumstances include: (1) a real estate development partnership in which the general partner must administer the planning, construction and leasing of a building; (2) an investment partnership in which the general partner is to identify and evaluate investments of the partnership; and (3) any partnership in which the general partner is required to contribute additional capital to the partnership and, indeed, may have control over the issuance of capital calls to all partners. Similarly, the identity of each general partner is significant in a general partnership comprised of professional persons, such as lawyers or accountants.

On the other hand, partnerships exist in which the identity of a general partner is less significant. These may include (1) real estate partnerships owning matured projects that require only routine management and leasing functions and (2) certain large syndication operations that administer a network of separate partnerships. In these cases, it is arguable that another organization with sufficient resources could take over the work of the original general partner without material detriment to the limited partner investors.

In circumstances in which the identity of a general partner is critical to the success of the partnership's investment or business, it may be argued that the nondebtor partners, and not the court, should determine whether the bankrupt general partner remains able to manage the affairs of the partnership. This would mean, in Code terminology, that section 365(e)(2)(A) would be read to permit the nondebtor partners to terminate a partnership agreement under an *ipso facto* provision or state law unless they consented to the continuation of the partnership relationship with the debtor. Moreover, although section 365(c) no longer renders enforceable *ipso facto* provisions in partnership agreements if the assuming party is a debtor in possession, an issue may still arise as to whether a general partner, whose attention, skill, personnel resources and financial resources are critical to the partnership, can provide adequate assurance of future performance as a condition to assumption of the partnership agreement.^{n48a}

In circumstances in which the identity of the general partner is not critical to the partnership, and the trustee desires to assume, or perhaps assume and assign the agreement, the nondebtor partners have a less compelling argument concerning the continuation of the debtor-general partner or the selection of a new general partner. In such instances, the nondebtor partners should not be adversely affected by an assumption or assignment transaction, whereas the debtor and its estate may realize substantial benefits therefrom.

The foregoing formulation was adopted by the United States District Court for the District of Maryland in *Gould v. Antonelli*.^{n48b} *Antonelli* was decided in the context of the largest chapter 11 case then filed in the District of Maryland and involved a major real estate developer, Antonelli, who was a general partner in various limited partnerships related to real estate. After Antonelli suffered significant losses, a chapter 7 case was filed against him, which was subsequently converted to a chapter 11 case. The bankruptcy court, affirmed by the district court albeit on different grounds, confirmed a plan of reorganization which provided that the economic benefits from Antonelli's general partnership interests would be transferred to a liquidating trust.^{n48c} Under the plan, Antonelli would remain a nominal general partner in the various partnerships and would exercise the rights and duties of a managing general partner under the direction and as a member of a plan committee. The other members of the plan committee were to be appointed by the court. Antonelli, although required to cast his vote on partnership matters as directed by the committee, was permitted to file a motion with the bankruptcy court seeking a determination as to how to vote if he believed that a proposed directive of the committee would violate his fiduciary obligations or exceed his authority as a general partner. The committee was to indemnify Antonelli for any liability for actions taken at its direction.

Two partners of one of the limited partnerships appealed to the district court the entry of the confirmation order, asserting that (a) *section 365(c) of the Code* prohibited the assignment to the liquidating trust of Antonelli's economic

rights as a general partner inasmuch as "applicable law" excused the nondebtor party from accepting performance from an entity other than the debtor, (b) the assignment of Antonelli's management rights to the plan committee without the consent of the nondebtor partners was contrary to the laws of Maryland and the District of Columbia, which were the relevant "applicable law" for purposes of section 365(c), and (c) the plan provided for an impermissible *de facto* assignment of Antonelli's management rights to the plan committee.

The bankruptcy court had rejected these arguments on the basis that the applicable plan provisions did not violate the partnership laws of Maryland and the District of Columbia.^{n48d} The district court, however, assumed that the plan provisions did constitute a prohibited transfer of management authority under the applicable partnership laws, but nevertheless found that section 365(c) did not operate to bar confirmation of the plan.^{n48e} The court held that the question whether the management powers of a general partner are assignable in bankruptcy turned not upon the treatment that "applicable law" generally accords to the partnership relationship but rather upon the importance to the partnership and its business of the identity of the general partner.^{n48f}

Citing the analysis set forth above in this P 4.07[2], the district court noted that the real estate partnerships at issue involved "matured" projects consisting of completed office buildings managed by a separate property management firm, thereby rendering Antonelli and the other partners more passive investors than active managers.^{n48g} The court also noted that Antonelli's continuing advice on such matters as building maintenance, renovation and tenant occupancy remained available to the nondebtor partners. Thus, the district court found both that (1) the partnerships owned assets that could be managed by any experienced real estate operator and, therefore, did not involve a special relationship among the partners for the purposes of section 365(e)(2)(A) and section 365(c), and (2) in any event, Antonelli would remain available to lend his special expertise to certain issues affecting the projects.

The Fourth Circuit Court of Appeals, in affirming the decision of the district court, refused to adopt the rationale of either the bankruptcy court or the district court, but accepted the district court's holding that the plan's requirement that Antonelli accept direction from the plan committee did not introduce "impermissible external factors" into the exercise of his judgment as a general partner. The Fourth Circuit further noted that the nondebtor partners were not entitled to prohibit Antonelli from consulting with and accepting direction from the committee.^{n48h}

The functional test employed by the district court in *Antonelli* appears to have been adopted by the Court of Appeals for the First Circuit in *Summit Investment & Development Corp. v. Leroux*.ⁿ⁴⁸ⁱ *Summit* involved a Massachusetts limited partnership in which three general partners had the authority to manage the business of the partnership by majority vote. One of the general partners was designated the managing general partner, with the authority to conduct the day-to-day affairs of the partnership. The partnership agreement provided that in the event of the bankruptcy of the managing general partner, the partner's interest would be converted to that of a limited partner with no voice in management unless otherwise agreed by all partners.

After the managing general partner and another general partner filed petitions under chapter 11 of the Code, the third general partner sought a judicial declaration that the debtors' respective general partnership interests had been terminated pursuant to (a) the partnership agreement, and (b) the Massachusetts limited partnership law (which provides that the filing of a petition for reorganization by a general partner of a limited partnership terminates its general partnership interest unless otherwise provided in the partnership agreement).

The court held that the general partnership interests had not been terminated by reason of the filing of the respective chapter 11 petitions by the general partners, inasmuch as section 365(e)(1) of the Code proscribed enforcement of the contractual *ipso facto* provisions and of the corresponding provisions of the Massachusetts limited partnership statute.^{n48j} The court also held that section 365(e)(2)(A) of the Code did not mandate the termination of the general partnership interests under the facts of the case.^{n48k} The nondebtor partner had asserted that section 365(e)(2)(A) contemplates a strict "hypothetical" test under which a contract that cannot be assumed, or assumed and assigned to a third party, must be terminated at the request of the nondebtor party to such contract even though no actual assumption

or assignment transaction has been proposed.^{n48l} The nondebtor party argued that the anti-assignment provision of the Massachusetts limited partnership act constituted the "applicable law" under section 365(e)(2)(A) that excuses a nondebtor party from accepting performance from a trustee or from an assignee of a contract. Although the court acknowledged that the "hypothetical" approach to section 365(e)(2)(A) is "not precluded" by the language of that section and of section 365(c), it held that the Code contemplated a case-by-case inquiry into the actual consequences to the nondebtor party of permitting postpetition performance by the "debtor party."^{n48m} The court cited to the 1978 legislative history of the Code, dealing with assumption of executory contracts, to demonstrate that Congress required the courts to be sensitive to the rights of nondebtor parties in the context of contractual assumptions.ⁿ⁴⁸ⁿ The court further cited to the legislative history of the 1984 *Harms* Amendment^{n48o} to demonstrate that Congress intended to permit the assumption of a personal service contract by a debtor in possession. The court did note that the *Harms* Amendment dealt only with section 365(c) and not section 365(e)(2)(A), but stated that section 365(e)(2)(A) should be construed as if also amended in order to avoid the "absurd result" that a contract could be terminated under section 365(e) although assumable under section 365(c)(1).^{n48p} The court also asserted that the assumption of an executory contract by a debtor in possession did not constitute an actual assignment of the contract from one person or entity--the debtor--to another--the debtor in possession--because the Supreme Court in *Bildisco* ^{n48q} had dispensed with the fiction that the prepetition debtor and the debtor in possession are separate legal entities.^{n48r} Finally, the court rejected the *Harms* ^{n48s} contention that there is an inherent conflict of interest between a debtor general partner and the nondebtor partners, and held that an actual conflict or other inability on the part of the debtor in possession to exercise the necessary skill and expertise for the benefit of the partnership must be shown before a motion to assume would be denied.^{n48t}

If it is ultimately determined that section 365(e)(2)(A) permits enforcement of partnership dissolution or termination provisions triggered by the bankruptcy of a general partner, the courts will have to address further the enforceability of partnership agreement provisions purporting to govern the amounts distributable to the debtor-general partner upon the winding-up or reconstitution of the partnership.

If nondebtor partners elect to dissolve or not to reconstitute a partnership, the partnership's affairs will be brought to a conclusion, its assets liquidated, and the remaining profits and surplus, if any, will be distributed to the partners. If, however, the nondebtor partners elect not to dissolve the partnership (under RULPA), or to otherwise reconstitute the partnership without the bankrupt general partner, will the trustee of the bankrupt general partner be entitled to a distribution from the partnership? If the partnership agreement provides for a nominal distribution in these circumstances, will the provision be enforceable in the partner's Bankruptcy Code case? If the distribution provision establishes a greater than nominal payment, but in an amount less than the fair value of the debtor-partner's interest in the ongoing enterprise, will this provision be sustainable under the Bankruptcy Code?

The principal issue raised in the preceding paragraph, restated in Bankruptcy Code terminology, is whether the property interests of a general partner's estate in the surplus and profits of a partnership may be forfeited or substantially impaired by operation of section 365(e)(2)(A). In other words, may the enforcement of the bankruptcy termination clause in a partnership agreement or of the bankruptcy provisions of state partnership law result in economic loss to the estate of a general partner?

It is clear that the policy of the Bankruptcy Code is to avoid forfeitures of property of a debtor's estate.ⁿ⁴⁹ Although little authority exists on the point, it appears more likely than not that a bankruptcy court will not permit the loss of a debtor's interest in the profits and surplus of a partnership. Under section 541(a), a debtor's interests in partnership profits and surplus constitute property of the estate, and under section 541(c) such property is not to be forfeited by reason of the debtor's filing.ⁿ⁵⁰ Accordingly, if a partnership agreement or applicable law provides for the forced withdrawal of a debtor partner, the court in enforcing such provisions should nevertheless carefully scrutinize the fairness of the buy-out price to be paid to the estate. If the buy-out provisions are based upon a fair market valuation of the debtor's partnership interest, some prospect exists for enforceability under the Code. It should be particularly helpful in this regard if the buy-out provisions for an "involuntary withdrawal" for bankruptcy are the same as the provisions for

voluntary withdrawal (or the buy-sell provisions relating to the voluntary disposition of a partnership interest).ⁿ⁵¹

It has been suggested earlier that a partnership agreement may be viewed as creating in each partner:

(1) a property interest in the profits and surplus of the partnership, with the property interests surviving any termination of the agreement upon the partner's bankruptcy; and

(2) an executory contract with respect to the governance of the partnership property.

If courts that have determined to enforce bankruptcy termination provisions in partnership agreements were to adopt this view, they would apply section 365 to the executory contract elements of the agreement, but would not affect the original grant to the debtor of its economic interest in the partnership nor the trustee's continuing economic rights in the partnership and its property.ⁿ⁵² The continuation of the trustee's economic interest in the partnership would render inapplicable any involuntary buy-out provisions and obviate the need for a determination as to whether a particular buy-out price is fair.

This approach to termination and, indeed, rejection of partnership agreements by a general partner's trustee, is analogous to the pattern evidenced in sections 365(h) and 365(n). As noted above, under section 365(h), a debtor-landlord may reject an unexpired lease of real property; if the tenant elects to remain in possession of the premises, the debtor-landlord is relieved from performance of its affirmative obligations under the lease, but must recognize the leasehold estate of the tenant for the balance of the stated term and any stated renewal or extension thereof. Under section 365(n), a debtor-licensor may reject an unexpired license of intellectual property, but the licensee may elect to retain substantially all of the benefits of the license. These sections reflect the recognition that in the case of a lease or contract involving interconnected property rights and contractual rights, a party may be compelled to lose its right to specific performance of the contractual obligations of the other party, but is also entitled to preserve its investment and economic rights created by the agreement. Ample precedent exists further for the suggested approach in partnership law and in many partnership agreements. Section 27 of the UPA deals with the rights of an assignee of a partnership interest (as distinguished from a substitute partner) in a manner suggesting similar treatment for a partner's Bankruptcy Code trustee. Section 27 provides:

(1) A conveyance by a partner of his or her interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with the contract the profits to which the assigning partner would otherwise be entitled.

(2) In the case of a dissolution of the partnership, the assignee is entitled to receive the assignor's interest and may require an account from the date only of the last account agreed to by all the partners.ⁿ⁵³

Section 27 provides a substantive underpinning for the definition of the rights and disabilities of the trustee of a general partner. The trustee may be viewed as an assignee of the debtor's partnership interest, with the assignment having been effected under *section 541(a) and (c) of the Code* without the consent of the other partners. No issue would arise as to assumption or rejection of the trustee's interests under Section 27, inasmuch as these interests would be characterized as property in the hands of the estate (under section 541(a) and (c)) rather than as executory rights and obligations.ⁿ⁵⁴ The trustee could indeed further convey this property interest to another assignee (under section 363(b)) and receive as consideration for the assignment cash that may be available for distribution to creditors. Nevertheless, under all circumstances, the trustee and any such assignee would have no voice in the management of partnership affairs. A similar precedent may be found in many small business partnership agreements, in which each general partner provides upon death for a continuing interest of the surviving spouse in the partnership's business, but with the spouse's

partnership interest deemed to be that of a limited rather than a general partner. Indeed, in the case of a limited partnership, a similar approach would be to provide for the conversion of the debtor general partner's interest into that of a limited partner in a separate class of limited partners that would preserve the original economic rights of the debtor.ⁿ⁵⁵

The movants in *Cardinal* proposed that the debtor's economic interests in the subject partnerships be protected by converting the same from a general to a limited partnership interest with financial attributes identical to the preexisting arrangements.ⁿ⁵⁶ The court rejected this proposal on the grounds that in the circumstances of that case the debtor's rights to control over management and asset dispositions were intrinsically valuable to the estate. Although not made completely clear in the court's opinion, the value of the control rights appears to have resided in the management fees payable by the partnerships to the debtor's management company affiliate, and in the debtor's ability to defer disposition of the partnerships' assets until the second mortgages held by the debtor might begin to have value.ⁿ⁵⁷

However, when a debtor-general partner's economic interests in a partnership arise solely from its allocable share of partnership distributions, it may be argued that the control rights of the general partner have no inherent economic value and conversion thereof to limited partner status will not result in a forfeiture of any property of the estate.

If the assignment or limited partner conversion concept is a correct accommodation of the competing interests arising upon the filing of a general partner's bankruptcy petition, then appropriate provisions in both general and limited partnership agreements should be included:

- (1) to provide for the creation of assignee or limited partner status, as appropriate, in the event of a general partner's bankruptcy;

- (2) to ensure continuity of management; and

- (3) in the case of limited partnerships, to provide for a new general partner in the case of the bankruptcy of a sole general partner. The RULPA in Section 801(3) sets forth a mechanism for continuity that permits the remaining partners to avoid dissolution by appointing a new general partner. Under the ULPA, which does not provide such a mechanism, it may be acceptable to include in the partnership agreement an arrangement similar to that set forth in RULPA Section 801(3). In addition, partnership agreements governed by either statute could provide for:

- (1) two general partners at the outset of the agreement, with one general partner to maintain or assume managerial responsibilities upon the bankruptcy of the other; or

- (2) a designated standby who would become the new general partner upon the bankruptcy of the sole general partner.

If a partnership agreement contemplates the substitution of a new general partner for a debtor general partner, provision should be made to convey to the new general partner at least a small partnership interest in the business and assets of the enterprise. This interest must either come from the remaining nondebtor partners or from the debtor partner. If the partnership interest is to be purchased from the debtor general partner, the purchase price should be keyed to fair market value.ⁿ⁵⁸ Nevertheless, it is suggested that this fractional interest be transferred by the remaining partners rather than by the debtor partner:

- (1) to avoid issues discussed above regarding forfeiture of the trustee's economic interest in the partnership or the fairness of a buy-out arrangement; and

- (2) to eliminate the possibility of rejection by the trustee of the debtor partner's obligation to convey the fractional interest to the new general partner.

The partnership interest transferred to the new general partner need not be substantial in the absence of a new investment by the new partner. The partnership agreement should also provide for indemnification of the new partner against preexisting partnership liabilities notwithstanding provisions such as Section 17 of the UPA which limit the new partner's liability for preexisting obligations to the partner's interest in partnership property. The following is a suggested provision for a limited partnership agreement which seeks to convert a general partnership interest into a limited partnership interest upon the bankruptcy or other act of withdrawal of the general partner:

(1) The partnership shall be dissolved upon the death, withdrawal, liquidation, dissolution or entry of an order for relief in a proceeding under the Bankruptcy Code (*11 U.S.C. §§ 101 et seq.*) of a general partner or the occurrence of any other event causing the dissolution of a limited partnership under the laws of the State of (any of the foregoing are hereinafter referred to as a "Dissolution Event"); provided, however, that upon the occurrence of a Dissolution Event with respect to a general partner, then, if the remaining general partners, or if no general partners remain, all remaining partners, elect to continue the partnership and the partnership business:

(a) the partnership shall not be dissolved;

(b) the partnership and the business of the partnership shall be continued, under and pursuant to the provisions of this Agreement;

(c) the general partnership interest owned by the general partner with respect to which a Dissolution Event has occurred shall be deemed to be a Class A limited partnership interest, and such general partner (or the trustee in bankruptcy, successors or assigns, or other personal or legal representatives) shall thereafter be deemed to be a Class A limited partner; and

(d) the Certificate shall be amended to reflect such continuation.

If there is no continuing general partner and the Class B limited partners elect to continue the partnership and the partnership business, the Class B limited partners, within sixty (60) days of any such event, shall select a person, firm or corporation to become the succeeding general partner, who shall become the general partner upon the execution of this Agreement and the purchase of at least a one (1%) percent general partnership interest in accordance with subparagraph (2) below.

(2) If under subparagraph (1) above the Class B limited partners shall have selected a person, firm or corporation to become the general partner, then such proposed general partner shall purchase from each Class B limited partner, and each Class B limited partner shall sell to such proposed general partner, the amount of such limited partner's partnership interest as shall equal one (1%) percent of all partnership interests multiplied by a fraction, the numerator of which shall be the percentage of all Class B limited partnership interests held by such limited partner and the denominator of which shall be 100. Payment shall be in cash in an amount agreed upon by all Class B limited partners and the proposed general partner of partnership interests of the Class B limited partners, the proposed general partner shall become the general partner and all the powers vested in the general partner(s) pursuant to this Agreement shall vest in such succeeding general partner, and all limited partnership interests so purchased shall constitute a general partnership interest.

(3) The partnership interest of any such former general partners shall continue as if it were a Class A limited partnership interest to the extent of the capital account of such former general partner at the time of continuation of the partnership hereunder, except that such limited partnership interest shall be entitled only to such allocations and distributions to which it would have been entitled had it remained a general partnership interest.

Inasmuch as the suggested provision may be characterized as a bankruptcy default or termination clause, and in certain circumstances may be deemed to affect the economic rights of a debtor-general partner, there can be no assurance that a bankruptcy court will find such a provision to be enforceable. However, the suggested provision may be regarded as a useful guideline for the crafting of an appropriate remedy, and, indeed in certain circumstances should, for the reasons stated above, be found to be enforceable.

[3] The Effect on a Limited Liability Company of the Bankruptcy of a Managing Member

The creditors' rights issues relating to the bankruptcy of a general partner of a partnership^{n58a} also arise in the context of the bankruptcy of a managing member of a limited liability company ("LLC").^{n58b} The LLC is a relatively new form of entity that provides to its members limited liability protections similar to those of corporate shareholders, as well as the benefits of "pass-through" tax treatment available to partnerships.^{n58c}

The constituent documents of the LLC generally are the articles of association and the operating agreement.^{n58d} The articles of association is a statutorily prescribed document setting forth certain fundamental information relating to the LLC and is generally filed with the office of the secretary of state or similar governmental official in the appropriate jurisdiction.ⁿ⁵⁹ The operating agreement is a detailed contract governing the relationship among the members of the LLC and often resembles a limited partnership agreement. In some jurisdictions, this governing contract is referred to as the "limited liability agreement."^{n59a} The articles and operating agreement of an LLC will provide for "membership interests" held by its members and may also designate one or more persons or entities as managing members.ⁿ⁶⁰ Inasmuch as membership interests in an LLC closely resemble partnership interests in a partnership, and the position of a managing member closely resembles that of a managing general partner, it appears that the issues arising from the filing of a petition commencing a case under the Bankruptcy Code by or against a managing member of an LLC likewise closely resemble those arising from the filing of a petition by or against a general partner of a partnership.

The limited liability laws of the various states deal with the bankruptcy of a member of an LLC in a manner similar to the treatment in the Revised Uniform Limited Partnership Act.ⁿ⁶¹ For example, under *section 701(d) of the New York Limited Liability Company Law*, an LLC is dissolved and its affairs shall be wound up upon the bankruptcy of any member, or of only the members, or classes or groups of members, specified in the operating agreement, unless within 180 days after such event the LLC is continued by the vote or written consent of the percentage in interest of the members or classes or groups of members specified in the operating agreement. If no voting percentage is specified in the operating agreement, the vote or consent is to be of the majority in interest of all remaining members. The operating agreement may also simply provide for a right of continuation of the LLC notwithstanding the bankruptcy of a member. The New York statute defines "bankruptcy" as "... bankruptcy under the United States Bankruptcy Code, as amended, or insolvency under any state insolvency act."ⁿ⁶²

Under California law, unless otherwise specified in the operating agreement, an LLC is to be dissolved and its affairs wound up upon the bankruptcy or dissolution of any member who is a manager (in the case of an LLC managed by one or more managers who are members), or of any member (in the case of an LLC managed by its members or by one or more managers who are not members), unless, in either case, the business of the LLC is continued by a vote of a majority in interest of the remaining members within 90 days of the occurrence of the event.ⁿ⁶³ The California Code defines "bankrupt" and "bankruptcy," with respect to any person, as being the subject of an order for relief under title 11 of the United States Code, or any successor statute or other statute in any foreign jurisdiction having like import or effect.ⁿ⁶⁴

The Delaware law provides that unless otherwise provided in the operating agreement or by the written consent of all members, a member ceases to be a member of an LLC when it is the subject of a voluntary or undismissed involuntary Bankruptcy Code case or similar state law proceeding.ⁿ⁶⁵ The occurrence of any such event is defined as a "bankruptcy."ⁿ⁶⁶ The Delaware law further provides that unless otherwise provided in the operating agreement, the

bankruptcy or dissolution of a member will not result in the dissolution of the LLC unless, within 90 days of the occurrence of the event, the members of the LLC, or, in the case of classes or groups of members, each such class or group, by vote of members owning more than fifty percent of the then-current percentage or other interest in the profits of the LLC, or within such class or group, as the case may be, agree in writing to dissolve the LLC.ⁿ⁶⁷

In re Garrison-Ashburn L.C. interpreted the provisions of the Virginia limited liability act that provides for the dissociation of a member from a limited liability company upon the occurrence of that member filing a petition in bankruptcy.ⁿ⁶⁸ *In re Allentown Ambassadors, Inc.* interpreted the provisions of the North Carolina limited liability act in a like situation.^{n68a}

Each of the state laws described above contemplates the possibility that an LLC may be dissolved as a consequence of a Bankruptcy Code filing by or against certain of its members. Under the New York and California statutes, the dissolution will occur unless otherwise provided in the operating agreement or unless the remaining members act in accordance with applicable law to forestall the dissolution. Under the Delaware statute, unless otherwise provided in the operating agreement, the nondebtor members must act affirmatively to cause a dissolution upon the bankruptcy of a member. In each instance, applicable state law provides for bankruptcy termination clauses in operating agreements that implicate the provisions of *sections 541(c), 365(e)(1), 365(e)(2)(A) and 365(c) of the Bankruptcy Code*.ⁿ⁶⁹

In re Daugherty Construction ⁿ⁷⁰ involved a member in several limited liability companies that had been formed to develop apartment complexes in Nebraska. The debtor-member had agreed to provide general contracting services for the construction of the apartment buildings as its capital contribution to the respective limited liability companies. The articles of organization and operating agreements incorporated a section of the Nebraska Limited Liability Companies Act providing that the bankruptcy of a member would constitute an event of dissolution unless two-thirds of the remaining members elected otherwise.ⁿ⁷¹ The nondebtor member of certain of the limited liability companies elected to treat the chapter 11 filing of the debtor as an event of dissolution, to reconstitute the companies, and to terminate the debtor-member as the general contractor for the projects. Another nondebtor member of another LLC elected dissolution and reconstitution and also added a new member to the LLC to comply with the two-member minimum requirement of the Nebraska statute.ⁿ⁷² The debtor brought an adversary proceeding seeking a determination that the actions taken by the nondebtor members violated the automatic stay and *sections 541(c), 363(l) and 365(e) of the Code*.

The court held that the provisions of the Nebraska Limited Liability Companies Act authorizing the dissolution of an LLC upon the filing of a chapter 11 petition by a member conflicted with *sections 541(c), 363(l) and 365(e) of the Code*.ⁿ⁷³ The court found that the debtor and debtor in possession were the same entity for the purposes of an executory contract assumption under the Code and rejected the contention that the debtor's interest in the LLC constituted a personal services obligation that could not be assigned to the debtor in possession. The court commented on the "personal services" nature of the relationship among LLC members as follows:

The fact that a partnership agreement or LLC agreement constitutes an intensely personal contract is relevant to the question of whether the interest of the debtor in possession can be assigned to a third party under section 365(c), but is irrelevant to the question of whether the interest of the debtor in the partnership or the LLC can be "transferred" to the debtor in possession upon commencement of a bankruptcy case under section 541. Section 365(c) should not be construed to limit the ability of the debtor in possession to succeed to the interest of the debtor and it certainly does not provide a rationale for concluding that because the LLC or partnership interest of the debtor cannot be transferred to a third party, the partnership or LLC dissolves.ⁿ⁷⁴

The court in *Broyhill v. DeLuca (In re DeLuca)* ⁿ⁷⁵ also accepted the partnership agreement analogy in analyzing the effect on an LLC of the chapter 11 filing of its members engaged in active management. This case involved a Virginia LLC that had been formed to develop a shopping center and office project. The operating agreement contained a provision similar to that in *Daugherty*, under which the bankruptcy of a member would effect a dissolution of the LLC

unless the remaining members subsequently elected to continue its business and to elect a new manager (if the debtor-member had been the sole manager). Prior to the filing of the chapter 11 petition, in light of certain questionable practices on the part of the managing members, the other members voted to remove the offending members as managers and to install a new managing member. Following the filing of the chapter 11 petitions by the former managing members, the remaining members, acting under the terms of the operating agreement, elected to continue the business of the LLC and confirmed the election of the new managing member. Thus, the court was presented with the question whether the dissolution and reconstitution provision of the operating agreement constituted an unenforceable *ipso facto* clause under the Bankruptcy Code.

The court, in employing the precedents established in partnership cases,ⁿ⁷⁶ noted the district court's holding in *Breeden v. Catron (In re Catron)*,ⁿ⁷⁷ to the effect that a chapter 11 debtor in possession is a different entity from the debtor and that partnership agreements are necessarily personal service contracts terminable under section 365(e)(2)(A) of the Code.ⁿ⁷⁸ However, the court also noted that *Catron* had been criticized by other courts, and appeared to adopt the approach employed in *Gould v. Antonelli* ⁿ⁷⁹ by determining whether the identity, skill and expertise of the debtor-members were essential to the conduct of the business of the LLC. Under the *Antonelli* formulation, a nondebtor member or partner cannot be compelled to accept the assumption of an operating or partnership agreement by a debtor member or partner if such person is essential to the continuing conduct of the entity's business and can no longer function as an acceptable and viable manager.ⁿ⁸⁰

The court determined that the projects undertaken by the LLC were prototypical development projects with impending operational and financial decisions in which the debtor-members could not be permitted to participate, in view of their financial condition and questionable past conduct.ⁿ⁸¹ The court concluded that the debtor-members had been properly dismissed from their management positions prior to the filing of their chapter 11 petitions, and that the dissolution and reconstitution provisions of the operating agreement would be enforced in a manner that would disenfranchise the debtors with respect to decisions that could not be made unilaterally by the new managing member. Finally, the court observed that its actions did not deprive the debtors' estates of their interest in the profits, losses and distributions of the LLC.ⁿ⁸²

In *In re Allentown Ambassadors, Inc.*, ^{n82a} the court had to construe the nature of a debtor-member's interest in a minor league baseball league, organized as a limited liability company, in a situation where the other members dissolved the LLC following the debtor's bankruptcy and subsequently formed a new league without the debtor. The debtor later brought an adversary proceeding asserting that such acts violated the automatic stay in that the dissolution of the old league and reconstitution of the new league was an act to exercise possession or control over the debtor's preexisting rights in the old league. The key legal issue before the court was whether subsections 365(c)(1) and (e)(2) rendered the debtor's interest in the LLC incapable of being assumed or assigned. The court first concluded that the North Carolina Limited Liability Company Act itself did not unequivocally prohibit an assignment of the member's interest, noting that the provisions of the Act that restrict assignment were subject to exceptions to the extent set forth in the limited liability company agreement itself.^{n82b} Once that conclusion was reached, the court, citing *DeLuca*, next found that it needed to analyze whether the identity of the assignee would be material to the non-debtor partners, taking into consideration the nature of enterprise in which the debtor and the non-debtors were engaged. The court concluded that it could not decide that question on the record before it because there was some evidence that in the past membership interests have been assigned with some regularity and, given that day to management of the league, as opposed to each team itself, was placed in the hands of a specific individual, it could be said that financial strength and general experience in the "business of baseball" were the key requirements of membership rather than any personal trust or confidence in the identity of the members themselves.^{n82c}

The cases discussed above indicate that the courts will generally refer to partnership casesⁿ⁸³ to resolve the issue of whether the filing of a petition commencing a case under the Bankruptcy Code by or against a member of an LLC will necessarily affect the rights and interests of the debtor-member in the LLC. Operating agreements will generally be treated in the same manner as partnership agreements, and the language and import of sections 541(c), 365(e)(1),

365(e)(2)(A) and 365(c) will remain the focus of the effort to balance the competing interests of the debtors and nondebtor parties in this area.ⁿ⁸⁴

However, in *In re Garrison-Ashburn L.C.* the court held that a limited liability company operating agreement was not an executory contract, and, therefore, the dissociation of the member from the management rights in the limited liability company, pursuant to the relevant state statute, did not run afoul of *section 541(c), 365(c) or 365(e) of the Bankruptcy Code*.ⁿ⁸⁵ In *Garrison-Ashburn*, Chapman, a chapter 11 debtor and member of the LLC (Garrison-Ashburn, L.C.) sought to block the LLC from selling a parcel of real property without his consent. The debtor referred to a provision in the operating agreement that required the consent of both the operating manager and the assistant operating manager in order to execute deeds. However, the court determined that even if Chapman was in fact the assistant operating manager of the entity prior to his chapter 11 filing, pursuant to the Virginia Limited Liability Company Act, as recently amended by the Virginia legislature, such bankruptcy event resulted in his dissociation from the LLC.ⁿ⁸⁶ The statute had been amended to delete automatic events of dissolution such as the death, resignation, retirement or bankruptcy of a member, and to provide that those events would merely result in the members dissociation.ⁿ⁸⁷ Pursuant to the revised statute, a dissociated member was vested only with the rights of an assignee of a membership interest, and those rights were limited to the rights to receive any share of profits, losses and distributions of the former member. Specifically, the statute provided that the deemed assignment arising from the dissociation divested the member of any right to participate in the management and affairs of the limited liability company or to become or to exercise any rights of a member.ⁿ⁸⁸ As a result of this statutory framework, the court concluded that Chapman's rights with respect to the limited liability company were analogous to that of a shareholder to a corporation, *i.e.* economic rights only, and he had no right to exercise any management rights or otherwise interfere with the company's decision to sell the parcel.

Although not disagreeing with the Bankruptcy Court's analysis of the Virginia Limited Liability Company Act, Chapman argued that the dissociation was ineffective under *sections 541(c), 365(c) and 365(e) of the Bankruptcy Code*. With respect to the 541(c) argument, the Bankruptcy Court read the statute literally and determined that nothing in the Virginia statute had the effect of restricting the transfer of the membership interest, with all of its rights and burdens, to Chapman's estate.ⁿ⁸⁹ With respect to the argument that the dissociation provisions of the Virginia statute were in the nature of an *ipso facto* contract provision that was unenforceable under sections 365(c) and 365(e), the court cited the Countryman definition of an executory contractⁿ⁹⁰ and determined that the operating agreement was not executory with respect to its members because the agreement merely provided the structure for the management of the company and imposed no additional duties or responsibilities on its members. Therefore, sections 365(c) and 365(e) were inapplicable, and the dissociation was simply a function of Virginia law rather than any provision in an executory contract.ⁿ⁹¹

The court went out of its way to state that it did not believe that its holding was contrary to the policy of the Bankruptcy Code to preserve valuable property rights notwithstanding the occurrence of a bankruptcy event:

This result does not offend the Congressional intention behind sections 541(c) and 365(c) and (e). These provisions were intended to expand the bankruptcy estate to the maximum feasible extent and to prevent the loss of valuable assets by the operation of ipso facto clauses that terminate valuable leases and other rights upon bankruptcy. Here the estate received the entire interest of the debtor in Garrison-Woods including its burdens and restrictions. The economic interest, that is the membership interest, remains in the estate and is available for the benefit of creditors. The enforcement of Chapman's statutory dissociation does not cause a forfeiture of those rights or impair the legal capacity of the Company to continue in business.ⁿ⁹²

Although the *Garrison-Ashburn* court obviously strained to reach its result notwithstanding the fact that the bankruptcy-triggered dissociation arguably terminated the valuable right to participate in the management of the company (or, as it might be characterized, the right to veto significant transactions), the case appears to signal that in balancing the competing interests of debtors and nondebtors in the limited liability company arena, courts will view

contractual or statutory provisions that merely result in the forfeitures of management rights, thereby protecting the interests of the nondebtor in the future conduct and operations of the entity, with less offense than provisions that impair the debtor's economic interest in the enterprise.

[4] The Effect of the Bankruptcy of a General Partner on Nonrecourse Creditors of the Partnership

In some circumstances, the bankruptcy of a general partner of a single-asset real estate partnership may affect not only the nondebtor partners of the partnership but also third parties holding claims against the partnership itself.ⁿ⁹³ Thus, the holder of a nonrecourse mortgage against the real property of a partnership may view the transaction as involving only the relationship between the borrowing partnership and the mortgage lender and as unaffected by events involving any of the partners or any other third party. However, in some instances, the Bankruptcy Code case of a general partner of the borrowing partnership may affect the rights of a holder of a nonrecourse mortgage to pursue the remedy of foreclosure. The reason that the holder of the nonrecourse mortgage may be affected is that:

- (1) foreclosure of the mortgage may terminate the partnership's legal and financial interest in its sole asset, the real property;
- (2) the termination of the partnership's interests in the real property will consequently eliminate the investment of the debtor-general partner in the partnership; and
- (3) the debtor-general partner's trustee therefore may seek under section 362(a) or 105 to enjoin the foreclosure action in order to protect the debtor's investment in the partnership.ⁿ⁹⁴

As discussed below, the property of the estate of a debtor-general partner is its interest in the partnership and not the partnership's interest in partnership property. However, efforts at obtaining the protection of the automatic stay and of section 105 under these facts have become increasingly frequent, and, therefore, must be considered in analyzing the status of a nonrecourse mortgage creditor of a nondebtor real estate partnership.

As more fully discussed above, the interests of a general partner in a partnership are generally viewed as comprised of: (1) control rights; (2) economic rights; and (3) its tenancy-in-partnership.ⁿ⁹⁵ However, in many partnership transactions involving investments in real estate, the general partner or its affiliate may have received additional benefits as part of its initial sponsorship, promotion and syndication of the transaction. These benefits generally take the form of additional methodologies for compensation to the general partner or its affiliates in exchange for value provided to the partnership. Thus, in many transactions, the general partner may be entitled to compensation for functioning as the administrative partner of the partnership. The administrative partner will generally be responsible for the preparation of partnership tax returns and financial statements. In addition, the general partner, often through an affiliate, may be a party to a management agreement with the partnership providing for the day-to-day management and leasing of the partnership's real property. In many transactions, the general partner or an affiliate will have made advances to the partnership, or will have sold the property to the partnership, and will receive a second mortgage on the partnership assets to secure repayment of such advances or any purchase money indebtedness arising from the sale. In other instances, advances from the general partner will not be secured, and will merely take the form of a receivable in the hands of the general partner or its affiliate. From time to time, a general partner or an affiliate will guarantee some or all of the indebtedness of the partnership, and will receive a guarantee fee from the partnership, payable in installments. In other transactions, an affiliate of a general partner may be entitled to commissions upon the ultimate disposition of the partnership property or as compensation for arranging a refinancing transaction. In still other cases, a general partner or an affiliate may be granted a long-term purchase option for the partnership's property.ⁿ⁹⁶ Thus, in a typical developer or syndicator-sponsored, single-asset real estate limited partnership transaction, the general partner's interests in the project may include not only the attributes of its partnership interest, but additional contractual and financial rights that are intended to create additional value for the general partner or its affiliates.

Absent an express agreement to the contrary, it is generally the case that the foreclosure of a first mortgage lien on the

partnership's property will eliminate not only economic value of the general partner's partnership interest in the partnership, but also the other contractual rights and receivables held by the general partner, as well as any second mortgage lien held by the general partner or its affiliate encumbering the partnership's real property. Although these rights, receivables and liens are certainly not inherent in the relationship between a general partner and a partnership and may be held by any third party, they very often happen to be held by a general partner or its affiliate, and are, therefore, considered by bankruptcy courts in the context of a partnership relationship. Accordingly, the question arises whether:

(1) the automatic stay applicable to the Bankruptcy Code case of the general partner will be deemed to protect the debtor-general partner's interests in these various rights, receivables and liens from loss by reason of the mortgage foreclosure, and thereby be deemed to stay the foreclosure action; and

(2) the bankruptcy court may be willing to issue an injunction under section 105 staying the foreclosure action to protect the interests of the estate of the general partner in such assets.

If the foreclosure action of a nonrecourse mortgage creditor of a real estate partnership is stayed by reason of the bankruptcy of a general partner of the partnership, the rights and remedies of the mortgagee have been affected by events involving a party other than the actual obligor under the mortgage.

In a number of cases decided under the Code, the courts have issued stays under section 105 against actions by creditors against third party guarantors and insurers of the obligations and liabilities of the debtor and against nondebtor co-obligors.ⁿ⁹⁷ The rationale for these decisions involves the protection and marshalling of sources of recovery which may be used in the formulation and implementation of a plan.ⁿ⁹⁸ In addition, the courts have issued stays to protect subsidiaries of a debtor against a multiplicity of actions in state courts or administrative agencies.ⁿ⁹⁹ In another instance, a court has stayed a parent company of a debtor in possession from implementing an election under the Internal Revenue Code that would impair the debtor's ability to claim a net operating loss carryover.ⁿ¹⁰⁰ Finally, one court, in the context of a chapter 11 case in which the debtor and its affiliates had general partnership interests in several hundred real estate limited partnerships, issued a section 105 stay against the foreclosure of first mortgages encumbering assets of the nondebtor partnerships. The rationale for this holding was that the effort involved in administering and defending a large number of foreclosure actions would impair the ability of the debtor in possession to conduct its regular business and to formulate a plan of reorganization.ⁿ¹⁰¹

On the other hand, bankruptcy courts have generally been unwilling to issue a stay against a foreclosing mortgagee to protect the value of the partnership interest of a debtor general partner in a single-asset real estate partnership.ⁿ¹⁰² These courts have determined that the property of the estate that constitutes the proper subject of the protections of the automatic stay is its interest in the partnership, and that the debtor-general partner has no direct interest in the underlying real property owned by the partnership justifying the imposition of the stay or the issuance of a section 105 injunction.ⁿ¹⁰³ These courts have acknowledged that the economic investment of the general partner in the partnership may be adversely affected by reason of the completion of the foreclosure action on the partnership's property, but have determined nevertheless that the debtor's partnership interest in such property is too remote to warrant extension of the automatic stay or the issuance of a section 105 injunction to protect this interest. Similarly, it has been held that foreclosure of a mortgage will not be stayed to protect a debtor-general partner's interests in management fees and unsecured advances payable by a partnership.ⁿ¹⁰⁴

However, in other cases, the courts have tended to protect "property rights" of Bankruptcy Code debtors against actions by parties that are not creditors of those debtors but which would nevertheless virtually eliminate the interests of the debtors in the particular property rights.ⁿ¹⁰⁵ Thus, one court has enjoined the action of a landlord in terminating a lease where the effect of the termination would have been to destroy the subleasehold estate and possessory rights of the debtor in possession.ⁿ¹⁰⁶ Similarly, a court has enjoined the foreclosure of a mortgage when the foreclosure sale would have resulted in the termination of a subordinate lease that was held by a Bankruptcy Code debtor.ⁿ¹⁰⁷ Moreover, ample precedent exists for the proposition that the foreclosure of a first mortgage will be enjoined if the effect of such

foreclosure will be to cut off the rights of the holder of a second mortgage on the same asset when such holder is a Bankruptcy Code debtor.ⁿ¹⁰⁸

Accordingly, it is possible to discern a trend under which possessory and lien rights held by a Bankruptcy Code debtor, but not partnership interests, will be deemed eligible for the protections of the automatic stay or of a section 105 injunction against actions by a third party who is not a creditor of the debtor. It is also reasonably clear that in the partnership context, the rights a general partner as a manager, the holder of a contract receivable from a partnership or the holder of a prospective commission opportunity will not be protected by issuance of a stay against foreclosure of the underlying mortgage encumbering the partnership's asset.ⁿ¹⁰⁹

The import of the foregoing developments for prospective nonrecourse mortgage lenders to single asset partnerships is two-fold.

First, it is clear that the underwriting for the loan should consider not only the viability of the specific project, but also the financial standing of the general partners of the borrowing partnership.

Second, the prospective lender should consider lending into a structure under which a general partner holds a second mortgage on the prospective collateral.

In the first case, the bankruptcy of one of the general partners may result in a stay of the lender's foreclosure action if the court finds that prosecution of the action would impair the administration of the estate. In the second circumstance, the bankruptcy of the general partner who is also a second mortgagee will probably result in a stay of the lender's foreclosure action in order to protect the debtor's interests in the second mortgage. Accordingly, a prospective lender may wish to consider and retain the right to approve the structure of the borrowing partnership, and the rights and interests of the general partners in respect of the partnership and the underlying asset, as part of the underwriting and commitment process.

FOOTNOTES:

(n1)Footnote 1. See, e.g., articles cited at P 4.07[2] note 2 *infra* .

(n2)Footnote 1a. Pub. L. No. 99-514.

(n3)Footnote 2. References herein to a trustee also constitute references to a debtor in possession having the powers of a trustee under *section 1107(a) of the Bankruptcy Code*, unless the context otherwise requires. Articles discussing other and broader issues concerning partner and partnership bankruptcy include Hanley, *Partnership Bankruptcy Under the New Act*, 31 *Hastings L.J.* 149 (1979); Kashner, *Financing Limited Partnerships and Their Partners: Caveat Creditor*, 37 *Bus. Law.* 171 (1981); Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filing in the Interstices*, 56 *N.Y.U.L. Rev.* 1173 (1981); Kennedy, *Partnerships and Partners Under the Bankruptcy Reform Act and the New (Proposed) Bankruptcy Rules*, 27 *St. Louis U.L.J.* 507 (1983); Kennedy, *Partnerships and Partners Under the Bankruptcy Code: Claims and Distributions*, 40 *Wash. & Lee L. Rev.* 55 (1983); Seneker & Lewis, *Selected Bankruptcy Aspects of Real Estate Partnerships and Hybrid Debt-Equity Arrangements*, ABA Section of Real Prop., Prob. & Trust Law, Real Estate Bankruptcies and Workouts 177 (1983); Kaster and Cymbler, *The Impact of a General Partner's Bankruptcy Upon the Remaining Partners*, 21 *Real Prop., Prob. & Trust J.* 539 (1986); Neely, *Outline Re Selected Problems in Partnership and Partner Bankruptcy Cases*, 1996 N.Y.U. Workshop on Bankruptcy and Business Reorganization.

(n4)Footnote 3. The indisputable characterization of a partnership agreement as a "contract" has not foreclosed litigation over the question whether partnership agreements are "executory contracts" for the purposes of *section 365 of the Bankruptcy Code*. See cases cited in note 24 *infra*.

(n5)Footnote 4. The Uniform Partnership Act of 1914 provides that "[t]he property rights of a partner are (1) his

rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management." UPA § 24, 6 U.L.A. 697 (1995). Similarly, the Revised Uniform Partnership Act of 1997 (RUPA), which, as of December 1, 2000, has replaced the 1914 Uniform Partnership Act in 30 states, provides that "[t]he only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. The interest is personal property." RUPA § 502, 6 U.L.A. 90 (2001 Pocket Part).

The rights of a partner in specific partnership property is called a tenancy in partnership. This is a right to possess specific partnership property for the purpose of carrying out the business of the partnership, and is not a direct ownership interest in the partnership property itself corresponding to a joint tenancy or tenancy in common. UPA § 25(1). An understanding of the nature of a tenancy in partnership is relevant to the issue of whether the trustee of a partner may compel the sale of the partnership's property without the consent of the other partners. See *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 10 C.B.C.2d 408, 37 B.R. 755 (Bankr. D. Colo. 1984), *rev'd and remanded*, 831 F.2d 205 (10th Cir. 1987). Under section 363(h) a trustee of a co-owner may compel such a sale.

(n6)Footnote 5. See note 29 *infra*.

(n7)Footnote 6. For example, section 403(a) of the Revised Uniform Limited Partnership Act provides that a general partner of a limited partnership has the rights and obligations of a general partner in a general partnership except as provided in the Act or in the partnership agreement. See also RUPA § 103 (except for certain nonwaivable provisions, relations among the partners and between the partners and the partnership governed by partnership agreement).

(n8)Footnote 7. Other examples of agreements that involve both contractual and property rights include mortgages and deeds of trust, leases, reciprocal easement agreements, franchise agreements and intellectual property licenses. See P 4.04 *supra* dealing with reciprocal easement agreements.

(n9)Footnote 7a. 11 U.S.C. § 365(h)(1)(A)(ii). There is also a line of cases holding that certain provisions of an unexpired lease or contract, most often a covenant not to compete, survive rejection of the lease or contract as though such provisions constituted a property right. See *In re Steaks To Go, Inc.*, 40 C.B.C.2d 1391, 226 B.R. 35 (Bankr. E.D. Mo. 1998); *In re Hughes*, 30 C.B.C.2d 2010, 166 B.R. 103 (Bankr. S.D. Ohio 1994); *Fellerman & Cohen Realty Corp. v. Clinical Plus, Inc.*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993); Cf. *Medical Malpractice Ins. Assoc. v. Hirsch (In re Lavigne)*, 114 F.3d 379, 38 C.B.C.2d 67(1997). The court in *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994) held that a restrictive use covenant running with the land was not a rejectable executory contract but rather a property right. The court noted the "elusive" distinction between contractual and property rights, stating "While distinguishing between contracts and property rights may seem elusive, the neighbors' present enjoyment of the right [to enforce a restrictive covenant limiting development to residential uses], their completion of performance noted by both the bankruptcy and the district court, and the traditional treatment of their rights as running with the land, all indicate to use that the ... [covenant] is an interest in real property. As such § 365 of the bankruptcy code is inapplicable." *Id.* at 299. See also *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (treating right of first refusal as nonrejectable property right in favor of nondebtor), discussed at P 4.04 *supra*.

(n10)Footnote 8. *In re Safren*, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986).

(n11)Footnote 9. RULPA § 801(3). The revised Uniform Partnership Act (RUPA), which was first approved by the National Conference of Commissioners on Uniform State Laws in 1992 and subsequently revised in 1993, 1994 and 1997 provides in section 601(6) that a person ceases to be a partner if it (i) becomes a "debtor in bankruptcy," (ii) executes an assignment for the benefit of creditors, (iii) seeks or consents to the appointment of a trustee, receiver or liquidator of that partner or of all or substantially all of that partner's property, or (iv) fails, within 90 days after the appointment, to have stayed the appointment of a trustee, receiver or liquidator of the partner or all or substantially all of the partner's property obtained without the partner's consent or acquiescence, or fails, within 90 days after the

expiration of a stay, to have the appointment vacated. A "debtor in bankruptcy" is defined in section 101(2) of the RUPA as:

... a person who is the subject of: (i) an order for relief under Title 11 of the United States Code or a comparable order under a successor statute of general application; or (ii) a comparable order under federal, state, or foreign law governing insolvency.

Uniform Partnership Act (1997), 6 U.L.A. 10 (2001 Pocket Part). As of December 1, 2000, the RUPA has been adopted by 30 states.

(n12)Footnote 10. UPA § 29 defines dissolution as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." Section 30 of the UPA provides that "[o]n dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed." Under UPA § 41, the remaining partners may continue the business under a reconstituted partnership, and the creditors of the dissolved partnership become creditors of the new partnership. Under ULPA § 20, the remaining general partners of a limited partnership dissolved on account of the retirement, death or insanity of a general partner may continue the partnership's business. Weidner, *Three Policy Decisions Animate Revisions of the Uniform Partnership Act*, 46 *Bus. Law* 427, 435-38 (1991).

(n13)Footnote 10a. RUPA § 801(3).

(n14)Footnote 10b. RUPA § 601(2).

(n15)Footnote 10c. Section 802 of the Revised Partnership Act of 1997 provides that at any time after the dissolution of the partnership and before the winding up of its business is completed, all of the partners, other than a wrongfully dissociating partner, may waive the right to have the partnership's business wound up and the partnership terminated. In that event, among other things, the partnership resumes carrying on its business as if dissolution had never occurred. RUPA § 802(b).

(n16)Footnote 11. 11 U.S.C. § 365(e)(2)(A).

(n17)Footnote 12. *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 10 C.B.C.2d 408, 37 B.R. 755 (Bankr. D. Colo. 1984), *rev'd and remanded*, 831 F.2d 205 (10th Cir. 1987). See also Kennedy, *Partnerships and Partners Under the Bankruptcy Code: Claims and Distributions*, 40 *Wash. & Lee L. Rev.* 55 (1983); Kennedy, *Partners and Partnerships Under the Bankruptcy Reform Act and the New (Proposed) Bankruptcy Rules*, 27 *St. Louis U. L.J.* 507, 536 (1983). This result is not mandated by the Bankruptcy Code and is not always beneficial to the estate or the partnership. See *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, *supra*; *In re Corky Foods Corp.*, 18 C.B.C.2d 1087, 85 B.R. 903 (Bankr. S.D. Fla. 1988); *In re Safren*, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986), and text accompanying ns.17-18 *infra*.

(n18)Footnote 13. ULPA § 9(1)(e).

(n19)Footnote 14. RULPA §§ 401, 701.

(n20)Footnote 15. The exceptions concerning the satisfaction of any penalty rate or defaults relating to nonmonetary obligations were added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). The provision was further amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), with the addition of the word "penalty" before "provision" to clarify the scope of the exception to the cure requirement. See P 3.01[3] *supra*.

(n21)Footnote 15a. UPA §§ 29, 30, 43; ULPA § 23; Bromberg & Ribstein, Partnership, §§ 7.09, 7.10 (1988).

(n22)Footnote 16. UPA §§ 29, 30, 43; ULPA § 23; Bromberg & Ribstein, Partnership, §§ 7.09, 7.10 (1988).

(n23)Footnote 17. Bromberg & Ribstein, Partnership, § 7.13 (1988); cf. *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 10 C.B.C.2d 408, 37 B.R. 755 (Bankr. D. Colo. 1984) , rev'd and remanded, 831 F.2d 205 (10th Cir. 1987) ; UPA § 42.

(n24)Footnote 18. Bromberg & Ribstein, Partnership, § 7.22 (1988).

(n25)Footnote 19. *In re Safren*, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986) held that the filing of a chapter 11 case by or against the general partner of a general partnership does not dissolve the partnership. The court stated:

Such a dissolution was not contemplated when section 31(5) [of the UPA] was drafted in 1914, because no reorganization bankruptcy existed. In addition, if a partner is to reorganize his business affairs, he should not be faced with an automatic dissolution of all partnerships in which he is a partner, with the administrative and tax complications resulting therefrom.

16 C.B.C.2d 315, 319, 65 B.R. 566, 570 ; accord *In re Priestley*, 93 B.R. 253, 262 n.9 (Bankr. D.N.M. 1988) .

(n26)Footnote 20. See the discussion accompanying note 10 *supra*. The provisions of the UPA, discussed in note 10 *supra*, evidences that the drafters of the UPA viewed dissolution to be the first step in the ultimate termination of the partnership relationship. Under the Bankruptcy Code, however, an executory contract is to be either assumed or rejected. If rejected, the contract is deemed breached by the trustee. 11 U.S.C. § 365(g). In contrast, under partnership law, a partnership agreement may be "terminated" by reason of events that do not constitute a breach of the agreement, as well as by events that do constitute such a breach. See generally Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 Bus. Law. 427 (1991).

(n27)Footnote 21. See *Skeen v. Harms (In re Harms)*, 4 C.B.C.2d 691, 10 B.R. 817 (Bankr. D. Colo. 1981) .

(n28)Footnote 22. H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). The definition was first proposed in Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439 (1973). See PP 4.01[1], 4.02[2] *supra* .

(n29)Footnote 23. *Skeen v. Harms (In re Harms)*, 4 C.B.C.2d 691, 10 B.R. 817 (Bankr. D. Colo. 1981) .

(n30)Footnote 24. *Phar-Mor, Inc. v. Strouss Bldg. Assocs.*, 204 B.R. 948 (N.D. Ohio 1997) ; *In re Corky Foods Corp.*, 18 C.B.C.2d 1087, 85 B.R. 903 (Bankr. S.D. Fla. 1988) ; *In re Priestley*, 93 B.R. 253, 262 (Bankr. D.N.M. 1988) ; *In re W. & L. Associates, Inc.*, 71 B.R. 962 (Bankr. E.D. Pa. 1987) ; *In re Sunset Dev.*, 69 B.R. 710 (Bankr. D. Idaho 1987) ; *In re Safren*, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986) ; *In re Rittenhouse Carpet, Inc.*, 14 C.B.C.2d 115, 56 B.R. 131 (Bankr. E.D. Pa. 1985) ; *In re Norquist*, 11 C.B.C.2d 1146, 43 B.R. 224 (Bankr. E.D. Wash. 1984) ; See *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992) (adopting functional approach to determine whether contract is capable of rejection or assumption under section 365 such that analysis is not whether contract is "executory" but, rather, whether the estate will benefit from rejection or assumption); see also *In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982) ; Julis, *Classifying Rights and Interests Under the Bankruptcy Code*, 55 Am. Bankr. L.J. 223, 252-59 (1981); see also *In re Riodizio*, 37 C.B.C.2d 868, 204 B.R. 417 (Bankr. S.D.N.Y. 1997) . See generally, Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U.Colo. L.Rev. 845 (1988).

(n31)Footnote 25. Julis, 55 Am. Bankr. L.J. 223, 259 (1981).

(n32)Footnote 25a. *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37 (D.R.I. 1999) contains a review of the issues involved in the debate over whether the classic Countryman definition of an executory contract or the so-called "functional analysis" provides the proper standard for determining whether a contract is executory within the meaning of section 365 of the Code. The *Butler* court, in opting for the Countryman definition, argued that the functional analysis ignores the statutory mandate that the contract be executory. 241 B.R. at 44 . However, it may be argued that the functional analysis does presume that there are unperformed obligations remaining under a contract, but only on the part of the debtor. To argue that for Bankruptcy Code purposes an executory contract must have material obligations unperformed on both sides assumes a conclusion nowhere mandated in the language of the Code.

The *Butler* court further characterized the functional analysis as merely and embodiment of the business judgement test relating to the trustee's decision to assume or reject a contract. *Id.* at 44 . It may be argued, however, that the business judgement standard may be applied only after the functional analysis has determined that there are material obligations under a contract remaining to be performed by the debtor, and that assumption of rejection thereof will have an effect on the financial condition of the estate. The business judgement test will then apply to determine the court's scope of review of the trustee's decision to assume or reject the contract.

(n33)Footnote 26. 11 U.S.C. § 365(e)(2)(A).

(n34)Footnote 27. Pub. L. No. 98-353, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n35)Footnote 28. *In re West Elec., Inc.*, 852 F.2d 79 (3d Cir. 1988) ; *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) .

(n36)Footnote 29. Under UPA § 9(1), a general partner is expressly characterized as an agent of the other partners, with power to bind them to the obligations of the partnership. Under UPA §§ 13 and 14, a wrongful act or omission by a general partner will bind the partnership, as will a breach of trust by a partner in respect of obligations of the partnership to a third party. The Official Comment to UPA § 31, dealing with causes of dissolution, states that "[t]he relation of partners is one of agency. The agency is such a personal one that equity cannot enforce it even where the agreement provides that the partnership shall continue for a definite time."

In addition no person may become a general partner under the UPA without the consent of all partners except as otherwise provided in the partnership agreement; the bankruptcy of a general partner dissolves the partnership, and a debtor general partner is without authority to bind the partnership. UPA §§ 18(g), 31(5) and 35(3)(b). An assignee of a partnership interest may receive the economic rights of the assignor, but not its management rights. UPA § 27(1).

With respect to limited partnerships, it is likewise clear that a general partner is a fiduciary in respect of the limited partners, and has all of the duties of a general partner in a general partnership. ULPA § 9. Under the ULPA, a general partner may not without consent of the limited partners admit a new general partner, or continue the partnership business upon the death, retirement or insanity of another general partner unless so authorized in the partnership certificate. ULPA § 9(1)(e), (g). The retirement, death or insanity of a general partner dissolves the partnership unless the business is continued by remaining general partners pursuant to the partnership certificate or with the consent of all partners. ULPA § 20. As noted above, RULPA Sections 402(4) and (5) provide, with certain exceptions, for dissolution of the partnership upon the bankruptcy of a general partner. The Commissioners' Comment to Sections 402(4) and 402(5) is particularly instructive in stating:

Subdivisions (4) and (5) reflect a judgment that, unless the limited partners agree otherwise, they ought to have the power to rid themselves of a general partner who is in such dire financial straits that he is the subject of proceedings under the National Bankruptcy Act or a similar provision of law.

Commissioners on Uniform State Laws, Official Comment to RULPA section 402(4), (5); *cf. In re Sovereign Group, 1984-21, Ltd., 88 B.R. 325 (Bankr. D. Colo. 1988)*, holding in the context of the bankruptcy of a limited partnership that the plan provisions of *section 1123(a) of the Code* do not authorize the modification of a limited partnership agreement in contravention of the provisions of the agreement or of state law.

(n37)Footnote 30. *4 C.B.C.2d 691, 10 B.R. 817 (Bankr. D. Colo. 1981)*.

(n38)Footnote 31. *Skeen v. Harms (In re Harms), 4 C.B.C.2d 691, 695-96, 10 B.R. 817, 821-22 (Bankr. D. Colo. 1981)*.

(n39)Footnote 32. The "different entity" theory was criticized in *NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528, 104 S. Ct. 1188, 1197, 79 L. Ed. 2d 482, 497, 9 C.B.C.2d 1219, 1228-29 (1984)*. See also *Enstar Group v. Bank of New York (In re Amret, Inc.), 174 B.R. 315, 320 (D. Ala. 1994)* (rejecting application of different entity theory in the context of enforcing, with respect to postpetition intercompany loans, a prepetition subordination agreement between parent company debtor and senior creditor).

(n40)Footnote 33. *11 U.S.C. § 365(c)(1)(A)* (the italicized provision represents the changes to the section).

(n41)Footnote 34. H.R. Rep. No. 96-1195, 96th Cong., 2d Sess. 12 (1980). The cited report accompanied a technical amendments bill, S. 658, that was not enacted.

(n42)Footnote 35. A conforming amendment was included in the bill containing the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised), but was not enacted into law. 132 Cong. Rec. S. 5643 (daily ed. May 8, 1986).

(n43)Footnote 36. See text accompanying note 31 *supra*.

(n44)Footnote 37. The holding in *In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990)*, discussed *infra*, limits this rule to chapter 7 trustees.

(n45)Footnote 37a. This point is more fully discussed *infra*. *Cf. W.F. Dev. Corp. v. United States Tr. (In re W.F. Dev. Corp.), 905 F.2d 883, 23 C.B.C.2d 617 (5th Cir. 1990)*, *cert. denied*, 499 U.S. 921, 111 S. Ct. 1311, 113 L. Ed. 2d 245 (1991), holding that an attorney cannot represent both limited and general partners in the partnership's Bankruptcy Code case because a potential for conflict will always exist.

(n46)Footnote 38. See note 37 *supra*.

(n47)Footnote 39. A trustee in a chapter 11 case may be appointed pursuant to section 1104(a). Under section 1101(1), the appointment of a chapter 7 trustee means that no debtor in possession is in the case.

(n48)Footnote 40. *In re Cardinal Indus., Inc., 116 B.R. 964, 970 (Bankr. S.D. Ohio 1990)*.

(n49)Footnote 41. *In re Cardinal Indus., Inc., 116 B.R. 964, 972 (Bankr. S.D. Ohio 1990)*.

(n50)Footnote 42. *In re Cardinal Indus., Inc., 116 B.R. 964, 973 (Bankr. S.D. Ohio 1990)*.

(n51)Footnote 43. *In re Cardinal Indus., Inc., 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990)*.

(n52)Footnote 44. *In re Cardinal Indus., Inc., 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990)*.

(n53)Footnote 45. *In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990)*.

(n54)Footnote 46. *In re Cardinal Indus., Inc.*, 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990) .

(n55)Footnote 47. *In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990) .

(n56)Footnote 48. It should be noted that some holdings exist that are contrary to or inconsistent with the holding in *Cardinal*. See *Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. 1998) ; *In re West Elec., Inc.*, 852 F.2d 79 (3d Cir. 1988) (West was expressly disapproved by the *Cardinal* court). In *In re Fidelity America Mortg. Co.*, 10 B.R. 781 (Bankr. E.D. Pa. 1981) , the court held that section 365(e) of the Code invalidated the partnership agreement provision for the general partner's removal upon bankruptcy, but permitted removal because the general partner had diverted assets. Section 365(c) was not discussed in the opinion. The court in *In re Minton Group, Inc.*, 11 C.B.C.2d 1442, 1444, 46 B.R. 222, 224 (S.D.N.Y. 1985) , assumed without discussion that a bankruptcy of a general partner dissolves the limited partnership. *Contra*, *In re Safren*, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986) (general partnership). The *Safren* court found the *Harms* holding to be inapplicable because it dealt with a limited partnership and relied "...upon the absence of a general partner for its conclusion that the limited partnership dissolved." 16 C.B.C.2d 315, 320, 65 B.R. 566, 570 . The *Safren* court found that the *Minton Group* court, in dealing with a limited partnership, failed to consider the historical context of Section 31(5) of the UPA and misapplied that section to a chapter 11 case. *Id.* However, the court in *In re Sunset Dev.*, 69 B.R. 710 (Bankr. D. Idaho 1987) , held, in the context of a Bankruptcy Code filing by the general partner of a two-person general partnership and the subsequent filing of an involuntary petition for the partnership by the debtor-general partner, that:

- (1) the partnership relationship involves fiduciary obligations among the partners;
- (2) the partnership agreement, as an executory contract, therefore could not be assumed or assigned by the debtor-general partner by reason of the application of section 365(c);
- (3) the provisions of section 365(e), invalidating bankruptcy termination provisions in executory contracts, were inapplicable by reason of the debtor-general partner's disability under section 365(c) to assume and assign the partnership agreement; and
- (4) the partnership accordingly was placed in dissolution by the filing of a Bankruptcy Code petition by a general partner thereof and the involuntary petition against the partnership must be dismissed.

In re Priestley, 93 B.R. 253, 259-60 (Bankr. D.N.M. 1988) (chapter 7 case), and *In re Catron*, 158 B.R. 624 (Bankr. E.D. Va. 1992) , *aff'd*, 158 B.R. 629 (E.D. Va. 1993) , *aff'd*, 25 F.3d 1038 (4th Cir. 1994) , hold that section 365(c) applies to prevent assignment of a general partner's interest without the consent of the limited partners. The court in *In re Rittenhouse Carpet, Inc.*, 14 C.B.C.2d 115, 56 B.R. 131 (Bankr. E.D. Pa. 1985) held that section 365(e) proscribes termination of a limited partnership agreement solely by reason of the filing of a chapter 11 petition by the general partner. *Petrallex Stainless, Ltd. v. Bishop Tube Div. (In re Petrallex Stainless, Ltd.)*, 78 B.R. 738 (Bankr. E.D. Pa. 1987) , holds that the filing of a petition by a joint venturer does not dissolve the venture. *Calvin v. Siegal (In re Siegal)*, 190 B.R. 639 (Bankr. D. Ariz. 1996) , holds that a chapter 11 debtor in possession may assume a partnership agreement inasmuch as the identity of the parties to the agreement has not changed and the same performance may be rendered. The opinion in *In re Lil' Things, Inc.*, 40 C.B.C.2d 54, 220 B.R. 583 (Bankr. N.D. Texas, 1998) reviews the cases dealing with the relationship between sections 365(f) and 365(c) of the Code. See Kaster and Cymbler, *The Impact of a General Partner's Bankruptcy Upon the Remaining Partners*, 21 Real Prop., Prob. & Trust J. 539 (1986).

(n57)Footnote 48a. 11 U.S.C. § 365(b)(1)(C).

(n58)Footnote 48b. *Gould v. Antonelli (In re Antonelli)*, 148 B.R. 443 (D. Md. 1992) , *aff'd per curiam*, 4 F.3d 984 (4th Cir. 1993) (unpublished disposition).

(n59)Footnote 48c. The bankruptcy court's decision in this case is not reported, and references herein to that

decision are based upon the comments of the district court.

(n60)Footnote 48d. 148 B.R. 443, 448 (D. Md. 1992) .

(n61)Footnote 48e. 148 B.R. 443, 448 (D. Md. 1992) .

(n62)Footnote 48f. 148 B.R. 443, 448 (D. Md. 1992) .

(n63)Footnote 48g. 148 B.R. 443, 449 (D. Md. 1992) .

(n64)Footnote 48h. 4 F.3d 984, 29 C.B.C. 2d 935, 942-43 (4th Cir. 1993) .

(n65)Footnote 48i. 69 F.3d 608 (1st Cir. 1995) .

(n66)Footnote 48j. 69 F.3d 608, 610-11 (1st Cir. 1995) .

(n67)Footnote 48k. 69 F.3d 608, 612 (1st Cir. 1995) .

(n68)Footnote 48l. 69 F.3d 608, 612 (1st Cir. 1995) .

(n69)Footnote 48m. 69 F.3d 608, 612 (1st Cir. 1995) .

(n70)Footnote 48n. 69 F.3d 608, 612-13 (1st Cir. 1995) .

(n71)Footnote 48o. See text accompanying notes 30 through 37a *supra*.

(n72)Footnote 48p. 69 F.3d 608, 613 (1st Cir. 1995) .

(n73)Footnote 48q. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 524, 104 S. Ct. 1188, 1197, 79 L. Ed. 2d 482, 497, 9 C.B.C.2d 1219, 1228-29 (1984) .

(n74)Footnote 48r. 69 F.3d 608, 614 (1st Cir. 1995) .

(n75)Footnote 48s. See text accompanying note 31 *supra*.

(n76)Footnote 48t. 69 F.3d 608, 614 (1st Cir. 1995) .

(n77)Footnote 49. See 11 U.S.C. §§ 365(b)(2)(e)(1) and 541(c).

(n78)Footnote 50. *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 10 C.B.C.2d 408, 37 B.R. 755 (Bankr. D. Colo. 1984) ; *Seneker & Lewis*, ABA Section of Real Prop., Prob. & Trust Law, Real Estate Bankruptcies and Workouts 177, 190-92 (1983); *cf.*, *In re Adana Mortg. Bankers, Inc.*, 12 B.R. 977 (Bankr. N.D. Ga. 1980) .

(n79)Footnote 51. *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 10 C.B.C.2d 408, 37 B.R. 755 (Bankr. D. Colo. 1984)

(n80)Footnote 52. *In re Booth*, 9 C.B.C.2d 65, 19 B.R. 53 (Bankr. D. Utah 1982) demonstrates how an executory contract may be otherwise characterized if required to reach a desired result. The court in *Quarles House Apts. v. Plunkett (In re Plunkett)*, 7 C.B.C.2d 615, 23 B.R. 392 (Bankr. E.D. Wisc. 1982) , held that the term "property of the estate" under section 541 encompassed a managing general partner's right (notwithstanding the filing of a chapter 11 petition) to continue to manage the affected real estate partnership and to collect an annual management fee of 6% of gross rentals. The court did not reach the questions of characterization and assumption of the partnership agreement. *Cf. In re Don & Lin Trucking Co.*, (Bankr. N.D. Ala. 1990) , holding that a noncompetition covenant survives the lessee's rejection of an equipment lease. Although the holding is questionable, the court does expressly challenge the unitary

and mechanistic view of contract rejection. *See also In re Steaks To Go, Inc.*, 40 C.B.C.2d 1391, 226 B.R. 35 (Bankr. E.D. Mo. 1998) ; *In re Hughes*, 30 C.B.C.2d 2010, 166 B.R. 103 (Bankr. S.D. Ohio 1994) ; *Fellerman & Cohen Realty Corp. v. Clinical Plus, Inc.*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993) ; *Cf. Medical Malpractice Ins. Assoc. v. Hirsch (In re Lavigne)*, 114 F.3d 379, 38 C.B.C.2d 67 (1997) and the discussion in PP 4.02[2] and 4.04 *supra* .

(n81)Footnote 53. UPA § 27.

(n82)Footnote 54. *In re Sunset Dev.*, 69 B.R. 710, 713 (Bankr. D. Idaho 1987) accord *Tyler v. Walde (In re Walsh)*, 14 B.R. 385 (Bankr. D.D.C. 1981) ; *See In re Steaks To Go, Inc.*, 40 C.B.C.2d 1391, 226 B.R. 35 (Bankr. E.D. Mo. 1998) ; *In re Hughes*, 30 C.B.C.2d 2010, 166 B.R. 103 (Bankr. S.D. Ohio 1994) ; *Fellerman & Cohen Realty Corp. v. Clinical Plus, Inc.*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993) ; *Cf. Medical Malpractice Ins. Assoc. v. Hirsch (In re Lavigne)*, 114 F.3d 379, 38 C.B.C.2d 67 (1997) . *See also* the discussion in PP 4.02[2] and 4.04 *supra* .

(n83)Footnote 55. This approach was rejected by the court in *Cardinal*, 116 B.R. 964 (Bankr. S.D. Ohio 1990) , on the grounds that the disenfranchisement of the debtor-general partner could impair the debtor's management fee cash flow and the value of certain second mortgages held by it on the partnerships' property, which would be jeopardized if another entity became the managing partner.

(n84)Footnote 56. 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990) .

(n85)Footnote 57. *In re Cardinal Indus., Inc.*, 116 B.R. 964, 983-84 (Bankr. S.D. Ohio 1990) .

(n86)Footnote 58. *See* text accompanying ns.50-51 *supra*.

(n87)Footnote 58a. *See* P 4.07[2] *supra*.

(n88)Footnote 58b. Articles discussing these and additional issues concerning member and LLC bankruptcies include Symposium, *Check-the-Box and Beyond: The Future of Limited Liability Companies* (Ribstein & Sargents, eds), 52 *Bus. Law* 605 (1997); Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act*, 53 *Bus. Law* 101 (1997); Kornberg, Schorr & Antonoff, *Treatment of LLCs under Chapter 11 of the Bankruptcy Code*, J. Ltd. Liab. Cos. (1994); Blackmore, *Limited Liability Companies and the Bankruptcy Code: A Technical Review*, 13 *Am. Bankr. Inst. J.* 12 (1994); Keatinge, Ribstein, Hamill, Gravelle & Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 *Bus. Law* 378 (1992); Sabino, *LLC's and Member Bankruptcies: A New Milestone*, N.Y.L.J., February 27, 1996, p.1.

(n89)Footnote 58c. The first LLC statute was enacted in Wyoming in 1977. Forty-eight states have enacted LLC legislation. In August 1994, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Limited Liability Company Act (ULLCA), which was thereafter substantially revised.

(n90)Footnote 58d. *See, e.g., N.Y. Limited Liability Company Law* §§ 203, and 417.

(n91)Footnote 59. *N.Y. Limited Liability Company Law* § 203.

(n92)Footnote 59a. *See, e.g., Delaware Limited Liability Company Act* § 18-101(7).

(n93)Footnote 60. *N.Y. Limited Liability Company Law* § 401.

(n94)Footnote 61. *See* P 4.07[2] and text accompanying note 9 *supra*.

(n95)Footnote 62. *N.Y. Limited Liability Company Law* § 102(d). This definition is unduly limited. The court in *In re Safren*, 65 B.R. 566 (Bankr. C.D. Cal. 1986) , held under section 31(5) of the UPA that the filing of a chapter 11 case by or against the general partner of a partnership does not dissolve the partnership inasmuch as that section speaks only of the "bankruptcy" of a partner and does not address reorganization.

(n96)Footnote 63. *Cal. Corp. Code § 17350(d)*.

(n97)Footnote 64. *Cal. Corp. Code § 17001(c)*.

(n98)Footnote 65. Del. Limited Liability Company Act § 18-304.

(n99)Footnote 66. Del. Limited Liability Company Act § 18-101(1).

(n100)Footnote 67. Del. Limited Liability Company Act § 18-801.

(n101)Footnote 68. *In re Garrison-Ashburn L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000) .

(n102)Footnote 68a. 361 B.R. 422 (Bankr. E.D. Pa. 2007) .

(n103)Footnote 69. *See P 4.07[2] supra*.

(n104)Footnote 70. 188 B.R. 607 (Bankr. D. Neb. 1995) .

(n105)Footnote 71. 188 B.R. 607, 608 (Bankr. D. Neb. 1995) .

(n106)Footnote 72. 188 B.R. 607, 608 (Bankr. D. Neb. 1995) .

(n107)Footnote 73. 188 B.R. 607, 611-12, 614 (Bankr. D. Neb. 1995) .

(n108)Footnote 74. 188 B.R. 607, 614 (Bankr. D. Neb. 1995) .

(n109)Footnote 75. 194 B.R. 65 (Bankr. E.D. Va., 1996) .

(n110)Footnote 76. 194 B.R. 65, 74 (Bankr. E.D. Va. 1996) .

(n111)Footnote 77. 158 B.R. 624 (Bankr. E.D. Va. 1992) , *aff'd*, 158 B.R. 629 (E.D. Va. 1993) , *aff'd*, 25 F.3d 1038 (4th Cir. 1994) .

(n112)Footnote 78. 194 B.R. 65, 76 (Bankr. E.D. Va. 1996) .

(n113)Footnote 79. 148 B.R. 443 (D. Md. 1992) , *aff'd per curiam*, 4 F.3d 984 (4th Cir. 1993) (unpublished disposition). *See P 4.07[2]* and text accompanying notes 48b through 48h *supra*.

(n114)Footnote 80. *See P 4.07[2]* and text accompanying notes 48b through 48h *supra*.

(n115)Footnote 81. 194 B.R. 65, 77-78 (Bankr. E.D. Va. 1996) .

(n116)Footnote 82. 194 B.R. 65, 78 (Bankr. E.D. Va. 1996) . In *JTB Enters. v. D&B Venture (In re DeLuca)*, 194 B.R. 79 (Bankr. E.D. Va. 1996) , the same court dealt with a similar LLC issue involving the DeLucas, and held under the controlling authority of *Catron* that the nondebtor members of an LLC could not be compelled to accept the DeLucas as managing members. The court stated that it would reach the same result under the pragmatic approach of the *Antonelli* case, inasmuch as the identity and expertise of the managing member was critical to the success of the LLC. 194 B.R. 79, 91 . It is noteworthy that the court in *Broyhill* employed the *Antonelli* approach in reaching its holding, while noting and criticizing *Catron*, but cited *Catron* as controlling authority in reaching its holding in *JTB Enterprises*.

(n117)Footnote 82a. 361 B.R. 422 (Bankr. E.D. Pa. 2007) .

(n118)Footnote 82b. 361 B.R. 422, 455 .

(n119)Footnote 82c. 361 B.R. 422, 456 .

(n120)Footnote 83. See P 4.07[2] *supra*.

(n121)Footnote 84. It is not necessarily the case that the partnership analogy will apply in all respects. Unlike a partnership, there is a liability shield for all members of an LLC. Thus, with respect to the filing of a petition under the Code, an LLC may be treated as a corporation, and section 303(b)(3) may not apply. See *Code section 101(41)*, defining "person" as including a corporation and a partnership. The definition of "corporation" in section 101(9) includes a "partnership association... that makes only the capital subscribed responsible for the debts of such association..."

(n122)Footnote 85. *In re Garrison-Ashburn L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000) .

(n123)Footnote 86. 253 B.R. 700, 704 (citing Va. Code Ann. § 13.1-1040.1(6)(a)).

(n124)Footnote 87. The court noted that the change was made as a result of new Internal Revenue Code regulations that permitted an unincorporated entity, such as a limited liability company, to elect the manner in which it would be taxed (*i.e.* as a corporation or partnership). See 26 C.F.R. §§ 301.7701-1. As a result of the new regulations, it was no longer necessary for a limited liability company to avoid the corporate attribute of continuity of life in order to be taxed as a partnership, and thus provisions in the state limited liability statute providing for automatic dissolution upon the occurrence of events such as the bankruptcy of a member were no longer necessary. 253 B.R. 704, 706 .

(n125)Footnote 88. 253 B.R. 700, 704 .

(n126)Footnote 89. 253 B.R. 700, 707-08 .

(n127)Footnote 90. See P 4.01[1] *supra*.

(n128)Footnote 91. 253 B.R. 700, 708-09 .

(n129)Footnote 92. 253 B.R. 700, 709 .

(n130)Footnote 93. See P 4.07[2] *supra* for a discussion of the effect of the bankruptcy of a general partner on the nondebtor partners of a partnership.

(n131)Footnote 94. Section 362(a) provides for the imposition of an automatic stay in Bankruptcy Code cases. See PP 1.07 and 2.06 *supra* . Section 105(a) authorizes the bankruptcy court to issue any order necessary or appropriate to carry out the provisions of the Code.

(n132)Footnote 95. See P 4.07[1] *supra*.

(n133)Footnote 96. See *Cardinal Indus., Inc. v. Buckeye Fed. Sav. & Loan Ass'n (In re Cardinal Indus., Inc.)*, 105 B.R. 834 (Bankr. S.D. Ohio 1989) (hereinafter "Cardinal II").

(n134)Footnote 97. *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293, 26 C.B.C.2d 1413, 1422 (2d Cir. 1992) , cert. denied, 506 U.S. 1088, 113 S. Ct. 1070, 122 L. Ed. 2d 497 (1993) ; *A.H. Robins Co. v. Piccinin (In re A.H. Robins Co.)*, 788 F.2d 994, 15 C.B.C.2d 235 (4th Cir.) , cert. denied, 479 U.S. 976, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986) ; *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 18 C.B.C.2d 316 (2d Cir.) , cert. denied, 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed. 2d 145 (1988) .

(n135)Footnote 98. See, *e.g.*, *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 26 C.B.C.2d 1413 (2d Cir. 1992) , cert. denied, 506 U.S. 1088, 113 S. Ct. 1070, 122 L. Ed. 2d 497 (1993) .

(n136)Footnote 99. *Stoller v. Baldwin-United Corp.*, 11 C.B.C.2d 168, 41 B.R. 884 (S.D. Ohio 1984) .

(n137)Footnote 100. *In re Prudential Lines, Inc.*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989) , *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990) , *aff'd*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir.) , *cert. denied*, 502 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991) .

(n138)Footnote 101. *In re Cardinal Indus.*, 105 B.R. 834 (Bankr. S.D. Ohio 1989) .

(n139)Footnote 102. *A.H. Robins Co. v. Piccinin (In re A.H. Robins Co.)*, 788 F.2d 994, 15 C.B.C.2d 235 (4th Cir.) , *cert. denied*, 479 U.S. 976, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986) ; *In re Venture Properties, Inc.*, 37 B.R. 175 (Bankr. D.N.H. 1984) ; *Dominican Fathers of Winona v. Dreske (In re Dreske)*, 7 C.B.C.2d 1239, 25 B.R. 268 (Bankr. E.D. Wis. 1982) . *Cf.* *Hart Holding Co., Inc. v. Drexel Burnham Lambert Inc., Bank. L. Rep. P 74,333* (Ch. Ct., Del. 1991), in which the Delaware Chancery Court, in determining whether the section 362(a) automatic stay applied to a proceeding against a limited partner of a debtor's subsidiary, discussed the distinctions between owning interests in a partnership and the ownership of partnership property.

(n140)Footnote 103. *Hart Holding Co., Inc. v. Drexel Burnham Lambert Inc., Bank. L. Rep. P 74,333* (Ch. Ct., Del. 1991).

(n141)Footnote 104. *In re Cardinal Indus.*, 105 B.R. 834 (Bankr. S.D. Ohio 1989) .

(n142)Footnote 105. *Roslyn Sav. Bank v. Comcoach Corp. (In re Comcoach Corp.)*, 8 B.C.D. 1077 (Bankr. S.D.N.Y. 1982) , *aff'd*, 698 F.2d 571, 7 C.B.C.2d 1191 (2d Cir. 1983) ; 48th *In re 48th Street Steakhouse*, 835 F.2d 427 (2d Cir 1987) , *cert. denied*, 485 U.S. 1035, 108 S. Ct. 1596, 99 L. Ed. 2d 910 (1988) .

(n143)Footnote 106. *In re 48th Street Steakhouse*, 835 F.2d 427 (2d Cir 1987) , *cert. denied*, 485 U.S. 1035, 108 S. Ct. 1596, 99 L. Ed. 2d 910 (1988)n.70 .

(n144)Footnote 107. *Roslyn Sav. Bank v. Comcoach Corp. (In re Comcoach Corp.)*, 8 B.C.D. 1077 (Bankr. S.D.N.Y. 1982) , *aff'd*, 698 F.2d 571, 7 C.B.C.2d 1191 (2d Cir. 1983)n.70 .

(n145)Footnote 108. *Florida Inst. of Tech. v. Carpenter (In re Westec Corp.)*, 460 F.2d 1139 (5th Cir. 1972) .

(n146)Footnote 109. *In re Cardinal Indus.*, 105 B.R. 834 (Bankr. S.D. Ohio 1989) .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.08

P 4.08 Management Contracts

[1] The Manager as Debtor

A typical property management agreement will obligate the manager to (1) supervise and manage the property, (2) collect all rents, (3) pay out of collected rents the operating expenses of the property, including taxes, (4) reserve and retain a percentage of gross rents as a management fee, and (5) maintain books and records, and prepare budgets and financial reports with respect to the property. Some management agreements will also appoint the manager exclusive leasing agent with a right to specified leasing commissions. Most management agreements run for yearly terms, and provide for cancellation by the owner for cause, including bankruptcy, of the manager.

There are two principal concerns of the property owner that will arise upon the filing of a Bankruptcy Code petition by or against the manager: *first*, may the owner terminate the management agreement by reason of the filing of the petition, and *second*, will the owner be deemed an unsecured creditor with respect to rentals and other property- related funds in the hands of the manager's trustee?

Assuming a management agreement to be an executory contract,ⁿ¹ the first issue will be resolved under *section 365(a) of the Code*, which authorizes rejection and assumption of executory contracts; section 365(e)(1), which renders unenforceable bankruptcy termination clauses in executory contracts; section 365(e)(2)(A), which excludes from section 365(e)(1) contracts involving nondelegable duties, personal services, relationships of special trust and the like; and section 365(c), which prevents assumption of a contract of the type described in section 365(e)(2)(A).

The argument in favor of a management agreement as an executory contract involving a relationship of personal trust is clear. The property manager has been appointed as the owner's agent to supervise, operate and protect the property and to collect funds to be employed in the operation of the property and for remission to the owner. Although there may be many qualified and trustworthy management companies that could perform the same function, the owner had selected this management company, and should not be compelled by the bankruptcy court to accept performance by the manager's trustee, or indeed by an assignee of the management contract. The manager is given access to confidential books, records and even tax returns of the owner, and this information should not be transferable to other parties without the owner's consent.

The second issue referred to above should also be resolved in the owner's favor. Monies in the hands of the manager at

the time of filing of the petition that have arisen from the managed property should be characterized either as trust funds held for the benefit of the owner or as funds held by the manager as an agent-bailee. In either case, the funds would not constitute property of the manager's estate under *section 541(a) of the Code*.² The funds should be deemed held by the trustee under the trust or agency theories because the only claim thereto of the manager is its percentage compensation under the management agreement. The balance of the funds do not arise from any investment by the manager in the property or any loan to the manager by the owner, and would represent a windfall to the manager's estate if deemed part of the estate's general assets.

Although the above conclusions appear to be well-grounded in creditors' rights law, certain drafting suggestions may be considered to forestall any contrary claims by the trustee, or possibly to minimize the expense and delay of litigation. With respect to the enforceability of the bankruptcy termination clause of a management agreement, it may be helpful to include in the agreement language emphasizing the relationship of personal service and trust between manager and owner. This could be accomplished in the recitals in the agreement, or in a section that may even state in substance that "this is an agreement within the meaning of *sections 365(c) and 365(e)(2)(A) of the Bankruptcy Code, 11 U.S.C. §§ 365(c) and 365(e)(2)(A)*, under which applicable law excuses a party, other than the debtor, from accepting performance from or rendering performance to the debtor, any debtor in possession or trustee, or any assignee of any thereof, appointed or otherwise authorized to act under the Bankruptcy Code, *11 U.S.C. §§ 101 et seq.* " There can be no assurance that a bankruptcy court would accept this concededly self-serving provision in a management agreement; however, the inclusion of such a provision will provide the owner with an argument as to the intentions and understanding of the parties, and may be helpful to the court if it accepts the contention that the agreement does involve a relationship of personal trust and service.

The management agreement should also expressly provide that funds held by the manager not attributable to the manager's compensation are being held by the manager as trustee for the benefit of the owner, that such funds are the property of the owner and not the manager, and that the relationship between owner and manager with respect to the funds is that of beneficiary-trustee and not creditor-debtor. This declaration may also be helpful in establishing the relationship of personal trust discussed in the preceding paragraph.

[2] The Manager as Custodian

From time to time a mortgagee may assume possession of a real estate project that is the subject of a defaulted mortgage, and will engage either the existing or a new managing agent to run the project for the mortgagee. If the mortgagor thereafter files a petition under the Bankruptcy Code, the managing agent may find itself suddenly faced with new duties and liabilities.

Section 543 of the Code provides:

(a) A custodian with knowledge of the commencement of a case under this title concerning the debtor may not make any disbursement from, or take any action in the administration of, property of the debtor, proceeds, product, offspring, rents or profits of such property, or property of the estate, in the possession, custody, or control of such custodian, except such action as is necessary to preserve such property.

(b) A custodian shall--

(1) deliver to the trustee any property of the debtor held by or transferred to such custodian, or proceeds, product, offspring, rents or profits of such property, that is in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case; and

(2) file an accounting of any property of the debtor, or proceeds, product, offspring, rents or profits

of such property, that, at any time, came into the possession, custody, or control of such custodian.

(c) The court, after notice and a hearing, shall--

(1) protect all entities to which a custodian has become obligated with respect to such property or proceeds, product, offspring, rents or profits of such property;

(2) provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such custodian; and

(3) surcharge such custodian, other than an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, for any improper or excessive disbursement, other than a disbursement that has been made in accordance with applicable law or that has been approved, after notice and a hearing, by a court of competent jurisdiction before the commencement of the case under this title.

(d) After notice and hearing, the bankruptcy court--

(1) may excuse compliance with subsection (a), (b), or (c) of this section, if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property, and

(2) shall excuse compliance with subsections (a) and (b)(1) of this section if the custodian is an assignee for the benefit of the debtor's creditors that was appointed or took possession more than 120 days before the date of the filing of the petition, unless compliance with such subsections is necessary to prevent fraud or injustice.ⁿ³

The term "custodian" is defined in *section 101(11) of the Code* to include a "trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors."ⁿ⁴ It has been held that a managing agent designated by a mortgagee-in-possession is a custodian.ⁿ⁵

The filing of a Bankruptcy Code petition by a mortgagor will preclude further enforcement of a mortgage lien by a custodian, and will subject the rents and profits of the property to the jurisdiction of the bankruptcy court. The actions of the custodian immediately after the filing of the petition will be subject to the court's jurisdiction and control, and under section 543(b)(1) the custodian will be compelled to deliver to the trustee all property of the debtor held by the custodian on the date on which the custodian acquires "knowledge" of the commencement of the case unless such delivery is excused under section 543(d). Moreover, under section 543(c), the custodian's prepetition actions are made subject to review by the bankruptcy court, with the court empowered to establish the custodian's prepetition compensation and to effect a surcharge for "improper or excessive" disbursements.

The potential liabilities of a managing agent-custodian warrant inclusion in the management agreement of provisions protective of the managing agent. The agent may under section 543 be held liable if it (a) is deemed to have had "knowledge" of the commencement of a Bankruptcy Code case by the mortgagor and fails to deliver to the trustee rental proceeds and other property of the debtor, (b) took action in respect of the debtor's property after the filing of the petition which is ultimately determined not to have been "necessary to preserve such property" or (c) is surcharged for prepetition disbursements ultimately determined to have been improper or excessive. It is appropriate in these circumstances for the mortgagee to indemnify the managing agent for any of the foregoing liabilities incurred through acts or omissions directed or ordered by the mortgagee. It also seems appropriate for the managing agent to receive protection against such liabilities resulting from acts or omissions taken without the direction of the mortgagee but in

good faith. In addition, given the inevitable requirement for the managing agent to employ counsel in the event of a Bankruptcy Code filing by the mortgagor, the cost of such retention should be factored into the managing agent's compensation or right to expense reimbursement. Finally, the managing agent may also wish to provide for a direct right against the mortgagee for compensation or expense reimbursement to the extent that the bankruptcy court under section 543(c)(2) reduces the compensation and reimbursement payable to the managing agent out of the rents or income of the property to a level below that set forth in the agreement between the mortgagee and the managing agent.

FOOTNOTES:

(n1)Footnote 1. *See P 4.01[1] supra. See In re Holly's*, 140 B.R. 643 (Bankr. W.D. Mich. 1992) (hotel management agreement constituted executory contract).

(n2)Footnote 2. *In re Property Leasing & Mgmt., Inc.*, 50 B.R. 804 (Bankr. E.D. Tenn. 1985) . *See PP 4.05, 4.06 supra* .

(n3)Footnote 3. 11 U.S.C. § 543.

(n4)Footnote 4. 11 U.S.C. § 101(11)(C).

(n5)Footnote 5. *In re Pine Lake Vill. Apt. Co.*, 6 C.B.C.2d 83, 17 B.R. 829 (Bankr. S.D.N.Y. 1982) .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.09

P 4.09 Timesharing Agreements

The Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments") included amendments to *section 365(h)* and *(i) of the Code* intended to protect purchasers of timeshare interests. As a result of the amendments by the Bankruptcy Reform Act of 1994 to the provisions of section 365(h) relating to the rights of a lessee under a lease rejected by a debtor lessor, section 365(h) was amended and restructured such that the provisions of section 365(h) relating to timeshare interests were restated in a new section 365(h)(2). Further, the Bankruptcy Reform Act of 1994 amended these provisions in a manner similar to the provisions related to the rights of a lessee to provide the purchaser with the option of either (i) treating the timeshare plan as terminated or (ii) retaining its rights in such timeshare interest.ⁿ¹ Under section 365(h)(2)(A)(i), if a trustee of a timeshare seller rejects a timeshare interest, and the rejection constitutes a breach which would permit the purchaser to terminate its interest under the governing agreement or nonbankruptcy law, the purchaser may elect to treat the timeshare plan as terminated by such rejection.ⁿ² Under section 365(h)(2)(A)(ii), if the term of the timeshare interest has commenced, the timeshare purchaser may retain its rights in such timeshare interest for the balance of such term and any renewal or extension periods to the extent that such rights are enforceable under applicable nonbankruptcy law.ⁿ³ Under section 365(h)(2)(B), a timeshare purchaser who elects to "retain its rights" in such timeshare interest may, as the exclusive remedy against the seller's trustee, offset from subsequent payments for the timeshare interest the value of any damages caused by nonperformance after the date of such rejection of the seller's obligations under the timeshare plan.ⁿ⁴ The offset period extends to all renewal or extension periods under the timeshare plan.

Under section 365(i), as amended by the 1984 Amendments, if a trustee for a seller rejects an executory contract to sell a timeshare interest under a timeshare plan under which the purchaser is in "possession," the purchaser may treat the contract as terminated or remain in possession. If the purchaser elects to remain in possession, it is required to continue its payments under the contract for sale but may as its exclusive remedy offset any damages caused by the debtor's nonperformance of its contractual obligations after the date of such rejection. The seller's trustee is also required to deliver title pursuant to the contract to a purchaser that performs its payment obligations.

Section 365(j) of the Code grants to a purchaser who treats an executory contract as terminated under section 365(i) a lien against the subject property for recovery of any portion of the purchase price which has been paid. The 1984 Amendments did not amend section 365(j), and it therefore does not expressly mention timeshare interests. There is, accordingly, a question whether section 365(j) benefits timeshare purchasers.

Section 101(53D) of the Code, added by the 1984 Amendments, defines a "timeshare plan" to include "... that interest purchased in any arrangement, plan, scheme, or similar device, but not including exchange programs, whether by membership, agreement, tenancy in common, sale, lease, deed, rental agreement, license, right to use agreement, or by any other means, whereby a purchaser, in exchange for consideration, receives a right to use accommodations, facilities, or recreational sites, whether improved or unimproved, for a specific period of time less than a full year during any given year, but not necessarily for consecutive years, and which extends for a period of more than three years." Section 101(53D) also defines a "timeshare interest" as an interest purchased in a timeshare plan which grants the purchaser the right to use and occupy the accommodations, facilities or sites provided for in a timeshare plan.ⁿ⁵

The apparent purpose in drafting such an encompassing definition was to provide uniform treatment for all timeshare purchasers. Timeshare agreements may take several different forms, including contracts, leases, licenses, and grants of interest in real property. Prior to enactment of the 1984 Amendments, a timeshare purchaser holding a leasehold interest could have sought the protections of section 365(h) in the case of a rejection by the trustee for the timeshare seller, but a timeshare purchaser holding a license would not be so protected.ⁿ⁶ Similarly, a timeshare purchaser holding an interest in the form of a grant of rights in real property could have argued that the grant effected a conveyance, was not executory, and therefore could not be rejected by the seller's trustee.ⁿ⁷ Thus the sweep of the section 101(53D) obviates the need to deal with such distinctions and should result in uniform application of section 365(h) and (i).

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 103-394 (1994), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. 11 U.S.C. § 365(h)(2)(A)(i).

(n3)Footnote 3. 11 U.S.C. § 365(h)(2)(A)(ii).

(n4)Footnote 4. 11 U.S.C. § 365(h)(2)(B).

(n5)Footnote 5. These definitions were originally included in section 101(57). However, as a result of a renumbering of definitions in section 101 in connection with the Bankruptcy Reform Act of 1994, the definitions of "timeshare plan" and "timeshare interest" are now included in section 101(53D).

(n6)Footnote 6. *See* P 2.01[4] *supra*.

(n7)Footnote 7. *See In re Sombrero Reef Club, Inc.*, 6 C.B.C.2d 506, 18 B.R. 612 (Bankr. S.D. Fla. 1982) ; P 4.04 *supra* .

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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CHAPTER 4 Miscellaneous Transactions *

1-4 Collier Real Estate Trans & Bankruptcy Code P 4.51

P 4.51 Form--Mortgage and Security Agreement

Form--Mortgage and Security Agreement.

THIS MORTGAGE AND SECURITY AGREEMENT, made as of _____ [date]
_____, between XYZ ASSOCIATES LIMITED PARTNERSHIP (the "Mortgagor"), a New York limited partnership, having an office at 1001 East 19th Street, New York, New York, and JJ ASSOCIATES (the "Mortgagee"), a New York limited partnership, having an office at 1002 East 19th Street, New York, New York.

WITNESSETH

THAT pursuant to an agreement dated as of the date hereof and intended to be recorded concurrently herewith (the "Option Agreement"), Mortgagor has granted to Mortgagee the option (the "Option") to purchase from Mortgagor pursuant to the terms of the Option Agreement that certain plot, piece and parcel of land, with the buildings, structures and improvements now or hereafter located thereon, including building fixtures, which land is described by metes and bounds in Exhibit A hereto (collectively, the "Property");

THAT if the Mortgagee shall exercise the Option in accordance with the terms of the Option Agreement and otherwise performs its obligations thereunder, the breach by the Mortgagor of its obligation under the Option Agreement as the same from time to time may be modified or amended to convey to the Mortgagee the Property (the "Option Obligation") will give rise to damages and losses suffered by the Mortgagee in an amount equal to (a) the excess, if any, of (i) the actual value of the Property as of the date fixed for closing under the Option Agreement, over (ii) the purchase price for the Mortgagor's interest in the Property payable by the Mortgagee under the Option Agreement, (b) any sums paid by the Mortgagee to the Mortgagor under the Option Agreement in consideration of the grant by the Mortgagor to the Mortgagee of the Option, and (c) all reasonable costs and expenses of the Mortgagee incurred in the enforcement of the Option Agreement and this Mortgage and Security Agreement including, without limitation, reasonable attorneys' fees (the damages and losses described in clauses (a), (b) and (c) of this paragraph at any time arising are hereinafter referred to as the "Option Damages");

THAT in consideration of the payments to be made by Mortgagee to Mortgagor pursuant to the Option Agreement, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged by the Mortgagor;

TO SECURE the prompt and punctual performance of the Option Obligation and the payment of the Option Damages, the Mortgagor hereby gives, grants, bargains, sells and confirms, unto the Mortgagee, its successors and assigns,

forever, all of the Mortgagor's right, title and interest, in and to the Property;

TOGETHER with all right, title and interest of the Mortgagor in and to all machinery, apparatus, equipment, fittings, fixtures, furniture, furnishings and articles of personal property of every kind and nature whatsoever owned by the Mortgagor and now or hereafter attached or affixed to the Property or used or usable in connection therewith;

TOGETHER with all proceeds of the conversion, voluntary or involuntary, of any of the foregoing into cash or liquidated claims, including, without limitation, proceeds of insurance and condemnation awards with respect thereto, which proceeds are hereby assigned by the Mortgagor to the Mortgagee;

TOGETHER with all right, title and interest of the Mortgagor in and to all the tenements, hereditaments, easements, rights, privileges, servitudes, licenses and appurtenances of the Property at any time belonging or in anywise appertaining thereto (all of the foregoing real and personal property and rights and interest in property and proceeds being hereinafter collectively referred to as the "Mortgaged Premises");

To have and to hold the Mortgaged Premises, with the appurtenances thereof, unto the Mortgagee, its successors and assigns forever, to its and their own proper use and behoof.

And the Mortgagor and the Mortgagee covenant and agree as follows:

1. *Performance of Obligations.* The Mortgagor shall duly and timely perform the Option Obligation and agrees that upon a breach by the Mortgagor of the Option Obligation the Option Damages shall be immediately due and payable.

2. *Event of Default.* The default by the Mortgagor in the performance of the Option Obligation in accordance with the Option Agreement shall constitute an Event of Default hereunder.

3. *Remedies.* (a) If an Event of Default shall occur, the Mortgagee may institute proceedings for the foreclosure of this Mortgage and Security Agreement by strict foreclosure or otherwise.

(b) The purchase money proceeds or avails of any foreclosure sale, together with any other sums which then may be held by the Mortgagee under this Mortgage and Security Agreement, whether under the provisions of this Paragraph 3 or otherwise, shall be applied as follows:

FIRST: To the payment of the costs and expenses of such sale, including, without limitation, the reasonable fees of the Mortgagee's attorneys.

SECOND: To the payment of the Option Damages.

THIRD: The balance, if any, to the Mortgagor.

(c) Upon any such foreclosure sale, the Mortgagee may bid for and acquire the Mortgaged Premises or any part thereof and in lieu of paying cash therefor may make settlement for the purchase price by crediting against the Option Damages the net sales price after deducting therefrom the expenses of the sale and any other sums that the Mortgagee is authorized to deduct by law.

(d) After the happening of an Event of Default, immediately upon the commencement of any action or proceeding by the Mortgagee to foreclose this Mortgage:

(i) The Mortgagor shall, if required by the Mortgagee, consent to the appointment of a receiver or receivers of the Mortgaged Premises or any part thereof or any business or businesses conducted thereon and of all the earnings,

revenues, rents, issues, profits and income thereof; and

(ii) The Mortgagee shall be entitled, as a matter of right, if it shall so elect, without the giving of notice to any other party and without regard to the adequacy or inadequacy of any security for the Option Damages, to the appointment of such receiver or receivers.

(e) The Mortgagee may take immediate possession of the Mortgaged Premises or any part thereof (which the Mortgagor agrees to surrender to the Mortgagee) and manage, control or lease the same to such person or persons and at such rental as it may deem proper; and collect, with or without taking possession of the Mortgaged Premises, all the rents, issues and profits therefrom, including those past due as well as those thereafter accruing, with the right in the Mortgagee to cancel any lease, sublease, or tenancy for any cause that would entitle the Mortgagor to cancel the same; to make such expenditures for maintenance, repairs and costs of operation as it may deem advisable; and after deducting the cost thereof, to apply the residue to the payment of any unpaid portion of the Option Damages. The taking of possession and/or the collection of rents under this Paragraph shall not prevent concurrent or later proceedings for the foreclosure of the Mortgaged Premises as provided elsewhere herein.

(f) Subject to the provisions of Paragraph 4 hereof, no remedy herein or in Paragraph 5 hereof conferred upon or reserved to the Mortgagee is intended to be exclusive of any other remedy or remedies, and each and every such remedy shall be cumulative, and shall be in addition to every other remedy given hereunder or now or hereafter existing at law or in equity or by statute, including, without limitation, the remedy of injunctive relief to require the performance by the Mortgagor of its obligations hereunder and under the Option Agreement and the remedy of specific performance provided for in the Option Agreement. No delay or omission of the Mortgagee in exercising any right or power accruing upon any Event of Default shall impair any such rights or powers, or shall be construed to be a waiver of any such Event of Default or any acquiescence therein. Every power and remedy given by this Mortgage and Security Agreement to the Mortgagee may be exercised from time to time as often as may be deemed expedient by the Mortgagee.

(g) The Mortgagor shall not at any time insist upon, or plead, or in any manner whatsoever claim or take any benefit or advantage of any stay or extension or moratorium law, any exemption from execution or sale of the Mortgaged Property or any part thereof, whenever enacted, now or at any time hereafter in force, which may affect the covenants and terms of performance of this Mortgage and Security Agreement during the pendency of any foreclosure action or proceeding. The Mortgagor covenants not to hinder, delay or impede the execution of any power herein granted or delegated to the Mortgagee and waives, to the extent that the Mortgagor lawfully may, all right to have the Mortgaged Premises or any part thereof marshalled upon any foreclosure hereof.

(h) During the continuance of an Event of Default and pending the exercise by the Mortgagee of its right to exclude the Mortgagor from all or any part of the Mortgaged Premises, the Mortgagor agrees to pay the fair and total reasonable rental value for the use and occupancy of the Mortgaged Premises or any portions thereof that are occupied by it for such period and, upon default of any such payment, will vacate and surrender possession of such portion of the Mortgaged Premises to the Mortgagee or to a receiver, if any, and in default thereof may be evicted by any summary action or proceeding for the recovery of possession of premises for nonpayment of rent, however designated.

4. *Exculpation of Mortgagor.* Notwithstanding anything to the contrary contained in this Mortgage, (a) neither the Mortgagor nor any partner in the Mortgagor nor any legal representative, heir, estate, successor or assign of any such partner or any officer, director, shareholder or partner in any such partner or any other principal in the Mortgagor, whether disclosed or undisclosed, shall have any personal liability with respect to the performance by the Mortgagor of its obligations under this Mortgage and Security Agreement or under the Option Agreement, and (b) in the event of any default by the Mortgagor in the performance of its obligations under this Mortgage and Security Agreement, the Mortgagee's sole recourse shall be to the Mortgagor's interests in the Mortgaged Premises and the Mortgagee shall not seek to obtain any deficiency or any money judgment against the Mortgagor or any other person or party hereinabove named or referred to as being exculpated from personal liability. Nothing herein contained, however, shall in any way

be deemed to affect, limit or restrict the right of the Mortgagee to institute any action or proceeding against the Mortgagee that does not seek damages or a money or personal judgment (including, without limitation, any action for specific performance or other equitable relief against the Mortgagor), impair the validity of the obligations of the Mortgagor under this Mortgage and Security Agreement or the Option Agreement, or relieve the Mortgagor of any personal liability for fraud, any intentional misstatement or breach of trust.

5. *Security Agreement.* (a) This instrument shall constitute a "security agreement" within the meaning of the Uniform Commercial Code with respect to any personal property covered hereby, and a security interest shall attach thereto for the benefit of the Mortgagee to secure the sums secured by this Mortgage and Security Agreement and all other sums and charges that may become due hereunder. The Mortgagor hereby authorizes the Mortgagee to file financing and continuation statements with respect to such personal property, without the signature of the Mortgagor whenever lawful and, upon request, the Mortgagor shall promptly execute financing and continuation statements in form satisfactory to the Mortgagee to further evidence and secure the Mortgagee's interest in such personal property and shall pay all filing fees in connection therewith.

(b) Upon the occurrence of an Event of Default under this Mortgage and Security Agreement, the Mortgagee shall have all of the rights of a secured party under the Uniform Commercial Code, and, pursuant to Section 9-604 of the Uniform Commercial Code (Revised Article 9), as said Section is currently constituted or may be hereafter amended, shall have the option of proceeding as to both real and personal property in accordance with its rights and remedies in respect of the real property, in which event the default provisions of the Uniform Commercial Code shall not apply. The parties agree that in the event the Mortgagee elects to proceed with respect to such personal property, separately from the real property, fifteen (15) days' notice of the sale of the Mortgagor's interest in such personal property shall be reasonable notice.

6. *[Notice Clause]*

7. *Separability; Binding Effect.* Each provision hereof shall be separate and independent and the breach of any such provision by a party hereto shall not discharge or relieve such party from its obligations to perform each and every covenant to be performed by such party hereunder. If any provision hereof or the application thereof to any person or circumstance shall to any extent be invalid or unenforceable, the remaining provisions hereof, or the application of such provision to persons or circumstances other than those as to which it is invalid or unenforceable, shall not be affected thereby, and each provision hereof shall be valid and enforceable to the extent permitted by law. All provisions contained in this Mortgage and Security Agreement shall be binding upon, inure to the benefit of, and be enforceable by, the respective successors and assigns of the Mortgagee and the Mortgagor to the same extent as if each such successor and assign were named as a party hereto. This Mortgage and Security Agreement may not be changed, modified or discharged except by a writing signed by both the Mortgagee and the Mortgagor. This Mortgage and Security Agreement shall be governed by and interpreted in accordance with the law of the State of Connecticut.

8. *Headings.* The headings to the various paragraphs and Exhibits of this Mortgage and Security Agreement have been inserted for reference only, and shall not to any extent have the effect of modifying, amending or changing the expressed terms and provisions of this Mortgage and Security Agreement.

9. *Maximum Amount Secured.* Notwithstanding any provision of this Mortgage and Security Agreement to the contrary, the aggregate amount of the sums secured hereby shall at no time exceed \$

NOW THEREFORE, if the Option Obligation shall be duly performed in accordance with the terms of the Option Agreement, or if the Option Damages shall be paid, this Mortgage and Security Agreement shall become null and void, otherwise to remain in full force and effect.

IN WITNESS WHEREOF, the Mortgagor has caused this Mortgage and Security Agreement to be executed and

delivered as of the date first above written.

WITNESS:

XYZ ASSOCIATES LIMITED

PARTNERSHIP

a New York Limited Partnership

By:

[Acknowledgment]

* The author gratefully acknowledges the work of Steven M. Abramowitz, Esq. of Vinson & Elkins, llp in the revision of this chapter.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

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P 5.01 Introduction

The seemingly widening scope of creditors' rights issues affecting conveyancing, mortgage loan, and other real estate transactions inevitably has affected the real estate bar's approach to title insurance. During the era of the large leveraged buy-out transaction, substantial pressure was brought on title insurers to (1) eliminate or modify "bankruptcy" exceptions customarily included in policies issued for certain types of transactions and (2) provide affirmative insurance with respect to certain potential problems. Of course, the title insurance industry was also represented by counsel who carefully monitored developments in creditors' rights law affecting real estate transactions and who made judgments concerning the insurer's exposure if bankruptcy exceptions were omitted or modified or if affirmative insurance were issued.

Judgments dealing with creditors' rights exceptions and endorsements entail both a legal and underwriting risk analysis. The underwriting risk analysis takes into consideration the potential cost to the insurer of fulfillment of its obligation to defend against adverse (third-party) claims, even if the legal analysis shows that the insurer should ultimately prevail. Thus, the availability of certain coverage may depend not only on the correctness of the legal analysis of the transaction (*i.e.*, is it a fraudulent conveyance?), but also on the likelihood that the transaction will be attacked by a trustee or debtor in possession if the obligor becomes a debtor in a case under the Bankruptcy Code.ⁿ¹

As shown below, most of the title insurance issues relating to creditors' rights matters center around fraudulent conveyance problems arising in several contexts, including leveraged buy-outs,ⁿ² mortgage foreclosures,ⁿ³ deeds in lieu of foreclosureⁿ⁴ and lease terminations.ⁿ⁵ However, title insurance-creditors' rights issues also arise in the context of workouts (preference issues with respect to security for antecedent debt)ⁿ⁶ and transaction structures (purchase options, loans to partners and managing members, etc.).ⁿ⁷ As more fully set forth below, the American Land Title Association ("ALTA") and the New York Department of Insurance have taken steps with respect to fraudulent conveyance and preferential transfer concerns to protect title companies from exposure in these areas. The ensuing discussion is not intended to be an exhaustive discourse on each creditors' rights issue affecting title insurance coverage, but is instead intended to outline in various contexts the issues for consideration in requesting such coverage.

FOOTNOTES:

(n1)Footnote 1. Certain conclusions set forth herein with respect to a title insurer's willingness to provide or refuse to provide certain coverage are based upon conversations with some highly-skilled and knowledgeable persons in the title insurance community. These conclusions do not arise from a statistically valid or scientifically-conducted survey.

(n2)Footnote 2. *See P 5.02[1] infra.*

(n3)Footnote 3. *See P 5.02[2] infra.*

(n4)Footnote 4. *See P 5.02[4] infra.*

(n5)Footnote 5. *See P 5.02[3] infra.*

(n6)Footnote 6. *See P 5.03[6] infra.*

(n7)Footnote 7. *See P 5.03[1]-[4] infra.*



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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

1-5 Collier Real Estate Trans & Bankruptcy Code P 5.02

P 5.02 Fraudulent Conveyance Issues

[1] Leveraged Buy-Outs

[a] Description of Transaction

In a leveraged buy-out (an "LBO"), the stock of an acquired corporation, or the partnership interests in a partnership (or the equity interests involved in any other form of ownership, such as a trust), may be redeemed, repurchased, eliminated or otherwise acquired from the holders thereof for cash, debt obligations and/or other property, by the issuer of such stock or interests or the acquiror of such issuer. In the context of a real estate mortgage financing transaction, this may mean that stock or partnership interests in an entity that owns real property may be acquired with the proceeds of a loan secured by a mortgage on the real property owned by the entity. LBOs in the context of real estate assets are attractive for several reasons, including the possible avoidance of (1) real estate transfer taxes, (2) reassessment for real estate tax purposes, and (3) certain types of due-on-sale clauses.

[b] The Creditors' Rights Problems--Fraudulent Conveyances

In analyzing the structure of a mortgage loan in an LBO transaction, a mortgage lender will consider the risks that (1) its lien may be avoided as a fraudulent transfer under the Bankruptcy Code, and (2) its claim may be equitably subordinated to other claims against the debtor.

In a case commenced under the Bankruptcy Code, the debtor in possession or trustee may, pursuant to *section 548 of the Bankruptcy Code*, avoid and recover from the recipient thereof any payment, incurrence of indebtedness or other transfer of property made voluntarily or involuntarily by the debtor on or within two years¹ before the date of the filing of the petition commencing the case if:

(1) The transfer was made by the debtor "with actual intent to hinder, delay, or defraud" any creditor of the debtor; or

(2) The debtor received "less than a reasonably equivalent value" for such transfer, *and*

(a) was insolvent on the date such transfer was made, or became insolvent as a result thereof;

(b) was engaged or was about to engage in a business or a transaction for which the remaining property of the debtor was "an unreasonably small capital";

(c) intended to or believed that it would incur debts beyond its ability to pay as such debts matured; or

(d) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.^{n1a}

The Bankruptcy Code provision is derived from, and substantially similar to, the Uniform Fraudulent Conveyance Act first adopted in 1919 and presently in force in four states and the United States Virgin Islands.ⁿ² These provisions have been preserved in many respects in the Uniform Fraudulent Transfer Act, adopted in 39 states and the District of Columbia.ⁿ³ A number of other states have adopted similar but non-uniform fraudulent transfer laws.

Under *section 544(a) of the Bankruptcy Code*, a debtor in possession or trustee is given the avoidance powers of certain hypothetical creditors and purchasers under state law, including the Act and the Uniform Fraudulent Transfer Act. These avoidance powers also incorporate the applicable state statute of limitations, which generally is longer than the one-year period provided for in *section 548 of the Code*.ⁿ⁴ Also, state fraudulent conveyance acts are not generally limited to the bankruptcy context and are generally enforceable by creditors, as well as by a Bankruptcy Code debtor in possession or trustee under section 544.ⁿ⁵

In most LBO transactions, particularly those involving publicly-held corporations, the potential for a successful fraudulent transfer challenge based on actual fraudulent intent will be remote. However, as described above, even in the absence of actual fraudulent intent, a transfer may be avoided if the transferor did not receive reasonably equivalent value (the Act uses the term "fair consideration") for the property transferred and the transferor was insolvent or was rendered insolvent, undercapitalized or incapable of meeting its contemplated debts as they matured.ⁿ⁶ In the context of a mortgage loan transaction, this means that the mortgagor, in incurring the indebtedness and granting the mortgage lien to the lender (the transfer), did not receive reasonably equivalent value because the proceeds of the loan went to the selling shareholders or partners of the mortgagor (as the case may be), and not to the mortgagor itself.

The analysis of whether a transaction constitutes a fraudulent transfer should be made from the perspective of the creditors of the transferor (in the LBO context, the issuer of the stock or partnership interests being paid out).ⁿ⁷ From that perspective, the transaction viewed in its entirety will result in (1) the incurrence by the issuer (either directly or through a guarantee) of substantial indebtedness resulting from the mortgage financing of the acquisition of the stock or interests, (2) the grant of the mortgage lien, and (3) the making of a substantial payout to former stockholders or partners (directly by the issuer and/or from proceeds of such indebtedness). Such incurrence, grant and payout constitute transfers. Even if the payout results in the reacquisition by the issuer of its then outstanding stock, such reacquisition will probably be viewed as merely reducing the issuer's capital and not increasing its assets.ⁿ⁸ If the issuer is found to have been insolvent or undercapitalized at the time of the transaction, its stock will be viewed as having little or no value.ⁿ⁹ Moreover, even if the issuer receives the proceeds of the indebtedness incurred by it, such proceeds will not be viewed as benefitting the issuer if they are paid out to stockholders.ⁿ¹⁰ Thus, the issuer will be viewed as not having received reasonably equivalent value or fair consideration for the incurrence of such indebtedness and granting of the mortgage lien. Consequently, if the issuer was insolvent or was rendered insolvent, undercapitalized or incapable of meeting its contemplated debts as they matured, the mortgage lender's claim on the debt may be invalidated or subordinated and its lien avoided.ⁿ¹¹

[c] The Creditors' Rights Problems--Subordination

As noted above,ⁿ¹² a mortgage lender in an LBO transaction may run a risk that its claim will be equitably subordinated to other claims against the debtor. In many instances, equitable subordination results from some misconduct, usurpation of control, mismanagement or overreaching by a lender to the detriment of other creditors.^{n12a} The title insurance exception for LBO mortgage loans, set forth below,ⁿ¹³ includes an exception for equitable subordination.

If the subordination takes the form of reclassification of the loan as equity, it is probably more accurate to refer to the process as "recharacterization" rather than "subordination." Recharacterization most often occurs in cases involving "loans" from an affiliate of the debtor.

It is well established that a bankruptcy court has the power to disallow or subordinate a claim when it determines that the conduct of the claimant or the special position which the claimant occupies vis-a-vis the bankrupt and its other creditors was inequitable or unconscionable and that as a matter of equity the claim should be disallowed or subordinated.ⁿ¹⁴

Subordination may be ordered by a court by reason of the claimant's relationship to the bankrupt as dominant parent, controlling stockholder or other fiduciary, coupled with the claimant's failure to adhere to the standard of conduct required of persons in such relationship.ⁿ¹⁵

However, in the context of a title insurance exception providing for the application of principles of equitable subordination, the focus of concern is not the conduct of the lender subsequent to the making of the loan and issuance of the policy, because the policy does not insure against such subsequent events. Furthermore, in an arms-length institutional mortgage loan transaction (without equity participation) in an LBO, there is no issue of a parent, stockholder or other fiduciary relationship resulting in greater scrutiny of the lender-debtor relationship. Instead, the title insurer will be concerned that the mortgage loan, as structured at origination, will be found to be actually a capital contribution or other proprietary interest in recognition of what the court deems to be the essential nature of the transaction (*i.e.*, recharacterization). This rare situation is perhaps best illustrated by *United States v. Gleneagles Inv.*,ⁿ¹⁶ in which an unaffiliated lender made a mortgage loan to a corporate subsidiary (also secured by mortgages given by other subsidiaries), which relented the proceeds to the parent (in return for an unsecured note), which, in turn, used the bulk of the proceeds to pay selling shareholders for their stock. The court found that the borrower and lender knew that the borrower was in default under certain loan agreement covenants from and after the moment the loan was closed, that the corporate parent had no means to repay the advance received from its subsidiary, and that the borrower had an inadequate supply of cash with which to conduct its business.ⁿ¹⁷ Although the court devoted substantial discussion to the fraudulent conveyance aspects of the LBO and mortgage loan, it also appears that the lender's claim (apart from its lien) was subordinated to the claims of other creditors.ⁿ¹⁸ In other words, this case may be viewed as involving an LBO loan that the parties knew would probably not be repaid, and thus the lender's position was viewed as actually constituting equity. It is interesting to note that in this case the lender's title company agreed to remove the fraudulent conveyance exception from its policy in exchange for a personal indemnity.ⁿ¹⁹

[d] The Title Insurance

As noted above, in connection with LBOs, title insurers have been requested by the mortgage lender to eliminate the exception usually contained in mortgagee's title policies in such transactions. Prior to the adoption of the ALTA standard creditors' rights exclusion discussed below, the exception generally read:

Any loss or damage on account of the fact that, under either the Federal Bankruptcy Code or other similar state insolvency or creditors' rights laws, the insured mortgage is attacked either on the ground that such mortgage is a fraudulent conveyance or on the ground that the claim or lien of such mortgage should be subordinated to other claims or interests, under principles of equitable subordination.

This exception covers both the possibility of lien avoidance through application of fraudulent conveyance law, and the possibility of lien subordination through application of equitable principles.

Moreover, title insurers were sometimes requested to issue affirmative insurance to the effect that a mortgage lien will not be avoided as a fraudulent conveyance. The following is an example of such an affirmative insurance provision:

Notwithstanding the purchase by of the partnership interest of in the limited partnership known as Associates, a limited partnership, and the utilization of the proceeds of the Mortgage (insured herein) to purchase the partnership interests in Associates, policy insures that the making and delivery of the Mortgage (insured herein) in connection with the consummation of the above transaction will not be set aside as a result of being a fraudulent transfer or conveyance under Federal or State Law relating to fraudulent transfers or conveyances, the Company hereby assumes the costs and expenses of defense or any action to set aside the Mortgage (insured herein) as a result of the utilization of the proceeds of the Mortgage (insured herein) to purchase the partnership interests in Associates; and policy further insures against monetary loss (including, without limitation, attorneys' fees and expenses) resulting from a final determination that the insured mortgage is not a valid lien on the property, subject only to the terms and provisions of the policy herein including those items set forth in Schedule B herein, due to the application of Federal or State Law relative to fraudulent transfer(s) or conveyances. (*E.g. 11 U.S.C. Secs. 548 and 550 and New York Debtor and Creditor Law Section 270 et seq.*)

The foregoing provision, although very broad, did not reach the question of equitable subordination.

In 1990, the ALTA, in response to concerns raised by title insurance companies, approved a creditors' rights exclusion for lenders' policies that read:

Any claim, which arises out of the transactions creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.

The exclusion for owners' policies read:

Any claim, which arises out of the transaction vesting in the insured the estate or interest insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.

The original intention of the ALTA in preparing the exclusion was to protect against claims arising from fraudulent transfer and equitable subordination holdings.ⁿ²⁰ However, the exclusion as finally adopted, was both too narrow and too broad. The language in the loan policy limiting the exclusion to "transactions creating the interest of the mortgagee" failed to cover the possibility that, under *section 550 of the Bankruptcy Code*, a transaction may be avoided by reason of events relating to a previous transfer of the property.ⁿ²¹ The exclusion was therefore too narrow. On the other hand, the exclusion was too broad if construed to cover: (1) preferential transfer claims arising from the title insurer's failure to timely record a mortgage after the transaction has closed; (2) claims arising from the avoidance of a mortgage lien under *section 544(a)*--the so called "strong-arm" provision--by reason of basic defects in the execution, delivery or form of the mortgage instrument; or (3) claims arising under creditors' rights laws other than the Bankruptcy Code and state insolvency statutes that may nevertheless affect the priority of a mortgage lien.

In a "New York style" closing, the title closer receives the closing documents to be recorded and binds the title insurer to cover the gap period between the time of closing and recordation. It has generally been clear that the title company is responsible if it fails to record the instruments received at the closing. However, upon the adoption of the 1990 ALTA

creditors' rights exclusion, certain commentators expressed the concern that title insurers could be protected from claims arising from the avoidance of a mortgage lien as a preferential transfer by reason of the insurer's failure to timely record the mortgage.ⁿ²² As more fully discussed below,ⁿ²³ section 547 provides that a trustee may avoid a prepetition transfer--such as the granting of a mortgage lien--on account of an antecedent debt, to or for the benefit of a creditor, made while the debtor was insolvent, on or within 90 days before the date of filing of the Bankruptcy Code petition (the period is one year if the creditor, at the time of transfer was an "insider"), that enables the creditor to receive more than it would have received in a chapter 7 liquidation of the debtor had the transfer not been made. Exceptions in sections 547(c)(1), (3) and (4) protect transactions--such as mortgage loan transactions--in which the debtor receives contemporaneous consideration or new value from the creditor; however, under section 547(e)(2), the granting of the mortgage lien is deemed to have occurred when the mortgage is actually recorded unless it is recorded within 30 days after its effective date (or 30 days after a debtor receives possession of the property in the case of a purchase money mortgage covered by section 547(c)(3)). Therefore, a title company's failure to record a mortgage within the 30-day period could lead to avoidance of the mortgage lien as a preferential transfer, but under the 1990 ALTA policy the insurer could conceivably defend against the resulting claim under the creditors' rights exclusion as arising "by reason of the operation of federal bankruptcy laws. ..."n24

The second objection to the language of the creditors' rights exclusion related to section 544(a), which confers upon a trustee the rights of a hypothetical *bona fide* purchaser of real property or a judicial lien creditor, as of the date of filing of the petition. Thus, if a defect in execution, delivery or form of a mortgage occurs, the mortgage lien could be avoided under section 544(a). Protection against the consequences of such defects is one of the fundamental benefits of title insurance. Nevertheless, the broad language of the 1990 ALTA creditors' rights exclusion could have been construed to protect title insurers from liability arising from such defects inasmuch as the claim arises from the operation of the federal bankruptcy laws.

The third objection to the language of the 1990 ALTA exclusion related to the effect of state laws governing such matters as lien priorities, which may fall within the ambit of the exclusion as a "similar creditors' rights law." If this was the case, the consequences of defects in transfer instruments that give rise to lien priorities for third partiesⁿ²⁵ may have been omitted from title insurance coverage by reason of the creditors' rights exclusion.

Although in some states the exclusion could have been modified by negotiation between counsel for the insured party and the title insurer, some other states that adopt standard exclusions as part of their insurance regulations may prohibit title companies doing business in such jurisdictions from removing or modifying such exclusions.ⁿ²⁶ Moreover, in those jurisdictions in which removal or modification is permitted, the burden is on counsel for the principals to recognize the issue and to successfully negotiate a resolution.

The objections to the exclusion discussed above were considered by the New York State Department of Insurance, which adopted the exclusion in a modified form:

Owner's Policy

4. Any claim, which arises out of the transaction vesting in the insured the estate or interest insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- (i) the transaction creating the estate or interest insured by this policy being deemed a fraudulent conveyance or fraudulent transfer; or
- (ii) The transaction creating the estate or interest insured by this policy being deemed a preferential transfer except where the preferential transfer results from the failure:
 - (a) to timely record the instrument of transfer; or

(b) of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

Lender's Policy

7. Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

(i) the transaction creating the interest in the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer; or

(ii) the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination; or

(iii) the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure:

(a) to timely record the instrument or transfer; or

(b) of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

Under New York law, these exclusions cannot be removed or modified.ⁿ²⁷

Effective as of October 17, 1992, the ALTA deleted the forms of creditors' rights exceptions adopted in 1990 and substituted the New York forms in their place.ⁿ²⁸

[e] The Title Insurer's Analysis of the Request for Insurance Against Lien Avoidance

As noted above, adoption of the ALTA creditors' rights exclusion will not necessarily mean that in all states the opportunity to negotiate a limitation of the exclusion or even affirmative protection will have been eliminated. A title insurer requested to provide affirmative insurance of the type set forth aboveⁿ²⁹ will study the financial condition of the issuer of the debt and mortgage at the time of the transaction and the effect of the transaction on such financial condition.ⁿ³⁰

In theory, two types of analyses are required: (1) a balance sheet- type analysis to determine solvency and sufficiency of capital; and (2) a cash flow-type analysis, to determine ability to pay debts as they mature. However, since both the Bankruptcy Code and the Act would require a finding of intent on the part of the issuer to incur, or believe that it would incur, debts beyond its ability to pay at maturity in order to base a fraudulent transfer action on a cash flow-type analysis, and since the likelihood of any such finding will generally be small, attention will be addressed principally to the assets and liabilities of the issuer of the debt.ⁿ³¹

Insolvency is defined in *section 101 of the Bankruptcy Code* as a "financial condition such that the sum of [an] entity's debts is greater than all of such entity's property, *at a fair valuation* " (emphasis added). A special definition for partnership insolvency appears that takes into account the general partner's net assets.ⁿ³² The Act states that "[a] person is insolvent when the *present fair salable value* of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."ⁿ³³ Although there are, at least arguably, certain differences between the terms "fair valuation" and "fair salable value," both concepts refer to the market value of the assets, not their book value.ⁿ³⁴ It is clear that generally accepted accounting principles are not controlling in insolvency determinations.ⁿ³⁵

The term "unreasonably small capital" is not statutorily defined. Relevant case law indicates that it is closely related to

the insolvency concept, exists automatically if insolvency exists, and may be found even in the absence of insolvency if the debtor has insufficient working capital reasonably to operate its business and to meet its obligations.ⁿ³⁶

Accordingly, a title insurer's assessment of the financial information concerning the issuer of the debt and mortgage will take into account the following considerations:

- (1) As stated above, assets will be valued based on market value, not book value. Therefore, financial statements prepared in accordance with generally accepted accounting principles, while of course significant, are not necessarily determinative of asset value in this context.
- (2) Fraudulent transfer actions are almost invariably commenced after the transferor has encountered financial difficulties (usually bankruptcy). While stating that solvency is to be determined as of the time of the transaction, it is common for courts in such cases to employ a great deal of hindsight in valuing the assets and, at times, even the liabilities. Therefore, little or no value will be given to goodwill, prepaid items or other intangibles which are not useful in the absence of an ongoing profitable enterprise. Similarly, tangible items such as inventory and accounts receivable, the value, salability or collectibility of which are dependent upon the health of the enterprise, may receive discounted values.
- (3) The issuer may have potential liabilities which may become actual if the issuer meets with financial difficulty, particularly if it ceases operations. Some of these may be reflected in footnotes to the financial statements, such as pension-related liabilities, guarantees, and pending litigation against the issuer. Other potential liabilities, although more difficult to identify and quantify will also be taken into account. An example of such a liability are the claims arising from an issuer's rejection of certain of its executory contracts.
- (4) Assets may exist which are not reflected on the balance sheet, such as claims or pending litigation of the issuer against third parties, and valuable leasehold interests. In addition, some assets may have a market value in excess of book value, such as fixed assets for which historic cost less depreciation understates current market value.
- (5) Valuations and appraisals are often made in connection with leveraged buyouts. These will be reviewed if available. If performed on a reasonable basis to determine market value by qualified persons, such valuations and appraisals should have substantial evidentiary effect in any fraudulent transfer action relating to the transaction.

[2] The *Durrett* Problem and the *BFP* Holding

[a] The Holdings

In 1980, the Court of Appeals for the Fifth Circuit, in *Durrett v. Washington National Insurance Co.*,ⁿ³⁷ held that a regularly conducted, noncollusive, nonjudicial foreclosure sale, conducted within one year of the mortgagor's bankruptcy, in which the consideration paid was less than 70% of the value of the real property (as determined by the court) was a transfer for less than reasonably equivalent value and therefore fraudulent without regard to intent (insolvency was also found to exist). The *Durrett* holding called into question the finality of transactions such as lender and third-party acquisitions of real property at foreclosure sale, and purchases of property from parties that acquired title at foreclosure sale.

In 1994, the United States Supreme Court, in *BFP v. Resolution Trust Corp.*,ⁿ³⁸ held that a noncollusive, nonjudicial mortgage foreclosure sale properly conducted under state law cannot be avoided as a fraudulent transfer under *section 548(a) of the Bankruptcy Code*. The Court concluded that the "reasonably equivalent value" standard of section 548(a) was satisfied solely and conclusively by strict adherence to state mortgage foreclosure procedures and without otherwise

evaluating the adequacy of the consideration paid for the transfer.ⁿ³⁹ The majority opinion expressed concern over the prospect of unsettled real estate titles resulting from application of a federally-created standard where state law would otherwise respect the finality of such titles, and explicitly abrogated the *Durrett* holding.ⁿ⁴⁰

The Court's holding clearly is applicable to judicial foreclosure sales as well as the nonjudicial sale considered in the *BFP* opinion. However, although the Court's rationale may be determined to be applicable to creditor realization procedures under the Uniform Commercial Code, other consensual lien statutes and common law, the Court emphasized that the holding covered only mortgage foreclosures. The Court stated that "[t]he considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different."ⁿ⁴¹

Moreover, the Court did not address the applicability of its holding to avoidance proceedings under *section 544 of the Code*, which incorporates state fraudulent transfer laws. It is unlikely, in the absence of a state court ruling applying the *Durrett* rule under the state's fraudulent transfer statute to a mortgage foreclosure sale conducted in accordance with state law, that the Supreme Court would affirm the use of *section 544 of the Code* to upset real estate titles when the Court has held that *section 548(a)* cannot be used to do so. However, if such a state court ruling were to be rendered, the federal courts may be bound by the provisions of *section 544* to apply such a holding to an appropriate case arising under the laws of that state.ⁿ⁴² The Supreme Court in the *BFP* case appeared to be disturbed by the practice of the federal courts in upsetting real estate titles otherwise recognized as valid under state law, and thus may countenance a *section 544* avoidance of a mortgage foreclosure sale if such avoidance would also have occurred in a case brought in the courts of the appropriate state.

It is important to note that *Section 3(b)* of the Uniform Fraudulent Transfer Act provides that "[f]or the purposes of *Sections 4(a)(2)* [requirement for reasonably equivalent value with respect to rights of present and future creditors] and *5* [requirement of reasonably equivalent value with respect to rights of present creditors], a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement."ⁿ⁴³ Therefore, with respect to mortgage foreclosure sales and similar dispositions governed by the laws of a state that has adopted the Uniform Fraudulent Transfer Act in a version containing *Section 3(b)* or its equivalent,ⁿ⁴⁴ *section 544 of the Code* cannot be employed to avoid such a foreclosure sale or similar disposition that satisfies the standards set forth in *Section 3(b)* of the Act.

[b] The Title Insurance Issues

Prior to the Supreme Court's ruling in *BFP*, the principal questions were whether title insurance would be issued in a *Durrett* jurisdiction, or in a jurisdiction in which the issue had not been resolved, to (1) a mortgage lender bidding-in at foreclosure sale, (2) a third party purchasing at the foreclosure sale, and (3) a third party purchasing from a mortgage lender that has bid-in at foreclosure sale. In other words, in circumstances in which *section 548 of the Bankruptcy Code* or state fraudulent conveyance law (through *section 544*) would have been applicable, when would the title insurer accept the risk that the transaction will be avoided? In jurisdictions that adopted the ALTA creditors' rights exclusion discussed above,ⁿ⁴⁵ and in which variation of the exclusion is prohibited, the title insurer was free of risk inasmuch as the exclusion in the owners' policy ordinarily covered the *Durrett* problem. In other jurisdictions, the issue remained active and extremely complex, especially to the extent that *section 550 of the Code* came into play and had to be understood.

Section 550 deals with the liability of the transferee of an avoided transfer. Under *section 550* the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from (1) the initial transferee (or the party for whose benefit such transfer was made), or (2) any immediate or "mediate" transferee of such initial transferee. However, an immediate or mediate transferee of the initial transferee is not subject to recovery if such transferee takes for value (including satisfaction or securing a present or antecedent debt), in good faith, and without knowledge of the voidability of the avoided transfer.ⁿ⁴⁶ In addition, the trustee may not recover against any

immediate or mediate good faith transferee of a transferee described in the preceding sentence.ⁿ⁴⁷ Under section 550(d), the trustee is entitled to only a single satisfaction under section 550. Under section 550(e)(1), a good faith transferee from whom the trustee may recover under section 550(a) has a lien on the property so recovered to secure an amount equal to the lesser of (1) the cost of any improvements made to the property after the transfer, less the amount of any profit realized by or for the account of such transferee from the property, and (2) any increase in the value of the property resulting from such improvement. The term "improvement" is defined in section 550(e)(2) to include physical additions and changes, repairs, tax payments, payment of indebtedness on the property secured by a lien superior to the rights of the trustee, and costs of preservation of the property. Under section 550(f), an action or proceeding under section 550 may not be commenced after the earlier of one year after the avoidance of the transfer on account of which recovery is sought, or the time the case is closed or dismissed.

It should be noted that a transferee, other than the initial transferee, that takes for value is not required to meet the section 548(a)(2) requirement to give reasonably equivalent value in exchange for the transfer. Moreover, any immediate or mediate good faith transferee from a transferee (other than the initial transferee) that has given value is immune from recovery if it is acting in good faith, but there is no value requirement as long as the predecessor in title gave value and otherwise satisfied the requirements of section 550(b)(1).ⁿ⁴⁸ It appears that the term "good faith" means, in this context, that the transferee does not know that the transaction is not a normal trade and that there is reason to believe that the transferor was engaged in defrauding his creditors.ⁿ⁴⁹

The holding of *BFP* ⁿ⁵⁰ should eliminate any issue concerning avoidance under *section 548 of the Code* of a mortgage foreclosure sale or similar disposition conducted in accordance with applicable state law. Thus, a mortgage lender or third party purchaser at a foreclosure sale or similar disposition, and a purchaser from such lender or third party, can now rely on its title insofar as section 548 otherwise may have been implicated. Accordingly, the complexities and subjective judgments involved in a section 550 analysis likewise have become irrelevant under the *BFP* holding.

As discussed above, there remains for consideration by the title insurer the effect of *section 544 of the Code* in those jurisdictions that have not adopted the Uniform Fraudulent Transfer Act. To the extent that section 544 may still apply, the issues arising under *section 550 of the Code* must also be considered. There also remain the state law issues (which existed prior to the *Durrett* ruling), relating to (1) the compliance by the mortgage lender with state law foreclosure procedures, (2) the absence of any collusion in connection with the sale, or other chilling of the bidding, and (3) the realization of a price that does not raise a presumption of fraud or unfairness or otherwise "shock the conscience of the court."ⁿ⁵¹

[c] The Title Insurance Considerations

In jurisdictions in which (1) the ALTA or a similar creditors' rights exception is employed but may be omitted or modified under applicable law, and (2) Section 3(b) of the Uniform Fraudulent Transfer Act has been enacted,ⁿ⁵² a title insurer should be willing to omit the exception in the foreclosure sale context if the insurer is satisfied that the state law requirements for the foreclosure have been complied with. In jurisdictions in which (1) the ALTA or a similar creditors' rights exception is employed but may be omitted or modified by the insurer under applicable law, and (2) Section 3(b) of the Uniform Fraudulent Transfer Act has not been enacted, the title insurer should review state law to determine whether the courts have engrafted a *Durrett*-type standard onto the state fraudulent transfer statutes, in order to determine whether to omit the creditors' rights exception in a foreclosure sale context. If such a standard has been adopted, or if there is no law on the issue, the title insurer probably should refuse to omit or modify the creditors' rights exception in a foreclosure sale context.

However, the exception may be omitted in jurisdictions that permit variation of the ALTA creditors' rights exception in the rare instance in which a mortgagee presents an unequivocal and trustworthy appraisal report to the title company demonstrating that reasonably equivalent value is being paid for the asset, and the deletion of the exception is cleared on an underwriting basis on the divisional or national level. Title insurance companies are also more inclined to insure title

insurance without exception in the case of a third-party purchaser at a foreclosure sale. However, once again, an appraisal will be required. Moreover, as noted above, the title insurance company will seek to assure itself that the purchaser is proceeding in good faith and is dealing at arms-length. If any indication of collusive activity exists, the insurance will not be given without an appropriate exception. Finally, in the case of a purchaser from the initial transferee, the title insurance companies appear to be willing to issue insurance without an exception if the title company is satisfied that in the circumstances the requirements of section 550(b) have been met--that is, that the purchaser is acting in good faith and is giving value.

[3] Parcel Assemblage--The Lease Termination Problem

[a] The Legal Issue

In assembling parcels of land to obtain a larger site for the purposes of construction of a new building, a developer may from time to time be constrained to purchase from one or more tenants their leasehold rights in exchange for a conveyance or termination of their leases. It is possible that if such a former tenant subsequently files a petition under the Bankruptcy Code, the trustee will seek to avoid the surrender or conveyance of the lease to the developer. An avoidance action may be commenced under section 548 or 544.ⁿ⁵³ Little doubt remains that the surrender of a lease by the tenant, whether effected by means of a surrender or assignment, constitutes a transfer by the debtor of an interest in property within the meaning of the Bankruptcy Code.ⁿ⁵⁴ The landlord accepting the assignment or surrender of the lease from the tenant is an immediate transferee for purposes of section 550.ⁿ⁵⁵ A purchaser from the landlord, and perhaps even a new tenant, appears to be a transferee from an immediate transferee under section 550.ⁿ⁵⁶ Moreover, a mortgage lender receiving from the landlord a mortgage lien on the property will be dependent upon the validity of the landlord's title for the preservation of its lien position.

[b] The Title Insurance Issue

The foregoing considerations give rise to considerable problems for title insurers asked to issue a clean policy on an assembled parcel with respect to which leases have been surrendered or conveyed to the developer. Obviously, a clean policy is required in order to support construction and permanent financing. Nevertheless, in order to write such a policy, the title companies, in seeking to deal with lease termination problems, would be constrained to ascertain whether each terminated lessee was solvent or received reasonably equivalent consideration for the value of his leasehold. A value determination would necessitate an analysis of the rental levels under the lease, the duration of the lease, the rights of the lessee under the lease (including assignment and subletting rights), and the relation of the lease rental to the then fair market rental value of the property.ⁿ⁵⁷ Title companies are neither equipped nor generally willing to engage in this process. Moreover, it is not clear that the ALTA creditors' rights exclusion in the lenders' policy covers the lease termination issue. This exception relates only to the transactions creating the interest of the mortgagee insured by the policy. It cannot be concluded with any certainty that this language protects a title insurer against claims arising from leasehold surrenders effected during the course of an assemblage. Accordingly, title insurers may want to consider requiring indemnities or other financial coverage if called on to issue policies in these circumstances.

[4] Deeds in Lieu of Foreclosure

[a] The Legal Issue

The principal creditors' rights issues relating to the delivery by a mortgagor to a mortgagee of a deed in lieu of foreclosure are substantially the same as the fraudulent conveyance and avoidance concerns discussed above, that is, whether the mortgagee is paying or otherwise giving reasonably equivalent value for the conveyance.ⁿ⁵⁸ Prior to the Supreme Court's decision in *BFP*, the principal difference is that the imposition by the *Durrett* holdingⁿ⁵⁹ and its progeny of fraudulent transfer standards on regularly conducted foreclosure sales changed the rules applicable to such sales, and the expectations of the parties, notwithstanding several hundred years of history,ⁿ⁶⁰ whereas in the case of a deed in lieu of foreclosure, it has been generally acknowledged that fraudulent conveyance concerns are indeed

appropriate.

A second area of focus with respect to deeds in lieu of foreclosure deals with the question whether the deed is intended to be an absolute conveyance by the mortgagor to the mortgagee and not a new security instrument. Additional concerns include the effect of the deed on the mortgagor's right or equity of redemption, and the obtaining of consents of all necessary parties to the transaction, such as shareholders, partners, or trust beneficiaries.

[b] The Requirements of the Title Companies

The following is a broad form of exception that will be set forth in a title insurance policy relating to a deed in lieu transaction unless certain title company requirements are satisfied:

With respect to the transfer of title by deed from to dated and filed of record on in

(a) Any defect, lien or encumbrance arising by reason of the fact that said deed was given in satisfaction of a mortgage; or

(b) The effects of said transfer being a fraudulent transfer or preference in any proceedings in or related to any chapter of the Federal Bankruptcy Code or the effect of said transfer being invalid under any state insolvency or fraudulent conveyance laws.

If the prospective insured party is unwilling to accept such a broad exception, the title company may issue a policy without exception if all of the following conditions are satisfied:

(a) An estoppel affidavit is executed and acknowledged in recordable form by the grantor of the deed. The estoppel affidavit, a sample of which is set forth at the end of this chapter, includes representations that the deed is intended to be an absolute conveyance and not a mortgage, trust conveyance or security document of any kind; that the grantor was fully aware of the consequence of delivery of the deed; that delivery of the deed was not given as a preference; that there were no other persons, firms or corporations having an interest in the premises (other than the mortgagee) at the time of delivery of the deed; that the grantor is solvent and there are no other creditors whose rights would be prejudiced by the conveyance.

(b) The deed must contain a recital substantially to the effect that it is an absolute conveyance, the grantor having sold the land described therein to the grantee for a fair and adequate consideration, such consideration being full satisfaction of all obligations secured by the mortgage (as described), and that the grantor declares that the conveyance is freely and fairly made, and that there are no agreements, oral or written, other than the deed, between grantor and grantee with respect to the land.

(c) The note or other evidence of indebtedness secured by the mortgage must be surrendered and cancelled, and the deed of trust or mortgage securing such note or other evidence of indebtedness must be released of record.

(d) The grantor in the deed must surrender possession of the property to the grantee.

(e) Evidence of corporate authority (including shareholder resolutions, when required) must be delivered.

(f) The grantor must deliver an independent appraisal of the property satisfactory to the title company. At least one title company requires that the appraisal show that the property is not worth more than the amount of the unpaid principal balance of the mortgage plus accrued interest.

(g) There can be no other circumstances, such as a leaseback with option to repurchase, or an oral agreement to reconvey, which would imply the continued existence of the debt.

(h) The grantor must not be insolvent at the date of execution of the deed.

If less than all of the conditions described in subparagraphs (a) through (h) above are satisfied, it may be necessary to obtain approval on a regional or national office level of the prospective title insurer in order to obtain a clean policy.

Also set forth at the end of this chapter is a second form of estoppel affidavit required by a title company in connection with a deed in lieu of foreclosure which seeks to elicit information as to solvency, direct and contingent liabilities, and information concerning any reconveyance obligations in respect of the deed in lieu of foreclosure.

FOOTNOTES:

(n1)Footnote 1. Before enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the general reachback period under section 548 was one year. The Act extended the period to two years, Pub. L. No. 109-8, § 1402 (2005), but made the change effective only with respect to cases commenced on or after April 21, 2006, *id.* § 1406(b)(2).

(n2)Footnote 1a. 11 U.S.C. § 548.

(n3)Footnote 2. 7A U.L.A. 155 (Supp. 1998).

(n4)Footnote 3. 7A U.L.A. 209 (Supp. 1998).

(n5)Footnote 4. The New York statute of limitations is six years for most purposes pertinent here. See P 2.04 n.10 *supra*.

(n6)Footnote 5. Section 544(a) of the Bankruptcy Code is the "strong arm" provision granting to the trustee the avoidance powers of certain hypothetical creditors and purchasers under state law. Section 544(b) gives the trustee the rights, if any, actual creditors have to set aside prepetition transfers, e.g., under a state fraudulent conveyance law.

(n7)Footnote 6. Although Bankruptcy Code § 548(c) provides that a "transferee or obligee ... that takes for value and in good faith has a lien on or may retain any interest transferred, or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation," this is not likely to afford much protection to the mortgage lender because there was no value given to the debtor. The Act contains a similar provision.

(n8)Footnote 7. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 574 (M.D. Pa. 1983) , *aff'd sub nom. United States v. Tabor Court Realty Corp., et al.*, 803 F.2d 1288 (3d Cir. 1986) , *cert. denied*, *McClellan Realty Co. v. United States*, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987) .

(n9)Footnote 8. *In re Roco Corp.*, 701 F.2d 978, 982, 8 C.B.C.2d 457, 462 (1st Cir. 1983) .

(n10)Footnote 9. *In re Louisiana Indus. Coatings, Inc.*, 31 B.R. 688, 695 (E.D. La. 1983) ; *In re De Feo Fruit Co.*, 24 B.R. 220 (W.D. Mo. 1982) .

(n11)Footnote 10. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 575 (M.D. Pa. 1983) . *But see Credit Managers Ass'n of S. Cal. v. Federal Co.*, 629 F. Supp. 175 (C.D. Cal. 1985) .

(n12)Footnote 11. See P 2.04[2] *supra* for a discussion of the fraudulent conveyance issues affecting "upstream guarantees," and related drafting suggestions. The same analysis will apply in the unusual case of a standard commercial mortgage loan proceeds disbursement that fails to reach the actual borrower. In *Mark Twain Kansas City Bank v.*

Lawyers Title Ins. Corp., 807 F. Supp. 85 (E.D. Mo. 1992), *aff'd*, 996 F.2d 1221 (8th Cir. 1993), the mortgage loan proceeds were disbursed to the account of the general partner of the borrowing partnership, with only a small portion of the proceeds ever reaching the account of the borrower. In the context of a foreclosure, the state court ruled that the note and deed of trust issued in the transaction were invalid for failure of consideration, and the bank lender sought recovery from the title insurer under the policy provision insuring against "the invalidity or unenforceability of the lien of the insured mortgage." The district court denied the claim against the insurer on the grounds that: (1) the disbursement occurred after the issuance of the policy and was a defect occurring "after the date of the policy," and (2) the improper disbursement was known to or should have been known to the bank and was therefore an act of the insured. *Accord*, *Pacific Am. Constr. v. Security Union Title*, 1999 UT 87, 987 P.2d 45 (1999) (loan proceeds never reached issuer of deed of trust, which was held to be unauthorized and invalid).

(n13)Footnote 12. See P 5.02[1][b] *supra*.

(n14)Footnote 12a. See *In re 201 Forest Street LLC*, 409 B.R. 543 (Bankr. D. Mass. 2009); see also *In re Carty*, 400 B.R. 63 (Bankr. W.D. La. 2008) (court looks at true nature of the transaction).

(n15)Footnote 13. See P 5.02[1][d] *infra*.

(n16)Footnote 14. See, e.g., 11 U.S.C. § 510(c); *Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)*, 471 F.3d 977 (9th Cir. 2006); *Comstock v. Group of Inst. Inv.*, 335 U.S. 211, 228-29, 68 S. Ct. 1454, 1463, 92 L. Ed. 1911, 1923 (1948); *Pepper v. Litton*, 308 U.S. 295, 304-11, 60 S. Ct. 238, 244-47, 84 L. Ed. 281, 287-91 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 59 S. Ct. 543, 83 L. Ed. 669 (1939); *Frasher v. Robinson*, 458 F.2d 492, 493 (9th Cir.), *cert. denied*, 409 U.S. 1009, 93 S. Ct. 443, 34 L. Ed. 2d 302 (1972); *In re Credit Indus. Corp.*, 366 F.2d 402, 408-09 (2d Cir. 1966); *International Tel. & Tel. Corp. v. Holton*, 247 F.2d 178, 182-84 (4th Cir. 1957); 4 *Collier on Bankruptcy*, P 510.04 (Matthew Bender 15th Ed. Revised); 3 *Collier on Bankruptcy*, P 57.14 (Matthew Bender 14th ed.); 3A *Collier on Bankruptcy*, PP 63.06, 63.08, 65.06 (Matthew Bender 14th ed.). *But see In re Mobile Steel Co.*, 563 F.2d 692, 699 (5th Cir. 1977) ("equitable considerations can justify only the subordination of claims, not their disallowance"). See generally Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv. L. Rev. 505, 518-26 (1977).

(n17)Footnote 15. E.g., *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 59 S. Ct. 543, 83 L. Ed. 669 (1939); *Comstock v. Group of Inst. Inv.*, 335 U.S. 211, 68 S. Ct. 1454, 92 L. Ed. 1911 (1948) (dominant parent controlling its subsidiary); *In re Multiponics, Inc.*, 622 F.2d 709 (5th Cir. 1980) (director of bankrupt corporation); *DeMet v. Harralson*, 399 F.2d 35 (5th Cir. 1968) (organizers and operators of bankrupt corporation); *Bankers Life & Cas. Co. v. Kirtley*, 338 F.2d 1006 (8th Cir. 1964) (dominating stockholder); *In re Interior Forum, Inc.*, CCH Bankr. L. Rep. P 66,577 (W.D. Va. 1977) (president, director, auditor and business manager).

(n18)Footnote 16. 565 F. Supp. 556 (M.D. Pa. 1983), 584 F. Supp. 671 (1984), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, *McClellan Realty Co. v. United States*, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987), (hereinafter "*Gleneagles*").

(n19)Footnote 17. 565 F. Supp. at 556.

(n20)Footnote 18. 584 F. Supp. at 671.

(n21)Footnote 19. 565 F. Supp. at 571.

(n22)Footnote 20. Pedowitz, *Title Industry Faces Rights of Creditors*, N.Y.L.J., March 15, 1989, p.1, col.3.

(n23)Footnote 21. See P 5.02[2][b] *infra*.

(n24)Footnote 22. Forte & Williams, *Clarification of Change? The Creditors' Exclusion Threatens the Scope of*

Title Insurance Coverage, N.Y. St. Bar Assoc., Real Estate Law Section Newsletter, Vol. 19, No. 3 (July 1991).

(n25)Footnote 23. See P 5.03[b] *infra*.

(n26)Footnote 24. Forte & Williams, *Clarification of Change? The Creditors' Exclusion Threatens the Scope of Title Insurance Coverage*, N.Y. St. Bar Assoc., Real Estate Law Section Newsletter, Vol. 19, No. 3 (July 1991) at 2-3.

(n27)Footnote 25. Forte & Williams, *Clarification of Change? The Creditors' Exclusion Threatens the Scope of Title Insurance Coverage*, N.Y. St. Bar Assoc., Real Estate Law Section Newsletter, Vol. 19, No. 3 (July 1991) at 2-4.

(n28)Footnote 26. Fischman, *Title Insurance, Related Matters Are Updated*, N.Y.L.J., March 18, 1992, p. S-4, col. 3.

(n29)Footnote 27. Fischman, *Title Insurance, Related Matters Are Updated*, N.Y.L.J., March 18, 1992, p.S-4, col.3. In addition, the exclusion cannot be removed or modified in Texas, New Mexico or Florida. The ALTA policy is available in Florida. James L. Gasdin, *Title Insurance: A Comprehensive Overview*, American Bar Assoc., Section of Real Property, Probate and Trust Law (2d ed., 2000) at 91.

(n30)Footnote 28. The exclusion in the Texas forms of lender's and owner's policy is similar but more carefully crafted. The following is the exclusion in the Texas form of lender's policy, with the additions to the ALTA form shown in italics and deletions shown in brackets:

Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or other state or federal [similar] creditors' rights laws, that is based on either:

(i)[(a)] the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer or voidable distribution or voidable dividend or

(ii)[(b)] the subordination or recharacterization of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination or

(iii)[(c)] the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure of the Company or its issuing agent[-]

[(i)] to timely file for record the instrument of transfer to the insured after delivery or

[(ii)] the failure of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

The addition of exclusions for voidable distributions and voidable dividends cover the situations in which an entity violates state law by making distributions or issuing dividends while the entity is insolvent or would be rendered insolvent. This exclusion is probably most appropriate for the owner's policy where the distribution or dividend is in the form of real estate assets for which a policy of title insurance is issued. It is possible, however, that such real estate assets may then be involved in a financing transaction. Although it may be argued that voidable distributions and dividends are already covered by the fraudulent transfer exclusion, there may be concern that the valuation methodologies employed in fraudulent transfer analyses may differ from those employed under state law relating to such dividends and distributions. Valuation is, of course, related to the determination of solvency of an entity.

The addition of an exclusion for recharacterization in addition to equitable subordination is significant, inasmuch as a

transaction characterized as a loan or advance may be recharacterized as an equity investment. See *P 5.02[1][c]*, *supra*. However, the language of the Texas exclusion was not completed, in that the end of subparagraph (ii) refers only to the doctrine of equitable subordination and does not refer to the law of recharacterization. See generally *P 2.02[3]*, *supra*.

The modification of the failure to record exception to the exclusion properly narrows the language to deal with the failure by the title company or its agent to record, but the language or subparagraph (iii) does not connect with the last subsubparagraph, dealing with the failure of the recordation to provide proper notice. The reference to the failure of the title company or its agent should have been placed at the beginning of the first subsubparagraph of subparagraph (iii).

The provisions of the Texas forms and the tracking of the differences between such forms and the ALTA forms are found in James L. Gasdin, *Title Insurance: A Comprehensive Overview*, American Bar Assoc., Section of Real Property, Probate and Trust Law (2d ed., 2000) at 287-88 and 307-08.

(n31)Footnote 29. See *P 5.02[1][d]* *supra*.

(n32)Footnote 30. It may be asked whether a title insurance company should be required to engage in, and issue insurance arising from, a financial analysis that should be made by the insured.

(n33)Footnote 31. See 11 U.S.C. § 548(a)(2)(B)(iii); Unif. Fraud Convey. Act § 6.

(n34)Footnote 32. 11 U.S.C. § 101(31)(B).

(n35)Footnote 33. Unif. Fraud. Convey. Act § 2 (emphasis added).

(n36)Footnote 34. See *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 995-96 (2d Cir. 1981) ; 2 *Collier on Bankruptcy*, P 101.29 (Matthew Bender 15th Ed. Revised).

(n37)Footnote 35. *In re Sierra Steel, Inc.*, 96 B.R. 275 (B.A.P. 9th Cir. 1989) .

(n38)Footnote 36. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 580 (M.D. Pa. 1983) ; see *Wells Fargo Bank v. Desert View Bdg. Supplies, Inc.*, 475 F. Supp. 693 (D. Nev. 1978) , *aff'd without op.*, 633 F.2d 225 (9th Cir. 1980) .

(n39)Footnote 37. 621 F.2d 201, 23 C.B.C. 95 (5th Cir. 1980) .

(n40)Footnote 38. 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) .

(n41)Footnote 39. 511 U.S. 531, 545, 114 S. Ct. 1757, 1765, 128 L. Ed. 2d 556, 569, 30 C.B.C.2d 345, 354 .

(n42)Footnote 40. 511 U.S. 531, 544-45, 114 S. Ct. 1757, 1764-65, 128 L. Ed. 2d 556, 567-68, 30 C.B.C.2d 345, 353-354 . The Court cited *Collier Real Estate Transactions and the Bankruptcy Code at P 5.02[2]* (specifically, pages 5-18 - 19, as constituted in 1992) for the proposition that title insurers have reacted to the *Durrett* holding by including specially crafted exceptions from coverage in many policies issued for properties purchased at foreclosure sales. 511 U.S. at 544, 114 S. Ct. at 1765 . This contention was asserted in the context of a discussion about the harmful effects of uncertainty in the title system resulting from the unpredictable outcome of a post-conveyance *Durrett* challenge.

(n43)Footnote 41. 511 U.S. 531, 537 n.3, 114 S. Ct. 1757, 1761 n.3, 128 L. Ed. 2d 556, 565, 30 C.B.C.2d 345, 349 n.3 . However, several post-BFP cases have held that the price received at a tax foreclosure sale conducted in accordance with state law is "reasonably equivalent value" under section 548. *In re T. F. Stone Co., Inc.*, 72 F.3d 466 (5th Cir. 1995) ; *In re Golden*, 190 B.R. 52 (Bankr. W.D. Pa. 1995) ; *In re Hollar*, 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995) ; *In re Comis*, 181 B.R. 145, 149 (Bankr. N.D.N.Y. 1994) ; *In re McGrath*, 170 B.R. 78, 31 C.B.C.2d 586 (Bankr. D.N.J. 1994) .

(n44)Footnote 42. It is clear that avoidance proceedings under section 544 employ state law fraudulent transfer laws as well as the state law concerning lien priorities, recording statutes and the like. *E.g.*, *Stern v. Continental Assur. Co.* (*In re Ryan*), 851 F.2d 502, 19 C.B.C.2d 490 (1st Cir. 1988) .

(n45)Footnote 43. 7 U.L.A. 650 (1985).

(n46)Footnote 44. The Uniform Fraudulent Transfer Act has been adopted in 39 states and the District of Columbia. 7A U.L.A. 209 (Supp. 1998).

(n47)Footnote 45. See P 5.02[1][d] *supra*.

(n48)Footnote 46. 11 U.S.C. § 550(b)(1).

(n49)Footnote 47. 11 U.S.C. § 550(b)(2).

(n50)Footnote 48. 11 U.S.C. § 550(b)(2).

(n51)Footnote 49. 5 Collier on Bankruptcy, P 550.03 (Matthew Bender 15th Ed. Revised).

(n52)Footnote 50. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) .

(n53)Footnote 51. Osborne, *Mortgages* 689 (West 1970).

(n54)Footnote 52. See P 5.02[2][a], *supra*.

(n55)Footnote 53. See P 5.02[1][b] *supra*.

(n56)Footnote 54. *Darby v. Atkinson* (*In re Ferris*), 415 F. Supp. 33 (W.D. Okla. 1976) ; *Fitzgerald v. Cheverie* (*In re Edward Harvey Co.*), 68 B.R. 851, 16 C.B.C.2d 131 (Bankr. D. Mass. 1987) ; *In re Pinto*, 89 B.R. 486 (Bankr. E.D. Pa. 1989) ; *Spenciner v. Gettinger Assocs.* (*In re Brooklyn Overall Co.*), 57 B.R. 999 (Bankr. E.D.N.Y. 1986) ; *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985) ; *In re Fashion World, Inc.*, 44 B.R. 754 (Bankr. D. Mass. 1984) ; *cf. Pereira v. Checkmate Communications Co.* (*In re Checkmate Stereo & Elec., Ltd.*), 9 B.R. 585 (Bankr. E.D.N.Y. 1981) , *aff'd*, 21 B.R. 402, 6 C.B.C.2d 982 (E.D.N.Y. 1982) ; *In re Sheppard's Dental Ctrs., Inc.*, 65 B.R. 274 (Bankr. S.D. Fla. 1986) ; *In re Jermoo's, Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984) , holds that termination of a franchise agreement does not constitute a transfer under section 548, and that *In re Ferris, supra* , is "anomalous"; see generally Goodman, *Avoidance of Lease Terminations as Fraudulent Transfers*, 43 Bus. Law. 807 (1988).

However, the Supreme Court's holding in *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994) , does raise some doubts as to whether the surrender or loss of a leasehold interest in the ordinary course of a landlord's enforcement of its rights arising from a default can be avoided as a fraudulent transfer under section 548 of the Bankruptcy Code. The Court in *BFP* found that the price received in a regularly conducted, noncollusive, nonjudicial foreclosure sale inherently is a fair price, inasmuch as the value of the asset is a function solely of the forced-sale process to which it is subjected. 511 U.S. 531, 545, 114 S. Ct. 1757, 1765, 128 L. Ed. 2d 556, 569, 30 C.B.C.2d 345, 354 . This analysis is equally applicable to the loss or surrender of a leasehold (as distinguished from the consensual transfer or surrender of a leasehold) arising from a landlord's enforcement of its remedies upon the occurrence of a default. See *In re Durso Supermarkets, Inc.*, 193 B.R. 682 (Bankr. S.D.N.Y. 1996) (holding that although termination of lease pursuant to cross default provision constituted transfer of property, such transfer could not be a fraudulent conveyance because once lease was validly terminated in accordance with state law, debtor lost all rights thereunder), and *Haines v. Regind C. Dixon Trust* (*In re Haines*), 178 B.R. 471 (Bankr. W.D. Mo. 1995) (emphasizing the importance of finality for real estate purposes). Other cases calling into question the applicability of fraudulent transfer law to lease and executory contract terminations include *In re Wey*, 854 F.2d 196,

199 (7th Cir. 1988) (agreement expired); *In re Metro Water & Coffee Servs.*, 157 B.R. 742, 745-47 (Bankr. W.D.N.Y. 1993) ; and *In re Coast Cities Truck Sales*, 147 B.R. 674 (Bankr. D.N.J. 1992) , *aff'd*, 5 F.3d 1488 (3d Cir. 1993) .

(n57)Footnote 55. *In re Queen City Grain, Inc.*, 51 B.R. 722, 726 (Bankr. S.D. Ohio 1985) .

(n58)Footnote 56. 51 B.R. 722, 726-727 (Bankr. S.D. Ohio 1985) .

(n59)Footnote 57. An example of the depth of financial analysis that is required is illustrated in the opinion rendered in *In re Pinto*, 98 B.R. 200 (Bankr. E.D. Pa. 1989) .

(n60)Footnote 58. *See P 5.02[2][a] supra*.

(n61)Footnote 59. *See P 5.02[2][a] supra*.

(n62)Footnote 60. *See generally* Zinman, Houle & Weiss, *Fraudulent Transfer According to Alden, Gross & Borowitz: A Tale of Two Circuits*, 39 *Bus. Law* 977 (1984).



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

1-5 Collier Real Estate Trans & Bankruptcy Code P 5.03

P 5.03 Other Creditors' Rights Issues Affecting Title Insurance

[1] Option Agreements

In most circumstances, an option agreement is rejectable by the trustee for the obligor under the option. Option agreements are executory contracts within the meaning of *section 365(a) of the Bankruptcy Code*.ⁿ¹ A distinctive attribute of most contracts for the sale of real property, including option agreements, is the general availability of the remedy of a specific performance against a defaulting seller. If, however, the seller or obligor under the option is a debtor under the Bankruptcy Code, and rejects the agreement, it is highly unlikely that a bankruptcy court will order specific performance for the benefit of the complaining optionor.ⁿ² The reason for the denial of specific performance is that the issuance of a specific performance decree would deny the estate the benefits sought to be realized by rejection.ⁿ³

In light of the foregoing, title insurance companies will ordinarily take a broad bankruptcy exception in policies dealing with purchase options. The insurance, and the bankruptcy exception, may read as follows:

Company hereby assures the insured that the option to purchase provided for in the agreement dated between and, a memorandum of which is to be recorded in the office of the register of the county of, is as of the date hereof, valid, and that the right of the optionor under said option is vested in the insured, subject to the terms, covenants, conditions and provisions thereof, and subject to the following further exceptions:

(a) Bankruptcy or other insolvency of the optionee, its successors or assigns.

The more specific bankruptcy exception may still be necessary notwithstanding the adoption of the broad ALTA creditors' rights exclusion. The ALTA exclusion relates only to the transaction vesting in the insured the interest insured by the policy, that is, the creation of the option. This language could be construed against the title insurer as not covering a subsequent bankruptcy and rejection of the option.

[2] Contracts for Sale--Vendee in Possession

In contrast to the general unavailability of a specific performance decree under a standard contract of sale or option agreement wherein the vendor is a debtor in a Bankruptcy Code case and rejects the agreement, *section 365(i) of the*

Bankruptcy Code recognizes a specific performance right in vendee in possession situations. Section 365(i) provides:

(i)(1) If the trustee rejects an executory contract of the debtor for the sale of real property ... under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property ...

(2) If such purchaser remains in possession--

(A) Such purchaser shall continue to make all payments due under such contract, but may offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) The trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.

In contrast to the title insurance results obtained in option contract situations, some title companies are willing to issue affirmative insurance as to the vendor's obligation to deliver the deed in a vendee in possession situation. The following is an exception set forth in a policy insuring the vendee's rights under a contract for deed, with a carve-out from the exception affirmatively insuring that the deed will be delivered:

The effect of federal bankruptcy law on the interest of the insured, except that, if the vendee is in possession, the policy insures against the refusal of a trustee in the event of vendor's bankruptcy, to issue a deed pursuant to the contract. Even if the ALTA creditors' rights exclusion were deemed to apply to the creation of the interest of a vendee in possession,ⁿ⁴ the insured should be afforded the benefits of the affirmative insurance set forth above.

[3] Loans from a General Partner to the Partnership and from a Managing Member to the Limited Liability Company

Section 548(b) of the Bankruptcy Code provides that the trustee of a partnership debtor may avoid transfers made and obligations incurred to a general partner of the debtor within one year prior to the filing of the petition if the debtor was insolvent on the date of such transfer or incurrence, or became insolvent as a result thereof. For purposes of section 548(b), it is irrelevant that the debtor received fair consideration in return for the transfer. Accordingly, there is an inherent infirmity with respect to a mortgage loan transaction between a partnership, as borrower, and one of its general partners, as lender.ⁿ⁵ If a general partner secures a loan to the partnership with a mortgage on real property owned (or leased) by the partnership, the general partner may require a policy of lender's title insurance as a condition of consummating the transaction. The standard ALTA creditors' rights exceptionⁿ⁶ includes claims that are based on fraudulent conveyance or fraudulent transfer provisions of federal bankruptcy laws. Subsection (b) of *section 548 of the Bankruptcy Code* is of course part of section 548, which deals with fraudulent transfers and obligations. Therefore, the standard ALTA creditors' rights exception will include claims arising under section 548(b).

Thus a general partner--lender will have no title insurance protection for this claim unless it negotiates for the modification of the exception. In states which permit modification of a standard exception, modification may be achieved upon presentation of evidence described above demonstrating the solvency of the borrowing partnership.ⁿ⁷ The modification of the exception will have to be narrowly drawn and limited to claims under *section 548(b) of the Code*, inasmuch as the title insurer most likely will be unwilling to eliminate the other provisions of the creditors' rights exception.

The section 548(b) problem should be considered in transactions involving both a loan and an equity investment in a

real estate project by the same financial institution. In these transactions, the lending institution may be, or may be deemed to be, a partner of the real estate owner receiving the benefits of the investment. Thus the loan component of the transaction may be viewed as a loan by a general partner to the partnership. Although in some instances the financial institution is able to take its equity position in a different entity than the entity that makes the mortgage loan, consideration must be given to the possibility that a court might hold that there is an identity between the holder of the partnership interest and the holder of the mortgage loan.

Of course, many real estate transactions formerly executed in partnership form are presently done through the vehicle of a limited liability company ("LLC").ⁿ⁸ While such entities share many attributes with limited partnerships, absent amendments to the Bankruptcy Code that expressly address LLCs, it is likely that for purposes of the Bankruptcy Code LLCs will be treated as corporations under the provisions dealing with the filing of petitions, and will be treated as partnerships under section 365 and other provisions of the Code.ⁿ⁹

These other provisions may well include section 548(b) when a managing member of an LLC makes a loan to the LLC. In that circumstance, the ability of a managing member to control the affairs of an LLC, and to abuse its position by receiving a transfer from the LLC, are similar to the position of a general partner in a partnership. Accordingly, a court may deem section 548(b) to apply to the loan transaction.ⁿ¹⁰ It is therefore necessary in the LLC environment to take into account the same title insurance considerations discussed above with respect to insider loans.

[4] Upstream Transactions

It is clear that a guarantee by a corporate subsidiary of the indebtedness of its parent, with a mortgage securing the obligations of the subsidiary under the guarantee, may be subject to avoidance as a fraudulent transfer under *section 548(a) of the Bankruptcy Code* and similar provisions of state law. The subsidiary receives no consideration for the incurrence of the guarantee obligation and the subjugation of its property to the mortgage lien.ⁿ¹¹ Nevertheless, as indicated above, not all conveyances and obligations incurred without reasonably equivalent consideration constitute fraudulent transfers.ⁿ¹² The other elements of section 548(a), and of state law, must be present--principally, that the obligor be insolvent at the time of the transfer or that the transfer render the obligor insolvent. If it can be clearly demonstrated that insolvency is not present, and the guarantee obligations are otherwise enforceable in accordance with state law, there is no reason why a title policy without the exception cannot be issued with respect to the mortgage lien, unless the relevant jurisdiction prohibits the omission or any variation of the ALTA creditors' rights exclusion. It must be emphasized, however, that the demonstration of solvency must be clear and convincing, so that the title company will be satisfied that there is not a material risk of triggering its obligation to defend (as opposed to the substantive obligation on the claim).

[5] Mortgagee's Option to Purchase--Clogging the Equity of Redemption

[a] The Substantive Issue

In certain instances, a mortgage lender may make a loan, perhaps at a favorable interest rate, and receive in return, in addition to the mortgage collateral, an option to purchase an interest in the property at a future date. The exercise price of the option may be keyed to the unamortized balance of the loan. In some transactions, the lender may take a second option to buy the balance of the interests in the property at fair market value.

The principal legal difficulty with respect to the enforceability of these options, and its effect on the mortgage, arises under the doctrine generally called "clogging the equity of redemption." This means that the mortgagee cannot impair or circumvent the mortgagor's right of redemption of the property, through the exercise of the mortgagee's purchase option in lieu of the prosecution of its foreclosure remedies. The clogging doctrine may be viewed as incorporating the following three subdoctrines: (1) "once a mortgage always a mortgage"--meaning that the mortgage cannot be made irredeemable; (2) the mortgage shall not contain a "collateral advantage"--meaning that the lender is only entitled to

interest, principal and costs; and (3) the doctrine of "fettering"--meaning there can be no bargain binding the mortgaged property beyond the redemption period that can prevent the mortgagor, having paid principal, interest and costs, from retrieving the property.ⁿ¹³

[b] Title Insurance Considerations

In general, title insurers appear willing to insure an option given in connection with a mortgage loan only if the agreement contains an "unwind mechanism" under which the borrower, for additional consideration, may buy back the option of the lender and thereby redeem his property.ⁿ¹⁴ Title insurance companies also consider the following factors in determining whether to insure the option:

- (1) The existence of separate consideration given by the mortgagee for the option;
- (2) Whether the option is limited to part of the interests in the property, or a physical part of the property, and the extent of that limitation;
- (3) Whether the transaction has been negotiated at arms-length and with appropriate legal advice;
- (4) Whether the option is exercisable in the event of a default under the mortgage. The last factor is particularly important, in that the existence of the right of exercise upon default may be a means to circumvent the foreclosure requirements of applicable state law and cut off redemption rights.ⁿ¹⁵

An additional issue is whether the title insurance for the mortgage loan and the separate policy issued to the lender insuring the option will be issued under a simultaneous rate and provide that payment under the mortgage policy will reduce the amount of coverage under the policy insuring the option. If the lender elects to have the policy insuring the option reduced in amount if it realizes upon a foreclosure of property, the following special endorsement may be added to each policy:

The amount of insurance under this policy shall be reduced automatically by any amount that the title company may pay under its policy no. insuring that certain (mortgage or option to purchase) from to dated and recorded in

Of course, the lender may elect to treat the policies as independently issued and pay the appropriate premiums therefor. In that instance, the lender-optionee may obtain a special endorsement to the effect that the amount of insurance under each policy shall not be reduced by reason of any payments made under the other policy.ⁿ¹⁶

[6] Mortgages to Secure Antecedent Debt

The problems attendant to the delivery of security for antecedent debt begin with the issues affecting preferential transfers under *section 547 of the Bankruptcy Code*. Under that section, a trustee may avoid a prepetition transfer by a debtor on account of an antecedent debt, to or for the benefit of a creditor, made while the debtor was insolvent, on or within 90 days before the date of filing of the petition (the period is one year if the creditor at the time of transfer was an "insider"), that enables the creditor to receive more than it would have received in a chapter 7 liquidation of the debtor had the transfer not been made.ⁿ¹⁷ A number of exceptions in section 547(c) render unavoidable transfers that otherwise would be avoidable, including substantially contemporaneous transfers for new value, transfers in the ordinary course of business, the creation of certain purchase money security interests, and the transfer to a creditor in exchange for new value from the creditor.ⁿ¹⁸ Under section 547(e)(1)(A), a transfer of real property other than fixtures is deemed perfected for section 547 purposes when a bona fide purchaser from the debtor could not acquire an interest superior to that of the transferee. Under section 547(e)(2), a transfer is deemed made when it takes effect between the transferor and transferee if it is perfected within 30 days thereafter. However, in the case of the creation of a purchase money security interest, the transfer is deemed made when it takes effect between the transferor and the transferee if it is

perfected 30 days after the debtor receives possession of the property.ⁿ¹⁹ If not perfected within these 30-day periods, the transfer is deemed made when perfected.ⁿ²⁰ The transfer is deemed made immediately before the filing of the petition if it is not perfected at the later of the commencement of the case or 30 days after the transfer takes effect between the transferor and transferee.ⁿ²¹

There is a presumption of the debtor's insolvency during the 90 days immediately preceding the petition filing date.ⁿ²² The burden of proof of avoidability under section 547(b) is on the trustee and the burden of proof as to nonavoidability under section 547(c) is on the creditor.ⁿ²³

The foregoing recitation of the basic preference provisions of the Code largely explains the circumstances in which a title company will write a preference exception into a policy dealing with a mortgage securing an antecedent debt, or insist upon retention of the ALTA creditors' rights exclusion.ⁿ²⁴ In order to eliminate the exception, it is necessary either to demonstrate that one of the elements of a preferential transfer is absent (for example, that the transferor is not insolvent), or that the transfer falls within one of the section 547(c) exceptions.

Even if the preference issues are resolved in favor of elimination of the title insurance exception, there are other title insurance issues that arise in the context of a mortgage to secure an antecedent debt. Thus, under New York law, the mortgagee, although it records the mortgage, may not have the benefit of the recording act as against preexisting unrecorded interests, because the statute protects only as to transactions entered into "in good faith and for a valuable consideration."ⁿ²⁵ Similarly, again in New York, the absence of consideration may result in lien priority for unpaid mechanics and materialmen, who are ordinarily denied priority in exchange for the trust fund provisions of the New York Lien Law.ⁿ²⁶ If there is no consideration, then there is no trust fund. These circumstances will of course result in title insurance exceptions which appear to be unassailable unless appropriate indemnification is provided to the title company.ⁿ²⁷ Indeed, in the case of a New York, Texas, New Mexico or Florida transaction, the title insurer is without authority to eliminate the ALTA creditors' rights exclusion, and therefore the exclusion will in all cases be retained.ⁿ²⁸

[7] Partnership and Limited Liability Company Dissolution

Discussed elsewhere in this book is the question of whether the bankruptcy of a general partner of a general or limited partnership necessarily results in a dissolution of the partnership.ⁿ²⁹ In a nonbankruptcy context, it has been held that the dissolution of a general partnership under Ohio law by reason of the departure of one of the partners resulted in the formation of a new entity comprised of the remaining partners, and that, therefore, the title insurance coverage obtained by the dissolved partnership no longer protected the new partnership or its partners.ⁿ³⁰ It would appear that the rationale of this holding would also apply in the context of the dissolution of a partnership by reason of the bankruptcy of a general partner thereof. Moreover, if a bankrupt general partner were to be permitted to assume or assign its rights and obligations under a partnership agreement to a third party, it may be argued that the risk of loss of the original title insurance coverage would be lost if the partnership were deemed to have been dissolved and then reconstituted. By reason of the foregoing, an endorsement to title insurance coverage may be requested and obtained (in states that have approved the same) to continue coverage notwithstanding transfers of partnership interests, the omission, substitution or withdrawal of any partners, or any change in a partner's interest in the capital or profits of a partnership. This endorsement reads as follows:

The company hereby assures and agrees with the insured that, notwithstanding anything to the contrary contained in this policy, in the event of loss or damage insured against under this policy, the Company shall not deny liability under this policy to the insured on the ground that on or after the effective date of this policy a dissolution or termination of the insured partnership has occurred or a new partnership has been formed solely by reason of (a) any one or more transfers of all or any part of the partnership interests of any one or more of the partners of the insured partnership, or (b) the admission, substitution or withdrawal of any one or more partners, or (c) a change in any partner's interest in the capital or profits or, as a limited or general partner in, the insured partnership where, under the terms of

the partnership agreement of the insured partnership (as the same may be amended and restated), the business of the insured partnership continues after such event. Each of the events described in clauses (a)-(c) above is hereinafter referred to as a "Permitted Transfer."

The Company hereby agrees that it shall be and remain liable to the named insured or any successor of the named insured after any such Permitted Transfer, in accordance with all of the terms and provisions of this policy, notwithstanding any such Permitted Transfer. The benefits of the insurance coverage provided or herein shall be limited to the date of the policy and, except as provided herein, shall be subject to the Exclusions From Coverage, the Schedules and the Conditions and Stipulations of the Policy (except as the same have been or may be modified by the Company), and any rights or other defenses the Company would have had against the named insured or its constituent partners before or after any Permitted Transfer.

This endorsement is made a part of the policy. It is subject to all of the terms of the policy and prior endorsements. Except as expressly stated on this endorsement, the terms, dates and amount of the commitment or policy and prior endorsements are not changed.

If the foregoing endorsement is contained in a policy that also includes the creditors' rights exclusion discussed above,ⁿ³¹ then it should be made clear that the endorsement will prevail over any inconsistent language set forth in the creditors' rights exclusion. Inasmuch as some states may prohibit modification or omission of the creditors' rights exclusion, it should be determined in the appropriate jurisdiction whether a reconciliation of the two endorsements will be permitted.

Limited liability companies are also involved in the issue of the effect of the bankruptcy of a managing member.ⁿ³² However, it appears that under the statutes governing these entities, the termination of the existence of the entity is a matter of choice for the remaining members, and is not an event that would occur as a default event.ⁿ³³ Nevertheless, the issue should be considered in the light of the title insurance issue, and appropriate endorsements similar to those set forth above for partnerships should be requested.

FOOTNOTES:

(n1)Footnote 1. *See P 4.02[2] supra.*

(n2)Footnote 2. *See P 4.01[1] supra.*

(n3)Footnote 3. *See P 4.01[1] supra.* There is a view that the rejection of executory contracts and unexpired leases does not terminate the contract or lease from the perspective of the nondebtor party. The rejection merely signifies that the estate has elected not to take on the obligations of the contract or lease. *See generally* Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U. Colo. L. Rev. 845 (1988).

(n4)Footnote 4. *See P 5.03[1] supra.*

(n5)Footnote 5. Kashner, *Financing Limited Partnerships and Their Partners: Caveat Creditor*, 37 Bus. Law 171, 185-188 (1981).

(n6)Footnote 6. *See P 5.02 [1][d] supra.*

(n7)Footnote 7. *See P 502[2][e] supra.*

(n8)Footnote 8. *See generally P 4.07[3] supra.*

(n9)Footnote 9. *See Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996) .

(n10)Footnote 10. See *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996) .

(n11)Footnote 11. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 576-77 (M.D. Pa. 1983) , *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986) .

(n12)Footnote 12. See P 5.02[1][b] *supra*.

(n13)Footnote 13. Cases dealing with the clogging doctrine include *Humble Oil and Refining Co. v. Doerr*, 123 N.J. Super. 530, 303 A.2d 898 (N.J. Super. Ct., 1973) ; *Smith v. Smith*, 82 N.H. 399, 135 A. 25 (1926) ; *MacArthur v. North Palm Beach Utils., Inc.*, 202 So. 2d 181 (Fla. 1967) . A more comprehensive discussion of the "clogging" issue and related title insurance issues is set forth in Bowling, *Exotic Financing*, Title Insurance in 1984, 359, 378-94 (PLI 1984).

(n14)Footnote 14. Bowling, *Exotic Financing*, Title Insurance in 1984, 359, 386 (PLI 1984).

(n15)Footnote 15. Bowling, *Exotic Financing*, Title Insurance in 1984, 359, 386-88 (PLI 1984).

(n16)Footnote 16. Bowling, *Exotic Financing*, Title Insurance in 1984, 359, 391-93 (PLI 1984).

(n17)Footnote 17. 11 U.S.C. § 547(b).

(n18)Footnote 18. 11 U.S.C. § 547(c)(1), (3), (4).

(n19)Footnote 19. 11 U.S.C. § 547(e)(2)(A). In 2005, the period for transfers other than purchase money security interests was increased from 10 to 30 days, and the period for purchase money security interests was increased from 20 to 30 days.

(n20)Footnote 20. 11 U.S.C. § 547(e)(2)(B). The period was increased from 10 days to 30 days in 2005.

(n21)Footnote 21. 11 U.S.C. § 547(e)(2)(C). The period was increased from 10 days to 30 days in 2005.

(n22)Footnote 22. 11 U.S.C. § 547(f).

(n23)Footnote 23. 11 U.S.C. § 547(g).

(n24)Footnote 24. See P 5.02[1][d] *supra*.

(n25)Footnote 25. N.Y. Real Prop. L. § 291.

(n26)Footnote 26. N.Y. Lien L. § 13.

(n27)Footnote 27. See Colletti, *A Title Insurer Looks at the Avoidance Provisions of the Bankruptcy Reform Act of 1978*, 15 Real Prop., Prob. & Trust J. 588 (1980). Prior to the adoption of the standard ALTA creditors' rights exclusion, litigation arose from time to time when a lending institution would seek recovery from a title insurer after a mortgage was deemed avoidable under a theory of preferential transfer. The insurers prevailed under other policy exclusions or doctrines of law, including the exclusion for events occurring after the date of the policy and the failure of the lending institution to disclose to the insurer material facts concerning the borrower's financial condition. See *Chicago Title Ins. Co. v. Citizens & S. Nat'l Bank*, 821 F.Supp. 1492 (N.D. Ga. 1993) , *aff'd sub nom.*, *Chicago Title Ins. Co. v. Nations Bank*, 20 F.3d 1175 (11th Cir. 1994) ; *First Nat'l Bank & Trust Co. of Port Chester v. New York Title Ins. Co.*, 171 Misc. 854, 12 N.Y.S.2d 703 (Sup. Ct. Westch. Co. 1939) .

(n28)Footnote 28. See Fischman, *Title Insurance, Related Matters Are Updated*, N.Y.L.J., March 18, 1992, p. S-4, col. 3.

(n29)Footnote 29. *See P 4.07 supra.*

(n30)Footnote 30. *Fairway Dev. Co. v. Title Ins. Co.*, 621 F. Supp. 120 (D.C. Ohio 1985) .

(n31)Footnote 31. *See P 5.02[1][d] supra.*

(n32)Footnote 32. *See P 4.07[3] supra.*

(n33)Footnote 33. For example, under § 601(7) of the Uniform Limited Liability Company Act (1996), the event of a member's becoming a "debtor in bankruptcy" results in the dissociation of that member from the limited liability company. Under § 603, if the entity does not dissolve, it must purchase the distributional interest of the dissociated member. Dissolution of the entity is not mandatory.



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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

1-5 Collier Real Estate Trans & Bankruptcy Code §§ 5.04through 5.50

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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

*1-5 Collier Real Estate Trans & Bankruptcy Code P 5.51***P 5.51 Form--Affidavit of Corporation** Giving Deed in Lieu of ForeclosureForm--Affidavit of **Corporation** Giving Deed in Lieu of Foreclosure.

	)	
STATE OF	)	ss
COUNTY OF	)	

..... and, being first duly sworn, each for himself, deposes and says:

That they are the and respectively, of, the corporation which made, executed, and delivered that certain deed to dated, conveying the following described property, to wit:

(DESCRIPTION)

That they make this affidavit for and on behalf of said corporation pursuant to a resolution of its Board of Directors;

That the aforesaid deed was intended to be and was an absolute conveyance of the title to said premises to the grantee named therein, and was not and is not now intended as a mortgage, trust conveyance, or security of any kind; that it was the intention of said corporation as grantor in said deed and by said deed said corporation did convey to the grantee therein all of its right, title and interest absolutely in and to said premises; that possession of said premises has been surrendered to the grantee;

That aforesaid deed was not given as a preference against any other creditors of the deponent; that at the time it was given there was no other person or persons, firms or corporations, other than the grantee therein named interested, either directly or indirectly, in said premises; that the deponent is solvent and has no other creditors whose rights would be prejudiced by such conveyance, and that deponent is not obligated upon any bond of other mortgage whereby any lien has been created or exists against the premises described in said deed;

That in the execution and delivery of said deed said corporation was not acting under any misapprehension as to the effect thereof, and acted freely and voluntarily, and was not acting under coercion or duress; that the consideration for said deed was and is payment to said corporation of the sum of \$ by grantee and the full cancellation of all debts, obligations, costs and charges secured by the certain mortgage heretofore existing on said property, executed by to, dated, and recorded in the Book of Official Records, page, ... County, ... and release of record of said mortgage; that the time of making said deed said corporation believed, and affiants as officers of said corporation believed and now believe, that the aforesaid consideration therefor represents the fair value of the property so deeded;

This affidavit and estoppel certificate is made for the protection and benefit of the grantee in said deed, his successors and assigns, and all other parties hereafter dealing with or who may acquire an interest in the property herein described;

That affiants, and each of them, will testify, declare, depose, or certify before any competent tribunal, officer, or person, in any case now pending or which may hereafter be instituted to the truth of the particular facts hereinabove set forth;

That said affiants have executed this affidavit and estoppel certificate as individuals, and also for and on behalf of said corporation pursuant to authority of the Board of Directors of said corporation.

.....

.....

.....Company

By:

President

By:

Secretary

(Add appropriate language for recordable affidavit in your state.)



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CHAPTER 5 Creditors' Rights Issues Affecting Title Insurance

1-5 Collier Real Estate Trans & Bankruptcy Code P 5.52

P 5.52 Form--Proof as to Financial Condition of Grantor (Deed in Lieu of Foreclosure)

Form--Proof as to Financial Condition of Grantor (Deed in Lieu of Foreclosure).

Premises:

Information is required in connection with the proposed deed to be delivered to the insured in this title in order to assist in passing upon the question of the rights of creditors, if any, of the grantor. The statement should be signed, as indicated, and verified before an officer authorized to administer oaths and take acknowledgment of deeds. If grantor is a corporation, this statement should be made by some officer thereof familiar with the facts. *If additional space is required, additional sheets should be added and initialed.*

This statement should be properly filled in,
sworn to and returned prior to the
date of closing.

1. Name(s) and residence(s) of deponent(s). *If corporation, give office held by deponent and name and principal office of corporation.*
2. Are you/Is the corporation liable on any obligation secured by mortgage or on any extension or other agreement in and by which you/it assumed or agreed to pay a mortgage debt covering property other than that above mentioned? If so, give amount of such liability on each, together with location of the real estate security, and the equity in each parcel over and above the amount of the mortgages. State whether each such mortgage is a first or junior lien.
3. Are you/Is the corporation liable on any outstanding note, bond, endorsement, guaranty or any agreement to pay a sum of money, other than those mentioned in the preceding paragraph? If so, give full details and the amount unpaid thereon.
4. Is there any pending litigation against you/the corporation or do you know of any accidents or other circumstances for which you/it may be or become liable for damages or other claims? If so, give full details.
5. If the preceding question is answered in the affirmative are you/is the corporation covered by liability or other insurance, and if so, in what amount and in what Company?

6. Have you/Has the corporation ordered or had any work done or purchased any fixtures, equipment or articles of personal property, installed or to be installed, in any property owned by you/it which have not been paid for in full, or for which a financing statement under the Uniform Commercial Code could be filed? If so, give full details and amount remaining unpaid thereon.
7. Have you/Has the corporation any other outstanding indebtedness, obligation of liability, matured or unmatured, contingent or otherwise? If so, give full details and the amount thereof.
8. Is the deed about to be delivered an absolute, voluntary conveyance of the premises?
9. What is the consideration for such deed?
10. Is there any arrangement or understanding, express or implied, as to the use of the consideration for the deed for the payment of any specific group or class of creditors? If yes, explain fully.
11. Will the delivery of such deed render you/the corporation insolvent?
12. Is the income from said premises sufficient to meet the expenses and carrying charges thereof?
13. Does the present fair value of said premises exceed the amount of the existing mortgage or mortgages, with accrued interest, taxes, assessments and water charges with penalties, to which the grantee takes subject, including any mortgage which grantee will satisfy? (Attach appraisal or basis for value.)
14. If your answer to either of questions 12 and 13 is in the affirmative, set forth the comparative figures and state the reason for delivering the deed for the consideration mentioned.
15. Is there any understanding or agreement, written or oral, whereby said premises are to be reacquired by or for you/the corporation in any event whatsoever? If so, give substance thereof.

The undersigned makes the foregoing verified statements based upon personal knowledge, unless indicated otherwise, to induce to issue their policy of title insurance numbered as above, insuring the grantee of said deed, and to induce the grantee of said deed to accept the conveyance of said premises, knowing that they will rely on the trust of the statement herein made. This statement also includes additional sheets, each of which has been initialed by the undersigned.

Dated:

[Verification]



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CHAPTER 6 Environmental Issues in Bankruptcy *

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CHAPTER 6 Environmental Issues in Bankruptcy *

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P 6.01 Introduction

As the federal and state governments have adopted legislation to protect the public from the dangers of hazardous wastes, conflicts have arisen between the enforcement of these statutes and the Bankruptcy Code's goals of protecting the debtor from creditor harassment, offering the debtor a "fresh start" and maximizing the value of the estate for the benefit of creditors.ⁿ¹ In the words of one commentator:

There is a natural tension between the rehabilitative purpose of bankruptcy and the "polluter pays principle" underpinning environmental law. Whereas chapter 11 bankruptcy protection is intended to give debtors a "fresh start" and ensure equality of treatment of creditors, major environmental cleanup statutes attach strict, joint and several liability to responsible parties to ensure that the persons receiving the benefits of polluting pay for remedying it, not taxpayers or future generations.^{n1a}

Provisions of the Code--such as the automatic stay, stays issued under section 105, the discharge of debts and the trustee's right to abandon burdensome property--have been used by debtors to avoid or defer liability for the cleanup of contaminated real property.ⁿ² With respect to the fundamental protections of the automatic stay, there has been substantial case law, often inconsistent, concerning the rights of governmental units to bring actions or proceedings against debtors that are asserted to be exercises of the unit's police or regulatory powers.^{n2a}

Although two Supreme Court cases addressed the application of Code provisions to debtors facing environmental cleanup liability,ⁿ³ the Court's holdings have been narrow and their implications less than clear.ⁿ⁴ In addition, a United States Supreme Court case that addressed the issue of a parent corporation's liability under CERCLA for the environmental liability of its subsidiary may serve to both limit, in some cases, and also expand, in other cases, the scope of liability in the case of bankrupt or other financially distressed subsidiaries.ⁿ⁵

Uncertainty also exists about the priority of claims against a bankrupt debtor made by a governmental entity for funds expended to clean up the debtor's property. Several states have sought to resolve this question by adopting "superlien" statutes that grant the state a first priority lien, senior to any previously recorded security interest, against the affected real property (and, in some cases, other property of the responsible party) for cleanup costs incurred by the state.ⁿ⁶ It has been held that these superliens can be perfected postpetition, notwithstanding the automatic stay, pursuant to the stay exception in section 362(b)(3), and that a trustee may be limited in its ability to avoid any such superlien by reason of section 546(b)(1)(A).ⁿ⁷ Although such liens may, in certain circumstances, be subject to the trustee's lien avoidance

powers, the ability of such liens to prime preexisting security interests without notice raises serious constitutional and policy issues.

Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"),ⁿ⁸ which creates a "Superfund" to be used by the government to clean up hazardous waste sites and permits the government to seek reimbursement from responsible parties. Amendments to CERCLA adopted in 1986 grant the federal government a lien against the contaminated property for cleanup costs incurred. However, unlike the state "superlien" statutes, the lien provided for under CERCLA is subordinate to previously recorded encumbrances.ⁿ⁹ Not surprisingly, given the fact that debtors in bankruptcy often do not have meaningful or sufficient assets to cover such cleanup costs, there has been a substantial amount of litigation since the enactment of CERCLA concerning the scope of potentially responsible parties, including the possible liability of lenders having liens relating to a contaminated site. In response to certain court decisions, including the well-known *Fleet Factors* decision,ⁿ¹⁰ Congress further amended CERCLA in 1996 to provide certain guidance for secured lenders seeking to avoid becoming the "deep pocket" for the cleanup of a polluted site.ⁿ¹¹

Some of the principal CERCLA issues that arise in the bankruptcy context include the following: when does a CERCLA claim "arise" for purposes of the discharge provisions of the Code; the scope of the automatic stay with respect to governmental proceedings to enforce CERCLA obligations; whether claims for reimbursement of CERCLA response costs incurred postpetition should be treated as administrative expenses of the bankruptcy estate; and whether an estate's CERCLA liability survives the abandonment of contaminated property. These issues have been addressed by a number of judicial decisions, including rulings by several courts of appeals. There have also been a number of major judicial decisions delineating the scope of CERCLA liability for parent corporations and other affiliates of primarily responsible parties as well as the application of principles of successor liability.ⁿ¹² Finally, in light of statutory and case law developments under CERCLA, some suggestions are offered to minimize the risks to mortgage lenders of incurring liability for environmental hazards caused by their borrowers.

Congress also enacted the Resource Conservation and Recovery Act ("RCRA"),ⁿ¹³ which imposes obligations on persons who generate, store, dispose or treat hazardous wastes, and also deals with cleanup obligations of owners and operators of underground storage tanks.

FOOTNOTES:

(n1)Footnote 1. The interaction between environmental protection laws and the Bankruptcy Code has been the subject of much commentary. For an thorough overview of the subject, see Adam P. Strochak et al., *Collier Monograph: Environmental Issues in Bankruptcy Cases* (2009). See also Baird & Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 *Stan. L. Rev.* 1199 (1984); Broude, *Automatic Stay and Postpetition Recordation of State Environmental Superlien Laws*, 18 *The Bankruptcy Strategist* 1 (2001); Buschman & Joyce, *The Impact of the Bankruptcy Code on Environmental Disputes*, 12 *A.L.I.-A.B.A. Course Materials J.* 87 (1987); Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability and Toxic Waste Cleanup*, 50 *Law & Contemp. Probs.* 119 (1987); Cosetti & Friedman, *Midlantic National Bank, Kovacs and Penn Terra: The Bankruptcy Code and State Environmental Law-- Perceived Conflicts and Options for the Trustee and State Environmental Agencies*, 7 *J. Law & Comm.* 65 (1987); Drabkin, Moorman & Kirsch, *Bankruptcy and the Cleanup of Hazardous Waste: Caveat Creditor*, 15 *Envtl. L. Rep.* 10,168 (1985); Epling, *Environmental Liens in Bankruptcy*, 44 *Bus. Law.* 85 (1988); Goodwyn, *Claims Estimation and the Use of the "Cleanup Trust" in Environmental Bankruptcy Cases*, 9 *Am Bankr. Inst. L. Rev.* 769 (2001); Heidt, *The Automatic Stay in Environmental Bankruptcies*, 67 *Am. Bankr. L.J.* 69 (1993); Heidt, *Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies*, 40 *Rutgers L. Rev.* 819 (1988); Hennigan, *Accommodating Regulatory Enforcement and Bankruptcy Protection*, 59 *Am. Bankr. L.J.* 1 (1985); Hoffman, *Environmental Protection and Bankruptcy Rehabilitation: Toward a Better Compromise*, 11 *Ecology L.Q.* 671 (1984); Huss, *CERCLA Operator Liability: What Is Parent Corporation to Do After United States v. Bestfoods*, 111 *Del. L. Rev.* 111 (1999); Klein, *Hazardous Waste Liability and the Bankruptcy Code*, 10 *Harv. Env'tl. L. Rev.* 533 (1986); Klerman, *Earth First?*,

CERCLA Reimbursement Claims and Bankruptcy, 58 U. Chi. L. Rev. 795 (1991); Kruger, Walper & Shinderman, *Environmental Issues in Bankruptcy*, 1 Current Developments in Bankruptcy and Reorganization 7 (1990); Mirsky, Conway & Humphrey, *The Interface Between Bankruptcy and Environmental Laws*, 46 Bus. Law. 623 (1991); Nucciarone, *Overview of Bankruptcy Law as It Relates to Environmental Law Issues*, The Impact of Environmental Regulations on Business Transactions 735 (1989); Rosenbaum, *Bankruptcy and Environmental Regulation: An Emerging Conflict*, 13 Env'tl. L. Rep. 10,099 (1983); Smillie, *When Worlds Collide: The Effect of the Bankruptcy Stay on Environmental Cleanup Litigation*, 8 Temp. Env'tl. L. & Tech. J. 77 (1989); Spracker & Barnette, *The Treatment of Environmental Matters in Bankruptcy Cases*, 11 Bankr. Dev. J. 85 (1995); Sward, *Resolving Conflicts Between Bankruptcy Law and the State Police Power*, 1987 Wis. L. Rev. 403; Van Patten & Puetz, *Bankruptcy and Environmental Obligations: The Clash Between Private Relief and Public Policy*, 35 S.D. L. Rev. 220 (1990); Note, *At the Crossroads of Environmental Laws and the Bankruptcy Code: Abandonment and Trustee Personal Liability*, 23 Hofstra L. Rev. 879 (1995); Note, *The Bankruptcy Code and Hazardous Waste Cleanup: An Examination of the Policy Conflict*, 27 Wm. & Mary L. Rev. 165 (1985); Note, *Bankruptcy Versus Environmental Protection: Discharging Future CERCLA Liability in Chapter 11*, 14 Cardozo L. Rev. 1999 (1993); Note, *Belly Up Down in the Dumps: Bankruptcy and Hazardous Waste Cleanup*, 38 Vand. L. Rev. 1037 (1985); Note, *Cleaning Up in Bankruptcy: Curbing Abuse of the Federal Bankruptcy Code by Industrial Polluters*, 85 Colum. L. Rev. 870 (1985); Note, *Clean-Up Orders and the Bankruptcy Code: An Exception to the Automatic Stay*, 59 St. John's L. Rev. 292 (1985); Note, *Police and Regulatory Power vs. Pecuniary Interests: The Bankrupt Hazardous Waste Site Owner Faces the Music*, 30 Nat. Resources J. 423 (1990); Note, *Priority Lien Statutes: The States' Answer to Bankrupt Hazardous Waste Generators*, 31 Wash. U.J. Urb. & Contemp. L. 373 (1987).

(n2)Footnote 1a. Adam P. Storchak et al., Collier Monograph: Environmental Issues in Bankruptcy Cases, § 3, at 18 (2009).

(n3)Footnote 2. See, e.g., *United States v. Johns Manville Sales Corp.*, 18 Env'tl. Rep. Cas. (BNA) 1177 (D.N.H. 1982) (environmental enforcement proceeding stayed); *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649, 11 C.B.C.2d 1067 (1985) (obligation to comply with cleanup order held to be a dischargeable debt); *In re Oklahoma Ref. Co.*, 63 B.R. 562, 15 C.B.C.2d 621 (Bankr. W.D. Okla. 1986) (trustee permitted to abandon property containing hazardous wastes).

(n4)Footnote 2a. See P 6.02 *infra*.

(n5)Footnote 3. *Midlantic Nat'l Bank v. New Jersey Dep't of Env't'l Prot.*, 474 U.S. 494, 106 S. Ct. 755, 88 L. Ed. 2d 859, 13 C.B.C.2d 1355 (1986); *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649, 11 C.B.C.2d 1067 (1985).

(n6)Footnote 4. Compare *In re Oklahoma Ref. Co.*, 63 B.R. 562, 15 C.B.C.2d 621 (Bankr. W.D. Okla. 1986) with *In re Peerless Plating Co.*, 70 B.R. 943 (Bankr. W.D. Mich. 1987) and with *In re Guteri Special Steel Corp.*, 198 B.R. 128, 36 C.B.C.2d 486 (Bankr. W.D. Pa. 1996) (differing interpretations of the scope of the Supreme Court's holding in *Midlantic*).

(n7)Footnote 5. *United States v. Bestfoods*, 524 U.S. 51, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (1998); see P 6.07[5] *infra*.

(n8)Footnote 6. See, e.g., N.J. Stat. Ann. § 58:10-23.11f (discussed in *In re Perona Bros., Inc.*, 186 B.R. 833 (D.N.J. 1995)); Mass Gen. Laws ch. 21E, § 13 (discussed in *In re 229 Main Street Ltd. P'ship*, 262 F.3d 1 (1st Cir. 2001)).

(n9)Footnote 7. *In re 229 Main Street Ltd. P'ship*, 262 F.3d 1 (1st Cir. 2001). Section 362(b)(3) exempts from the stay, among other things, any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to perfection under section 546(b). Section 546(b)(1)(A) provides that the rights and powers of a trustee under

certain avoidance provisions (namely sections 544, 545 and 549) are subject to any generally applicable law that permits an interest in property to be effective against an entity that acquires rights in such property before the date of perfection. Notably, the ability of a trustee to avoid the superlien under the preference statute, section 547, and the federal fraudulent transfer statute, section 548, is not neutered by section 546(b). Thus, the trustee may, in appropriate scenarios, be able to avoid a superlien as a preference or as a section 548 fraudulent transfer.

(n10)Footnote 8. 42 U.S.C.A. § 9601-675.

(n11)Footnote 9. 42 U.S.C. § 9607(l)(3).

(n12)Footnote 10. *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990) , *cert. denied*, 498 U.S. 1046, 111 S. Ct. 752, 112 L. Ed. 2d 772 (1991) . *Fleet Factors* and the judicial, regulatory and, ultimately legislative, response to the decision are discussed in P 6.07[2]-[3] *infra*.

(n13)Footnote 11. See P 6.07[2] *infra*.

(n14)Footnote 12. See P 6.07[5].

(n15)Footnote 13. 42 U.S.C.A. §§ 6901-6992.

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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CHAPTER 6 Environmental Issues in Bankruptcy *

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P 6.02 Stay of Governmental Proceedings

[1] Automatic Stay--Exceptions for Certain Governmental Proceedings

The question of whether governmental proceedings against the debtor or its estate to enforce environmental laws are stayed pursuant to section 362(a)ⁿ¹ has been the subject of much controversy. At issue is the scope of two exceptions to the automatic stay for certain governmental actions. Before the amendment of subsections 362(b)(4) and (b)(5) in 1998,ⁿ² these two exceptions were set forth, respectively, in subsections 362(b)(4) and (b)(5). Section 362(b)(4), as originally enacted, excepted from the stay "the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power."ⁿ³ The legislative history of the original provision indicates that this exception was intended to apply to government actions to require compliance with environmental laws.ⁿ⁴

In addition, section 362(b)(5) provided that "the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power" is not subject to the stay.ⁿ⁵ According to its legislative history, this provision "extends to permit an injunction and enforcement of an injunction and to permit the entry of a money judgment, but does not extend to permit enforcement of a money judgment."ⁿ⁶ Section 362(b)(5) evidenced Congress's intent that the government, in attempting to enforce a money judgment, should not be preferred over other creditors having a pecuniary interest in the assets of the estate.

Amended section 362(b)(4) combines the substance of former sections 362(b)(4) and 362(5) and provides in full that:

(b) The filing of a petition under section 301, 302 or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay-- ...

(4) under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit or any organization exercising authority under the Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on Their Destruction, opened for signature on January 13, 1993, to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit's or organization's police or regulatory power;ⁿ⁷

Although the amended section appears to have preserved the substance of former sections 362(b)(4) and 362(b)(5) as they related to environmental law enforcement matters, it should be noted that former section 362(b)(4) was written solely as an exception to section 362(a)(1), and former section 362(b)(5) was written solely as an exception to section 362(a)(2). Section 362(b)(4), as now constituted, is written as an exception to section 362(a)(1), (2), (3) and (6). Neither the former nor the presently constituted section is an exception to section 362(a)(5), which is a stay against any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of a case under the Code.ⁿ⁸

The cases interpreting these provisions often have little difficulty concluding that the governmental action being challenged is one taken to enforce a police or regulatory power and generally turn on the question of whether the relief requested by the government, even if injunctive in form, is tantamount to the enforcement of a "money judgment." If so, the action comes within the "exception to the exception" set forth in amended section 362(b)(4) and is therefore stayed. As one court of appeals framed the issue, "[t]he difficulty in applying this exception comes in distinguishing between situations in which the state acts pursuant to its 'police and regulatory power' and situations in which the state acts merely to protect its status as a creditor."^{n8a}

[2] Automatic Stay--Governmental Proceedings Stayed

In *In re Kovacs* (*Kovacs I*),ⁿ⁹ the Court of Appeals for the Sixth Circuit held that proceedings relating to the enforcement of an environmental compliance order were stayed when a state-appointed receiver was in possession of the contaminated property and conducting a cleanup. Although the holding in *Kovacs I* was ultimately vacated after the Supreme Court determined that the debtor's cleanup obligation was dischargeable,ⁿ¹⁰ the Sixth Circuit's analysis nevertheless has important implications.

Kovacs was the chief executive officer and principal shareholder of Chem-Dyne Corporation, which operated a hazardous waste disposal facility in Hamilton, Ohio. The state of Ohio brought suit against Kovacs, Chem-Dyne and other businesses involved in the Hamilton site for polluting public waters, maintaining a nuisance and causing fish kills, all in violation of state environmental laws. Kovacs subsequently signed a stipulation, personally and on behalf of Chem-Dyne, enjoining the defendants from causing further pollution and bringing additional wastes on the site, requiring the removal of specified wastes from the property, and ordering the payment of \$75,000 to the state as compensation for injury to wildlife. When the defendants failed to comply with the stipulation, the state obtained the appointment of a receiver to take possession of the assets of Kovacs and the corporate defendants, to collect any amounts that would be payable to them in the future and to comply with the injunction by cleaning up the Chem-Dyne facility. After the appointment of the receiver, but before the cleanup was completed, Kovacs filed a personal bankruptcy petition under chapter 11. The case was later converted to a chapter 7 liquidation case.

When the state sought a hearing to determine Kovacs's employment status and income so that his postpetition income could be applied by the receiver against the cleanup costs, Kovacs objected, claiming that such proceedings were stayed. The lower courts held that the stay applied, and the Court of Appeals for the Sixth Circuit affirmed. The court concluded that although no actual judgment in the state's favor had been entered, the state

was seeking what in essence amounted to a money judgment against Kovacs, which was properly subject to the automatic stay. We note that the state court's order appointing a receiver also ordered that Kovacs turn over all his nonexempt assets to the receiver, and authorized the receiver to collect any sums of money that would become payable to Kovacs in the future. There is very little in substance to distinguish that order and a money judgment.ⁿ¹¹

In *United States v. Johns-Manville Sales Corp.*,ⁿ¹² the district court relied on the holding in *Kovacs I* to stay governmental efforts to obtain a cleanup injunction. The case involved several sites in Hudson, New Hampshire, on which Manville had disposed hazardous asbestos wastes. The six owners of the dumpsites were also made parties to the

action. The United States and the state of New Hampshire sought to require Manville to cover the contaminated property with vegetation, to erect fences and place warnings around the sites and to post a performance bond to insure its compliance with the requested order. The plaintiffs also sought to enjoin Manville from continuing to dispose of asbestos wastes on the sites. Manville, facing enormous potential liability for injuries allegedly caused by exposure to asbestos that it manufactured, filed a chapter 11 petition after the environmental proceeding had been commenced.

The district court noted that the requested relief "would require the expenditure of substantial funds by Manville."ⁿ¹³ The court, citing *Kovacs I*, held that the federal and state governments sought what amounted to a money judgment and the suit was therefore subject to the stay. The court suggested that its holding might have been different had the requested relief consisted only of an injunction prohibiting future waste deposits.ⁿ¹⁴ In addition, the court was concerned that requiring Manville to expend funds for remedial measures would deplete the assets available to asbestos victims and suggested that the plaintiffs should more appropriately pursue their claims against the then current owners of the dumpsites.

The court in *In re Thomas Solvent Co.* ⁿ¹⁵ resolved the question of the applicability of the stay in an unusual manner. Thomas, an operator of a chemical storage and distribution business, had been sued by the state of Michigan for contaminating groundwaters by improperly storing toxic chemicals. The state court ordered Thomas to take certain remedial action to purify the affected groundwaters. The company filed a chapter 11 petition shortly thereafter and continued to operate its business as debtor in possession. The court held that any state enforcement proceedings would be stayed, but if a liquidation plan were not confirmed or the case not converted to a chapter 7 liquidation within 90 days, the automatic stay would be lifted, since 28 U.S.C. § 959(b) requires that a trustee or a debtor in possession in a chapter 11 case comply with state environmental laws.ⁿ¹⁶

Finally, in *In re Goodwin*,ⁿ¹⁷ the court applied a straight-forward statutory analysis to hold that the automatic stay prevented the Idaho Department of Health and Welfare (the "Department") from obtaining an injunction against the debtor to clean up environmental contamination caused by prepetition spillage at an automobile service station formerly owned by the debtor. The court first noted that the automatic stay exception in section 362(b)(4) as then constituted,ⁿ¹⁸ applied only to the stay provided by subsection (a)(1) of section 362, relating generally to judicial, administrative or other actions to recover prepetition claims. Similarly, the automatic stay exception in section 362(b)(5), as then in effect, applied only to the stay provided by subsection (a)(2) of section 362, relating generally to enforcement of prepetition judgments. However, as the court noted, neither of these stay exceptions applied to the stay provided by subsection (a)(6) of section 362 which prohibits "any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case under this title."ⁿ¹⁹ After concluding that the Department's right to an injunction constituted a "claim" that arose prepetition,ⁿ²⁰ the court held that because the debtor no longer retained possession of the property and there was no continuing disposal of hazardous substances at the site, the Department's injunction request was in substance simply an attempt to shift the financial burden of the cleanup from the state to the debtor and, therefore, tantamount to the kind of claim enforcement which was prohibited by section 362(a)(6). As the court noted:

The choice to seek an injunction rather than perform the cleanup itself is not motivated by a concern over public welfare; it is motivated by the desire to make sure the debtor, rather than the state, bears the financial burden of the clean-up. The requested injunction is nothing more than an attempt to collect a debt from the debtor, and as such directly contradicts the purpose for the discharge provided by the Bankruptcy Code.ⁿ²¹

The *Goodwin* case suggested that section 362(a)(6) would constitute a bar to government action that would otherwise be viewed as a permissible use of the sovereign's police power. Although the direct holding of *Goodwin* may no longer be applicable in light of the 1998 amendment to section 362(b)(4) that added subsection (a)(6) to the scope of the automatic stay exception, the case is still noteworthy because the court looked beyond the form of the government's injunction request to the substance of the action in light of the fact that the debtor was no longer in possession of the

contaminated site. Thus, *Goodwin* can still be cited as support for the proposition that a court should examine all of the circumstances of the action or proceeding brought by the government in order to determine, as a threshold matter, whether such action or proceeding represents the exercise of police or regulatory power within the meaning of the section 362(b)(4), irrespective of which subsection of 362(a) is relevant.

[3] Automatic Stay--Governmental Proceedings Not Stayed

Numerous courts have rejected the narrow view of the section 362(b)(4) exception and the broad reading of the term "money judgment" that the *Kovacs I* and *Manville* cases adopted. The leading case excepting environmental enforcement actions from the automatic stay is *Penn Terra Ltd. v. Department of Environmental Resources*.ⁿ²² Penn Terra, a coal mine operator in western Pennsylvania, had agreed in a consent order with state authorities to correct certain environmental law violations at its mines. The consent order required Penn Terra to backfill land, seal off a mine opening, remove contaminated topsoil and submit comprehensive plans for further action. After Penn Terra filed a chapter 7 petition, the state sued to enforce compliance with the consent order.

The Court of Appeals for the Third Circuit held that the state's action was a valid exercise of its police powers under section 362(b)(4) and did not constitute the "enforcement of a money judgment" within the meaning of section 362(b)(5). The court narrowly construed the term "money judgment," concluding that it requires an identification of the parties for and against whom judgment is being entered, and a "definite and certain" amount owed by one party to the other.ⁿ²³ Since these elements were not present, the state's action to compel compliance with the consent order could not have resulted even in the entry of a money judgment, let alone the enforcement of one. Furthermore, the injunction was not tantamount to a "money judgment" simply because compliance with it would impose an expense on Penn Terra. The court observed:

Were we to find that any order which requires the expenditure of money is a "money judgment," then the exception to section 362 for government police action, which should be construed broadly, would instead be narrowed into virtual nonexistence. Yet we cannot ignore the fundamental fact that, in contemporary times, almost everything costs something. An injunction which does not compel some expenditure or loss of monies may often be an effective nullity.ⁿ²⁴

The court interpreted a "money judgment" to be a remedy that represents compensation for past wrongful acts resulting in injuries already suffered. The state's enforcement action, in contrast, was designed to prevent future harm to the environment. In the court's view, it could therefore not be equated with an action to enforce a money judgment.

Penn Terra has been widely followed,ⁿ²⁵ and its holding was cited with apparent approval by the Supreme Court in *Kovacs II*.ⁿ²⁶ One case in the *Penn Terra* line, *In re Commonwealth Oil Refining Co., Inc.*,ⁿ²⁷ is worth noting for its express rejection of the debtor's argument that the "police power" exceptions to the automatic stay require a showing of imminent and identifiable harm.ⁿ²⁸

Another case following *Penn Terra*, *United States v. Nicolet*,ⁿ²⁹ rejected the argument that the "police or regulatory power" exception in section 362(b)(4) applied to governmental actions seeking prospective relief only and held that it applied to the maintenance of a suit demanding money damages for past violations up to and including the entry of judgment.^{n29a}

A case from the Court of Appeals for the Fourth Circuit is also noteworthy for holding that the "police or regulatory power" exception to the automatic stay in section 362(b)(4) applied to permit a state agency to enforce, against a chapter 11 debtor, financial assurance regulations that required an operator of a hazardous waste disposal facility to post financial bonds for the benefit of the state as security for certain contingent facility closing obligations.^{n29b} The issue arose when the operator, Safety-Kleen, lost its bonding immediately prior to the petition date, which loss in fact precipitated the chapter 11 filing, and the relevant South Carolina agency, the Department of Health and Environmental

Control ("DHEC"), sought to force the debtor, post-filing, to close the facility for failure to satisfy the state law bonding requirements. The debtor had argued, and the district court agreed, that the financial assurance requirements were intended to protect the state's pecuniary interest and were therefore not an exercise of police or regulatory powers. The court of appeals reversed this lower court holding by determining that because the primary purpose of the financial requirements was to deter environmental misconduct, rather than to protect the pecuniary interests of the state, the applicable regulations could be enforced against the debtor. In looking beyond the apparent pecuniary purpose of the financial bonding requirements, the court saw the requirement as a means to a legitimate regulatory end and noted:

In considering whether the regulatory exception applies to environmental laws, courts often focus on whether deterrence is the primary purpose of the law. For example, in *United States v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988), the court considered whether the bankruptcy stay applied to the EPA's efforts to pursue a CERCLA suit to recover clean-up costs against the debtor. The EPA conceded that the plain language of the regulatory exception did not allow the agency to enforce a monetary judgment. Nevertheless, the EPA wanted to obtain a judgment against the debtor for a specific monetary amount. The Third Circuit agreed with the EPA. The court determined that CERCLA actions "interject[] a valuable deterrence element into the CERCLA scheme, ensuring that responsible parties will be held accountable for their environmental misdeeds." *Nicolet*, 857 F.2d at 210. See also *City of New York v. Exxon Corp.*, 932 F.2d 1020, 1024 (2d Cir. 1991) (holding that CERCLA suits fall within regulatory exception because such suits "provide an effective deterrent to violators, who will be forced to pay for the government's costs in responding to their violations"). Because the primary purpose of CERCLA suits is to deter environmental misconduct, the court held that the regulatory exception applied "up to and including entry of a monetary judgment." *Nicolet*, 857 F.2d at 210.

Safety-Kleen claims that DHEC's attempt to enforce the financial assurance requirements (which form the basis for the bond order) amount to "granting [the state] a preference not afforded the other creditors in the bankruptcy proceeding." Appellant's Answering & Reply Br. at 39. We disagree. The financial assurance regulations are within the regulatory exception because they serve the primary purpose of deterring environmental misconduct. Stated more positively, the regulations serve to promote environmental safety in the design and operation of hazardous waste facilities. The incentive for safety is obvious: the availability and cost of a bond will be tied directly to the structural integrity of a facility and the soundness of its day-to-day operations. When the EPA promulgated its financial assurance regulations (South Carolina's regulations are essentially parallel), it spelled out how the regulations would promote environmental protection at active hazardous waste facilities. Specifically, the EPA emphasized that the financial assurance requirements would give landfill owners and operators "an incentive to locate, design, and operate facilities to minimize closure and post-closure costs" and to "improve operating procedures and reduce the risk of accidents." *Standards Applicable to Owners and Operators of Hazardous Waste Treatment, Storage, and Disposal Facilities; Financial Requirements*, 47 Fed. Reg. 15032, 15044-45 (Apr. 7, 1982) (explaining benefits of financial assurance requirements). To put it more bluntly, sloppy "design and operating procedures ... are more likely to be avoided" with the financial assurance requirements and the resulting incentive to reduce bond costs. *Id.*

As we see it, the primary purpose of South Carolina's financial assurance regulations is to deter environmental misconduct and to encourage the safe design and operation of hazardous waste facilities. This is a clear exercise of the state's regulatory power. Accordingly, we hold that the regulatory exception applies to DHEC's issuance and enforcement of the bond order. The bankruptcy stay does not apply to these efforts.^{n29c}

Under the reasoning of *Penn Terra*, *United States v. Nicolet* and *Safety-Kleen* taken together, it could be argued that any action or proceeding of a governmental unit that is not precisely a direct action to enforce a money judgment is, by definition, an exercise of police or regulatory power so long as one could infer a deterrence rationale for the action. In

effect, those cases seem to have substantially diminished the government's burden in satisfying the statutory requirement in section 362(b)(4) of showing a "police and regulatory" purpose behind the action, and merely require a showing by the governmental unit that it is not seeking to enforce a money judgment.

State v. Electrical Utilities n30 similarly concluded that an action to enforce environmental laws was excepted from the stay, but on different grounds. The state had sued Electrical Utilities alleging that it had spilled large quantities of polychlorinated biphenyls (PCBs) at its manufacturing plant in violation of federal law. The action sought to enjoin the defendants from further pollution, to require removal of the hazardous waste from the property and to recover the costs incurred by the state in conducting its investigation. Electrical Utilities filed a chapter 11 petition subsequent to the commencement of the suit. The court held that the state's action was not stayed because it seeks only the entry of a judgment, and not the enforcement of one. However, the following language suggests that the court did not reject the broader reading of the term "money judgment" advanced by *Kovacs I* and *Manville*:

The suit is not for enforcement of a money judgment or for enforcement of an injunction requiring [Electrical Utilities] to spend money. If and when the State gets a judgment against [Electrical Utilities] requiring it to expend resources, the State will become a creditor like those presently before the bankruptcy court.n31

Thus it appears that the court would have stayed any attempt to enforce the injunctive order that the state was seeking, although the court permitted the state to sue to obtain the judgment.n32

The application of an environmental law enforcement exception under section 362(b)(4) does not necessarily mean that a debtor cannot otherwise obtain an injunction against a governmental unit in an environmental law enforcement proceeding. Section 105(a) provides that "[t]he court may issue an order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."n33 Thus, even if the police power exception is deemed to apply to a governmental enforcement action, the court, nevertheless, may enjoin the action if it is persuaded to make certain findings.

An excellent example of this process is found in *Walsh v. West Virginia (In re Security Gas & Oil, Inc.)*.n34 The debtor had operated natural gas and oil wells in West Virginia and in other states. Following the filing of its petition under the Code (and the appointment of Walsh as trustee), the debtor ceased operation of some but not all of its wells in West Virginia. Under West Virginia law, the debtor was required to plug the closed wells and to restore the well sites to their original condition. The debtor failed to take these actions, and the state of West Virginia directed the debtor to cease operating its remaining wells in the state as a remedy for its failure to reclaim the closed wells. The state also sought to charge the debtor's performance bond with the cost of reclamation of the discontinued well operations. The trustee sought to enjoin these actions, claiming a violation of the automatic stay and seeking an injunction under section 105.

The court held that the exceptions to the coverage of the automatic stay set forth in subsections 362(b)(4) and (b)(5) mandated dismissal (without leave to amend) of the trustee's complaint against the state relating to the order to reclaim the closed wells and to cease operation of the functioning wells.n35 The court refused to dismiss the trustee's complaint relating to the forfeiture of the debtor's performance bond as a violation of the stay.n36 Most significantly, the court dismissed the trustee's complaint seeking a section 105 injunction restraining the state from requiring reclamation and the closure of the debtor's operating wells, but with leave to amend the complaint based on the standards articulated in the opinion.n37 The court stated:

In determining whether to enjoin an environmental cleanup order under section 105, the Bankruptcy Court should weigh the State's interests against the policies of the federal Bankruptcy Code by considering the following factors:

- (1) The immediacy, severity, and certainty of the danger created by the environmental hazard subject

to the clean-up order;

(2) The extent to which debtor is uniquely able to effect the clean up;

(3) The extent to which creditor priorities would be distorted by enforcement of the clean-up order. The solvency of the estate, the cost of the clean up relative to the value of the unencumbered assets of the estate, and whether the State has a statutory lien to secure the debtor's clean up obligation will effect [sic] how much the percentage dividend to unsecured creditors will be affected by enforcement of the clean-up order.

(4) The effect of the enforcement order on the likelihood of a successful reorganization, and whether a successful reorganization will substantially increase the payoff to creditors and/or preserve jobs;

(5) How long the bankruptcy case has been open;

(6) How long the State has delayed in attempting to force debtor to clean up the environmental hazard;

(7) The extent to which debtor continues to operate a similar business in the State;

(8) The extent to which orders other than full prohibition of enforcement of clean-up orders can better accommodate the State health and welfare concerns with the policies of the Bankruptcy Code. For instance, where the major factor against injunctive relief for debtor is that debtor continues to operate a related business in the State, the State might be permitted to enforce State laws requiring debtor to cease operations in that State or to require debtor to devote all proceeds from such operations to the clean up, but would be enjoined from requiring the debtor to use unencumbered assets from other States to clean up the site. The court also must be creative in coordinating the enforcement activities each State will be allowed to engage in where more than one State seeks to enforce environmental clean-up orders against a single debtor.];

(9) Any other considerations relevant to whether injunction relief should be granted, including the good or bad faith of the parties.ⁿ³⁸

Perhaps the foregoing factors may be reduced to the proposition that the willingness of the court in the *Security Gas* case to issue a section 105 injunction restraining enforcement of an environmental clean-up order would depend on the fact-specific balance between the potential harm to the public that may result from a deferral of the clean-up and the effect of enforcement of a clean-up order on the prospects for a successful reorganization. However, it is likely that the debtor will have to make a very strong showing as to the absence of actual or potential environmental and public health harm before a court will restrain enforcement of a clean-up order. In enacting the police and regulatory enforcement exceptions to section 362(a), and in view of the requirements of 28 U.S.C. § 959(b),ⁿ³⁹ Congress has evidenced its judgment that public health and safety concerns are at least as significant as the business, financial and employment concerns addressed by the reorganization processes of the Bankruptcy Code.ⁿ⁴⁰

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 362(a). The stay arises by operation of law upon the filing of a bankruptcy petition, and prohibits the commencement or continuation of most proceedings and the enforcement of most judgments against the debtor. See P 1.07 *supra*. For an excellent discussion of the application of the automatic stay to environmental issues in bankruptcy, see Heidt, *The Automatic Stay in Environmental Bankruptcies*, 67 *Am. Bankr. L.J.* 69 (1993).

(n2)Footnote 2. These sections were amended in The Omnibus Consolidation and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681 (1998). The amendments deleted section 362(b)(5), but did not renumber the succeeding paragraphs of section 362(b).

(n3)Footnote 3. Former 11 U.S.C. § 362(b)(4). Paragraph (4) of section 362(b), as amended retains much of the same language.

(n4)Footnote 4. The House Report accompanying the Bankruptcy Reform Act of 1978, referring to the section 362(b)(4) exception, stated:

Paragraph (4) excepts commencement or continuation of actions and proceedings by governmental units to enforce police or regulatory powers. Thus, where a governmental unit is suing a debtor to prevent or stop violation of fraud, *environmental protection*, consumer protection, safety or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 343 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised) (emphasis added). The Senate Report contains identical language. S. Rep. No. 95-989, 95th Cong., 2d Sess. 52 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised).

(n5)Footnote 5. 11 U.S.C. § 362(b)(5).

(n6)Footnote 6. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 343 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 95-989, 95th Cong., 2d Sess. 52 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. These sections were amended in The Omnibus Consolidation and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681 (1998). The amendments deleted section 362(b)(5), but did not renumber the succeeding subsections of section 362(b).

(n8)Footnote 8. *See In re Goodwin*, 163 B.R. 825 (Bankr. D. Idaho 1993) , discussed *infra*. For a discussion of statutory liens securing payment of cleanup costs, *see* P 6.06 *infra*.

(n9)Footnote 8a. *Safety-Kleen, Inc. v. Wyche*, 274 F.3d 846, 866 (4th Cir. 2001) .

(n10)Footnote 9. 681 F.2d 454, 6 C.B.C.2d 951 (6th Cir. 1982) , *vacated and remanded*, 459 U.S. 1167, 103 S. Ct. 810, 74 L. Ed. 2d 1010 (1983) , *dismissed as moot*, 755 F.2d 484 (6th Cir. 1985) .

(n11)Footnote 10. *See* P 6.03 [1] *infra*. The decision of the Supreme Court in the *Kovacs* case is hereinafter referred to as *Kovacs II*.

(n12)Footnote 11. 681 F.2d 454, 456, 6 C.B.C.2d 951, 954 .

(n13)Footnote 12. 18 *Envtl. Rep. Cas. (BNA)* 1177 (D.N.H. 1982).

(n14)Footnote 13. 18 *Envtl. Rep. Cas. (BNA)* 1177, 1179 (D.N.H. 1982).

(n15)Footnote 14. *See, e.g., In re Canarico Quarries, Inc.*, 466 F. Supp. 1333 (D.P.R. 1979) (action by Puerto Rico environmental agency to prevent quarry operator from future violations of air quality laws not stayed under former Bankruptcy Act).

(n16)Footnote 15. 44 B.R. 83 (Bankr. W.D. Mich. 1984) .

(n17)Footnote 16. 28 U.S.C. § 959(b) provides:

(b) ... a trustee, receiver or manager appointed in any case pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

Notwithstanding the suggestion to the contrary in the *Thomas Solvent* case, section 959(b) has been held to apply to trustees in chapter 7 liquidation proceedings. *See, e.g., In re Wall Tube & Metal Prod. Co.*, 831 F.2d 118, 17 C.B.C.2d 736 (6th Cir. 1987) .

(n18)Footnote 17. 163 B.R. 825 (Bankr. D. Idaho 1993) .

(n19)Footnote 18. These sections were amended in The Omnibus Consolidation and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681 (1998). The amendments deleted section 362(b)(5), but did not renumber the succeeding subsections of section 362(b).

(n20)Footnote 19. 11 U.S.C. § 362(a)(6). As noted at P 6.02[1] *infra* , section 362(b)(4) as amended in 1998 now expressly constitutes an exception to section 362(a)(6).

(n21)Footnote 20. In determining that the right to an injunction was a "claim," the court viewed as dispositive the fact that the Department had an alternative damage remedy under the relevant state statute. 163 B.R. 825, 829 (Bankr. D. Idaho 1993) .

(n22)Footnote 21. 163 B.R. 825, 831 (Bankr. D. Idaho 1993) .

(n23)Footnote 22. 733 F.2d 267, 10 C.B.C.2d 949 (3d Cir. 1984) . As discussed above, subsections 362(b)(4) and (b)(5) were amended and combined into one section in 1999. These sections were amended in The Omnibus Consolidation and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681 (1998). The amendments deleted section 362(b)(5), but did not renumber the succeeding subsections of section 362(b). References herein to subsections 362(b)(4) and (b)(5) are references to those sections as in effect prior to the amendment thereof.

(n24)Footnote 23. 733 F.2d 267, 275, 10 C.B.C.2d 949, 958 .

(n25)Footnote 24. 733 F.2d 267, 277-78, 10 C.B.C.2d 949, 961 .

(n26)Footnote 25. *See, e.g., Nebraska ex rel. Linder v Strong (In re Strong)*, 2002 Bankr. LEXIS 1783 (Bankr. D. Nebr. 2002) ; *Cournoyer v. Town of Lincoln*, 790 F.2d 971, 14 C.B.C.2d 1085 (1st Cir. 1986) ; *In re Madison Indus., Inc.*, 161 B.R. 363 (D.N.J. 1993) ; *United States v. Mattiace Indus., Inc.*, 73 B.R. 816 (E.D.N.Y. 1987) ; *In re Security Gas & Oil, Inc.*, 70 B.R. 786, 790 (Bankr. N.D. Cal. 1987) ; *United States v. F.E. Gregory & Sons, Inc.*, 58 B.R. 590, 591-92 (D.W.D. Pa. 1986) ; *United States v. ILCO, Inc.*, 48 B.R. 1016, 1023 (D.N.D. Ala. 1985); *In re Williston Oil Corp.*, 54 B.R. 10, 11-12 (Bankr. D.N.J. 1984) ; *In re Laurinburg Oil Co., Inc.*, 49 B.R. 652 (Bankr. M.D.N.C. 1984) . *But see Wharton v. Virginia*, 1992 U.S. Dist. LEXIS 5987 (W.D. Va. Mar. 12, 1992) ; *United States v. Johns-Manville Sales Corp.*, 18 Env'tl. Rep. Cas. (BNA) 1177 (D.N.H. 1982); *In re Thomas Solvent Co.*, 44 B.R. 83 (Bankr. W.D. Mich. 1984) .

(n27)Footnote 26. 469 U.S. 274, 283 n.11, 105 S. Ct. 705, 710 n.11, 83 L. Ed. 2d 649, 658 n.11, 11 C.B.C.2d 1067, 1073 n.11 .

(n28)Footnote 27. 805 F.2d 1175, 15 C.B.C.2d 1387 (5th Cir. 1986) , *cert. denied*, 483 U.S. 1005, 107 S. Ct. 3228, 97 L. Ed. 2d 734 (1987) .

(n29)Footnote 28. *But see In re IDH Realty, Inc.*, 16 B.R. 55, 57 (Bankr. E.D.N.Y. 1981) (suggesting that an "urgent" public interest is required for the 362(b)(4) exception to apply).

(n30)Footnote 29. 857 F.2d 202 (3d Cir. 1988) ; *see also United States v. Sugarhouse Realty, Inc.*, 162 B.R. 113 (E.D. Pa. 1993) (recognizing deterrent value of allowing imposition of fine even though enforcement of the related judgment must be stayed).

(n31)Footnote 29a. *See also United States v. LTV Steel Co.*, 269 B.R. 576, 585 (W.D. Pa 2001) (following *Nicolet* and holding that automatic stay did not prevent calculation of penalty and entry of judgment for violation of environmental laws).

(n32)Footnote 29b. *Safety-Kleen, Inc. v. Wyche*, 274 F.3d 846 (4th Cir. 2001) .

(n33)Footnote 29c. 274 F.3d 846, 864-65 (certain citations omitted). The reasoning of *Safety-Kleen* was followed by a district court in requiring a coal mining company that was a chapter 11 debtor to comply with state bonding requirements that served as security for the miner's land reclamation obligations. The court concluded that although the bonding requirements could be construed as being for the financial benefit of the government, they also served the purpose of protecting persons from the dangers of unclaimed land, and were therefore within the police and regulatory power exception to the automatic stay. *Bickford v. Lodestar Energy, Inc.*, 310 B.R. 70, 78 (E.D. Ky. 2004) .

(n34)Footnote 30. 41 B.R. 874, 11 C.B.C.2d 1046 (Bankr. N.D. Ill. 1984) .

(n35)Footnote 31. 41 B.R. 874, 877, 11 C.B.C.2d 1046, 1051 .

(n36)Footnote 32. *See also New York v. Exxon Corp.*, 932 F.2d 1020 (2d Cir. 1991) (government action to obtain reimbursement of CERCLA cleanup costs is within police power and is not stayed--action was to establish liability and determine damages and not to enforce a money judgment); *United States v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988) (governmental action for monetary damages may be reduced to judgment and is not stayed); *Word v. Commerce Oil Co. (In re Commerce Oil Co.)*, 847 F.2d 291, 99 O.&G.R. 594, 18 C.B.C.2d 1256 (6th Cir. 1988) (action to fix civil liability against debtor under Tennessee Water Quality Control Act was within police power exception to automatic stay); *Utah Div. of Oil, Gas & Mining v. Kaiser Steel Corp. (In re Kaiser Steel Corp.)*, 87 B.R. 662 (Bankr. D. Colo. 1988) (commencement of environmental enforcement action by state is excepted from stay); *In re Lenz Oil Serv., Inc.*, 65 B.R. 292, 295 (Bankr. N.D. Ill. 1986) (environmental enforcement action not stayed when state seeks only to obtain, and not to enforce, a judgment). The "police power" exception has been held to be inapplicable to an action brought by a private citizen's group under the Clean Water Act. *See In re Chateaugay Corp.*, 118 B.R. 19 (Bankr. S.D.N.Y. 1990) . *But see Ohio Pub. Interest Research Group v. Wheeling-Pittsburgh Steel Corp.*, 29 E.R.C. (BNA) 1495 (Bankr. W.D. Pa. 1989) (action under Clean Water Act brought by private organization not stayed since case based primarily on postpetition conduct of debtor).

(n37)Footnote 33. *See generally Collier on Bankruptcy*, P 105.02 (Matthew Bender & Co.) (15th Ed. Revised).

(n38)Footnote 34. 70 B.R. 786 (Bankr. N.D. Cal. 1987) .

(n39)Footnote 35. 70 B.R. 786, 797 (Bankr. N.D. Cal. 1987) .

(n40)Footnote 36. 70 B.R. 786 .

(n41)Footnote 37. *Id.*

(n42)Footnote 38. 70 B.R. 786, 796-97 (citations omitted).

(n43)Footnote 39. 28 U.S.C. § 959(b). *See note 16 supra.*

(n44)Footnote 40. See *Commonwealth Oil Ref. Co. v. United States Envtl. Prot. Agency (In re Commonwealth Oil Ref. Co.)*, 805 F.2d 1175, 1188-90 (5th Cir. 1986) , cert. denied, 483 U.S. 1005, 107 S. Ct. 3228, 97 L. Ed. 2d 734 (1987) ("Assuming that a § 105 stay is available to stay an action expressly exempted by Congress from the operation of the automatic stay provisions, the bankruptcy court did not abuse its discretion in refusing to issue a stay under § 105 in this case."); *Corporation de Servicios Medicos Hospitalarios de Fajardo v. Mota (In re Corporation de Services Medicos Hospitalarios de Fajardo)*, 805 F.2d 440, 449 n.14, 15 C.B.C.2d 1375 (1st Cir. 1986) ("We reaffirm ... that a bankruptcy court does possess the power, in exceptional circumstances, to enjoin even administrative proceedings that are exempt from the automatic stay pursuant to section 362(b)(4)."); *In re Javens*, 107 F.3d 359 (6th Cir. 1997) (injunction against enforcement of regulations may be issued if powers are being employed in bad faith).

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

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P 6.03 Discharge of Debts

[1] *Ohio v. Kovacs.*

The first Supreme Court case to consider the conflict between the enforcement of environmental laws and the provisions of the Bankruptcy Code was *Ohio v. Kovacs (Kovacs II)*.ⁿ¹ The issue that reached the Court was whether the debtor's obligation under an environmental consent order constituted a "debt" dischargeable in a personal bankruptcy proceeding.ⁿ²

The Code defines a debt as "liability on a claim."ⁿ³ A claim is defined in section 101(5) as follows:

(4) "claim" means--

(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; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, secured or unsecured.ⁿ⁴

Kovacs II involved a situation in which Chem-Dyne Corporation and Kovacs, its president and principal shareholder, had failed to comply with a consent order requiring them to clean up the contaminated Chem-Dyne site and enjoining them from engaging in further activity causing pollution. The state obtained the appointment of a receiver to take possession of the property and undertake the required cleanup. Subsequent to Kovacs's filing of a petition under the Code, the state sought a declaration that the cleanup obligations under the consent order were not dischargeable in bankruptcy. The bankruptcy court, district court and court of appeals all ruled in favor of Kovacs, holding that the state was in essence seeking a monetary payment that was a dischargeable debt.

The Supreme Court affirmed the holding of the lower courts. The state had argued that the "breach of performance" referred to in section 101(5)(B) encompassed only contractual and not statutory breaches and therefore Kovacs's actions could not give rise to a "claim." The state also maintained that the breach of the injunction did not create a "right of payment," which was also a necessary element of a "claim" as defined in section 101(5)(B).

The Court rejected both arguments. It found nothing in the Code to support the contention that the right to performance can only be a claim if it arises from a contractual obligation, and concluded that Congress could have limited the definition of "claim" if it so chose. The Court noted that the state conceded that Kovacs's obligation to pay the \$75,000 compensation was dischargeable, yet it arose from a statutory and not a contractual breach.

The Court also concluded that equitable remedies could create a "right to payment" when the creditor seeks a money judgment as an alternative remedy. Here, the affirmative cleanup obligation did give rise to a "right to payment" because "the State was seeking no more than a money judgment as an alternative to requiring Kovacs personally to perform the obligations imposed by the injunction."⁵ In support of this conclusion, the Court noted that the state had sought discovery with respect to Kovacs's earnings for the purpose of levying on his wages.⁶

More importantly, the appointment of a receiver to take possession of Kovacs's nonexempt assets and clean up the site rendered it impossible for Kovacs personally to comply with the injunction. By appointing the receiver, the state had functionally dispossessed Kovacs and divested him of the assets he might have used to perform the cleanup. He could thereafter perform his obligations only through the payment of money. Therefore, the Court stated:

On the facts before it, and with the receiver in control of the site, we cannot fault the court of appeals for concluding that the cleanup order had been converted into an obligation to pay money, an obligation that was dischargeable in bankruptcy.⁷

The Court expressly narrowed its holding by emphasizing that: (1) discharge will not shield a debtor from criminal prosecution for violations of state environmental laws or for prepetition breaches of an injunction; (2) fines or penalties imposed on a debtor for environmental law violations are not dischargeable under section 523(a)(7); (3) the holding did not address the hypothetical of Kovacs's having filed his petition prior to the appointment of a receiver; (4) the Court held only that the affirmative cleanup obligation, and not the injunction against future contamination, was dischargeable; and (5) anyone in possession of the site, whether Kovacs himself, a third party purchaser or the bankruptcy trustee, must comply with state environmental laws.

Justice O'Connor, in her concurrence, suggested that since the determination of property rights in a debtor's estate is a function of state law, states can protect their interest in the enforcement of environmental laws by giving cleanup judgments the status of statutory liens.⁸ She also noted that classifying an obligation under a cleanup order as a "claim" would be advantageous to the state in the case of a corporate debtor in a chapter 7 proceeding since the debtor will generally dissolve after liquidation and have no postbankruptcy earnings to apply towards cleanup costs. Only holders of cognizable "claims" will be entitled to share in the distribution of the debtor's assets.⁹

The bankruptcy court in *In re Robinson* ¹⁰ expanded the holding in *Kovacs II* to discharge the cleanup obligation of a debtor who remained in possession of his property. Robinson had unlawfully excavated and filled marsh property that he owned in Florida. The federal government obtained a judgment against Robinson and his brother (to whom the disputed property had been conveyed) requiring the removal of the fill material and the replanting of the area. Robinson subsequently filed a chapter 7 petition.

Rejecting the government's argument that the cleanup obligation was a "remedial duty" unaffected by discharge, the court concluded that the obligation was "readily capable of being reduced to a monetary debt"¹¹ and, therefore, was dischargeable. Although the court acknowledged that, unlike Kovacs, Robinson had not been dispossessed of his property, it observed that Robinson could not personally perform the cleanup obligation without incurring some expense, and this expense could be reduced to a sum certain. The court concluded that:

while the defendant is in no less a position than he has ever been to perform the obligation, and we cannot find the *de facto* money judgment that existed in *Kovacs*, we find all of the prerequisites to a money judgment, and see no reason to determine that the defendant's obligation should be excluded from

the Code definition of "claim."ⁿ¹²

The court observed that it might have reached a different conclusion had the cleanup required only "incidental" expenditures for items such as transportation costs, rather than "direct expenditures."ⁿ¹³ In light of the decisions by the courts of appeals in *Chateaugay*, *CMC Heartland* and *Torwico*,ⁿ¹⁴ each of which held that the obligation to ameliorate ongoing pollution caused by prepetition conduct was not discharged by the debtor's bankruptcy, the continued vitality of decisions such as *Robinson* is subject to question.

[2] *In re Chateaugay*.

Subsequent cases have clarified the following issues: (1) whether the obligation under environmental law of a present or former debtor under the Bankruptcy Code to reimburse another person for costs incurred by that person in responding to an environmental hazard is a dischargeable debt under the Code; and (2) whether a former debtor under the Code is required to comply with an order to clean up ongoing pollution notwithstanding the discharge in the bankruptcy case.

In addressing the first issue, some courts have focused on the time of the event giving rise to the contamination to hold that monetary claims arising from a prepetition release or prepetition threatened release of hazardous substances are subject to discharge under the Bankruptcy Code, while other courts have analyzed the extent to which the incurrence of future cleanup costs was reasonably foreseeable during the bankruptcy case and held that only those future costs which could have been fairly contemplated by the parties during the case could be discharged. In addressing the second issue, virtually all recent decisions have held that an entity's prior status as a debtor under the Code does not permit it to avoid compliance with an order requiring the cleanup of ongoing pollution so long as the debtor has access to the site, and even if that pollution was caused by prepetition conduct. In other words, if the pollution is ongoing and the former debtor has access, the obligation to ameliorate pollution survives a bankruptcy discharge.

In *United States v. LTV Corp. (In re Chateaugay Corp.)*,ⁿ¹⁵ the Court of Appeals for the Second Circuit relied on *Kovacs II* and the "evident intent of Congress to apply broadly the definition of 'claim' " in section 101(5) to discharge the obligation of the debtor to reimburse the United States Environmental Protection Agency ("EPA") for any cleanup costs that were based upon "pre-petition releases or threatened releases of hazardous substances."ⁿ¹⁶

Chateaugay involved a claim by the EPA against LTV Corporation, a chapter 11 debtor, for reimbursement of \$32 million in cleanup costs actually incurred prepetition, as well as undetermined claims for reimbursement of cleanup costs not yet incurred at both known and unknown hazardous waste sites in which LTV was a "potentially responsible party" ("PRP") under CERCLA. The debtor had listed these latter claims for response costs that had not been incurred prepetition as "contingent" on its schedule of liabilities and had informed the EPA that confirmation of its expected plan of reorganization would result in the discharge of all potential environmental liabilities that were traceable to prepetition conduct, including obligations to reimburse the EPA for response costs that would be incurred postconfirmation. Disagreeing with LTV's position, the EPA sought a declaratory judgment that response costs incurred postconfirmation were not dischargeable because they did not arise from prepetition claims.ⁿ¹⁷

Affirming the district court, the court of appeals rejected the government's contention that the undeterminable and speculative nature of future response costs made the debtor's obligation to reimburse such costs nondischargeable:

The relationship between environmental regulating agencies and those subject to regulation provides sufficient "contemplation" of contingencies to bring most ultimately maturing payment obligations based on pre-petition conduct within the definition of "claims." True, EPA does not yet know the full extent of the hazardous waste removal costs that it may one day incur and seek to impose upon LTV, and it does not yet even know the location of all the sites at which such wastes may yet be found. But the location of these sites, the determination of their coverage by CERCLA, and the incurring of response costs by EPA are all steps that may fairly be viewed, in the regulatory context, as rendering EPA's claim "contingent,"

rather than as placing it outside the Code's definition of "claim."ⁿ¹⁸

In holding that all reimbursement obligations arising from "pre- petition releases or threatened releases of hazardous substances"ⁿ¹⁹ were "claims" subject to discharge,ⁿ²⁰ the court alluded to the policy rationale contained in Justice O'Connor's concurrence in *Kovacs II*:

Accepting EPA's argument in this Chapter 11 reorganization case would leave EPA without any possibility of even partial recovery against a dissolving corporation in a Chapter 7 liquidation case. Indeed, while EPA obviously prefers in this case to keep its CERCLA claim outside of bankruptcy so that it may present it, without reduction, against the reorganized company that it anticipates will emerge from bankruptcy, one may well speculate whether, if unincurred CERCLA response costs are not claims, some corporations facing substantial environmental claims will be able to reorganize at all.ⁿ²¹

In addition to addressing the treatment of pure monetary claims, the *Chateaugay* court also analyzed the circumstances in which an injunction relating to cleanup obligations would give rise to a dischargeable claim. Noting that "claim" includes a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment,"ⁿ²² the court held to be dischargeable any injunction that "does no more" than impose a cleanup obligation "entirely as an alternative" to the EPA cleaning up the site and thereafter seeking reimbursement from one or more responsible parties.ⁿ²³ However, as the court noted, the EPA had no authority under CERCLA to accept a payment from a responsible party as an alternative to continued pollution. Therefore, any order which relates to ongoing pollution was not a "claim" because the EPA had no right to payment for the debtor's breach of its statutory duty to ameliorate such pollution. Furthermore, the court noted, any "cleanup order that accomplishes the dual objectives of removing accumulated wastes and stopping or ameliorating ongoing pollution emanating from such wastes is not a dischargeable claim."ⁿ²⁴

In contrast to its broad interpretation of "claim" with respect to suits for money damages relating to prepetition releases and threatened releases, the Second Circuit apparently construed the term narrowly with respect to injunctions that would require the debtor to spend money directly in order to clean up sources of ongoing pollution:

Thus, if EPA directs LTV to remove some wastes that are not currently causing pollution, and if EPA could have itself have incurred the costs of removing such wastes and then sued LTV to recover the response costs, such an order is a "claim" under the Code. On the other hand, if the order, no matter how phrased, requires LTV to take any action that ends or ameliorates current pollution, such an order is not a "claim."

... [A] cleanup order that accomplishes the dual objectives of removing accumulated wastes and stopping or ameliorating on-going pollution emanating from such wastes is not a dischargeable claim We recognize that most environmental injunctions will fall on the non-"claim" side of the line.ⁿ²⁵

The court expressly rejected a classification that distinguished between injunctions forbidding activities that add to pollution, such as depositing new hazardous substances postpetition, and all other injunctions, including those that relate to the cleanup of sites from which hazardous substances, deposited prepetition, were contributing to pollution postpetition. Rather it held that any injunction that seeks to remedy "on-going pollution" is nondischargeable.ⁿ²⁶ Moreover, although the consent order that was held to be dischargeable in *Kovacs II* included an injunction against further pollution, the *Chateaugay* court distinguished the case by emphasizing the facts that in *Kovacs II*, the state's appointment of a receiver had made it impossible for the debtor to comply with the injunction, and that the state had only sought the payment of money from the debtor rather than affirmative remedial steps.ⁿ²⁷ The *Chateaugay* court justified its holding as being compelled by the statement in *Kovacs II* that an owner "may not maintain a nuisance, pollute the waters of the state, or refuse to remove the source of such conditions"ⁿ²⁸ as well as the holding in *Midlantic National Bank v. New Jersey Department of Environmental Protection* that the Bankruptcy Code does not entitle a

debtor to abandon property in violation of an environmental regulation "that is reasonably designed to protect the public health or safety from identified hazards."ⁿ²⁹

The decision of the Court of Appeals for the Seventh Circuit in *In re CMC Heartland Partners* ⁿ³⁰ is consistent with *Chateaugay* in holding that a former debtor was required to comply with a postconfirmation cleanup order issued by the EPA in respect of a site it still owned from which "harmful releases are threatened and ongoing."ⁿ³¹ Judge Easterbrook noted that CERCLA creates a "claim running with the land"ⁿ³² for ongoing hazards and that this liability continued postconfirmation notwithstanding the fact there may have also been a bankruptcy claim arising from the same prepetition acts. However, the court emphasized that if the former debtor could ultimately demonstrate after the cleanup that there was in fact no ongoing hazard and, therefore, that the cleanup order was merely an attempt by the EPA to "repackag[e] a forfeited claim for damages,"ⁿ³³ the EPA would have to reimburse those costs.ⁿ³⁴

In *In re Torwico Electronics, Inc.*, ⁿ³⁵ the Court of Appeals for the Third Circuit cited *CMC Heartland* and *Chateaugay*, but expanded those holdings in order to enforce a cleanup order imposed by the New Jersey Department of Environmental Protection and Energy ("NJDEP") against a chapter 11 debtor notwithstanding the agency's failure to file a proof of claim before the bar date, and the fact that the debtor no longer owned the property containing the hazardous waste. As noted, in *Kovacs II*, the appointment of a receiver which made the debtor's compliance with the cleanup order impossible was critical to the Supreme Court's decision. However, the third circuit panel distinguished the case before it by noting that, unlike the debtor in *Kovacs II*, Torwico Electronics was still able to conduct the cleanup and had access to the site. Moreover, in holding that the cleanup order was not a claim, the court emphasized that the NJDEP was not asking for money from the debtor and did not have the right, under the specific section of the state statute it invoked, to perform the cleanup itself and then seek reimbursement. Rather, the agency was seeking to "force the debtor to comply with applicable environmental laws by remedying an existing hazard."ⁿ³⁶ In effect, the *Torwico* court seems to have carved out an exception to dischargeability in cases where there exists an ongoing hazard, whether or not the debtor continues to own the site, provided that compliance with the order is not a practical impossibility and the government agency chooses to proceed under a statutory provision which authorizes an injunction rather than reimbursement. This goes beyond the rationale of *Chateaugay*, which pointed out that CERCLA did not provide an alternative damages remedy in cases of ongoing pollution, and *CMC Heartland*, which emphasized that the former debtor was liable for the cleanup of ongoing pollution because of its status as a current owner but would not be liable to the extent the cleanup order represented the repackaging of a damages claim for past pollution.

In sum, under *Chateaugay*, *CMC Heartland* and *Torwico*, the nature of the relief sought--money damages versus injunctive relief--and the nature of the environmental hazard at the time of suit--hazards arising from "pre-petition releases and threatened releases" versus hazards arising from conduct, whether prepetition or postpetition, that are "currently contributing to pollution"--appear to be the key factors in determining whether and to what extent environmental liabilities are dischargeable in bankruptcy.ⁿ³⁷

[3] The *National Gypsum* Fair Contemplation Approach

In *In re National Gypsum Co.*,ⁿ³⁸ the District Court for the Northern District of Texas adopted a different standard from that espoused in *Chateaugay* for determining whether a reimbursement obligation under environmental statutes was a dischargeable claim. The court criticized *Chateaugay* for adopting "so broad a definition of claim so as to encompass costs that could not fairly be contemplated by the EPA or the debtor prepetition." Noting that, in its view, there was no meaningful distinction between a debtor's prepetition conduct and a prepetition release or threatened release arising from such conduct, the court believed that the proper distinction was between, on the one hand, costs associated with prepetition conduct resulting in a release or threatened release that could have been "fairly contemplated" by the parties during the pendency of the bankruptcy case and, on the other hand, costs associated with such conduct that could not have been "fairly contemplated." Based on that approach, the court held that "all future response and natural resource damages cost based on prepetition conduct that can be fairly contemplated by the parties at the time of the Debtors' bankruptcy are claims under the Code."ⁿ³⁹ The court listed the following factors as relevant

to the question of whether the parties could fairly contemplate future costs based on prepetition conduct: (1) knowledge by the parties of a site in which a PRP may be liable; (2) listing of a site used by the debtor on the "National Priorities List" of sites targeted by the EPA for Superfund response; (3) notification by the EPA of PRP liability; (4) commencement of investigation and cleanup activities; and (5) incurrence of response costs.ⁿ⁴⁰

The "fair contemplation" approach has been widely followed by other courts. In *In re Jensen*,ⁿ⁴¹ the Court of Appeals for the Ninth Circuit held that a state agency's claim for reimbursement of cleanup costs was a dischargeable claim because a related state agency had evidenced actual awareness of a potential hazard at the debtor's property during the pendency of the case. On the other hand, in *Signature Combs, Inc. v. United States*,^{n41a} the District Court for the Western District of Tennessee held that there was no evidence that the EPA fairly contemplated or had reason to foresee the prior debtor's potential liability at the time of a prior bankruptcy discharge occurring nearly 12 years before the EPA brought suit. In reaching this conclusion, the court first considered other approaches to reconciling bankruptcy and environmental law and concluded that the "fair contemplation" model best reconciled the competing policy concerns.^{n41b}

Similarly, in *In re Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*,ⁿ⁴² a railroad reorganization case commenced in 1977 under Section 77 of the Bankruptcy Act of 1898, the state of Washington took soil samples at a railroad yard formerly owned by the debtor, conducted tests concerning the scope of contamination and received preliminary results indicating contamination, all prior to the effective date of the debtor's plan of reorganization. However, the state did not receive the final test results until after the plan's effective date. In rejecting the state's argument that its claim for cleanup costs did not arise until after the test results became final, the Court of Appeals for the Seventh Circuit held that a claim arises "when a potential CERCLA claimant can tie the bankruptcy debtor to a known release of a hazardous substance which [the] potential claimant knows will lead to CERCLA response costs."ⁿ⁴³ The court refused to tie the question of "claim" existence to the finality of test results and noted:

[W]hether [CERCLA] response costs were incurred at the time of sampling, the time in which the samples were sent to the laboratory, the time in which preliminary results were received or when the final results were sent out, it is clear that [the State] had sufficient information to give rise to a claim or contingent CERCLA claim ... before the November 25, 1985 [plan of reorganization] consummation date. In fact, any other conclusion would frustrate the bankruptcy court's interest in having all claims before it, and any other conclusion would frustrate CERCLA's goal of providing a speedy cleanup of hazardous sites.ⁿ⁴⁴

Thus, the court found that the state may have had a cognizable claim prior to the plan consummation date, and was barred from asserting the claim after that date.

In a later related case, the same court of appeals held that because the Union Pacific Railroad--the purchaser from the debtor of the affected property--had "constructive knowledge" of facts that would tie the bankruptcy debtor to a known release of hazardous substances on property it owned, that party's right to reimbursement by the debtor of CERCLA response costs constituted a "claim" that was discharged in the bankruptcy case.ⁿ⁴⁵ In deciding that constructive knowledge was a sufficient predicate for the existence of a bankruptcy claim, the court explained that it was not elevating national bankruptcy policy over environmental concerns:

If anything, we are acknowledging the importance of facilitating the cleanup of environmental contamination by placing upon property owners--whether longtime owners or new purchasers--the obligation of performing an environmental audit as early as possible. It is not too much to require a timely examination under any circumstances, but where a present owner expects reimbursement from a predecessor of interest, any delay may preclude relief, because of the intervention of a statute of limitations, or as here, the interposition of dates barring claims imposed by bankruptcy courts.ⁿ⁴⁶

In a still later related case, *CMC Heartland Partners v. Union Pacific Railroad (In re Chicago, Milwaukee, St. Paul & Pacific Railroad Co.)*,ⁿ⁴⁷ the Union Pacific Railroad Company sought to assert against CMC Heartland Partners, as successor to the debtor, a claim for remediation costs relating to the same property, but arising under Model Toxics Control Act of the state of Washington,ⁿ⁴⁸ which had been enacted in 1989, four years after the date of consummation of the debtor's plan. Although Union Pacific's claim under CERCLA had been held by the court of appeals in *Chicago II* to have been barred by reason of its failure to assert a claim prior to the plan consummation date,ⁿ⁴⁹ the new action was based on the argument that a separate cause of action had been created in 1989 under the Washington Model Act, and that Union Pacific's claim thereunder did not exist as of the consummation date and therefore could not be barred. CMC argued that state statutes in existence in 1985 provided for causes of action similar to those created by the Washington Model Act, and that Union Pacific's failure to timely assert a claim under those statutes and under CERCLA barred allowance of its new and similar claim.

As in the case of CERCLA, the Washington Model Act provided for strict liability for owners of contaminated property even where the pollution was caused by a predecessor owner or operator. The court of appeals sought to determine whether, from the perspective of a successor purchaser of contaminated property in 1985, the application of the strict liability standard under the Washington statutes, and the difficulties of proof with respect to a claim against the debtor, would have been such that it would not have been apparent that Union Pacific would one day be deemed liable for the acts of its predecessor in title and give rise to a claim against the predecessor. The court of appeals, affirming the district court, held that Union Pacific's claim under the Washington Model Act was not barred because it was not similar to any claim that could have been asserted under the state statutes.ⁿ⁵⁰ Accordingly, the new claim against CMC could not have been "fairly contemplated" in 1985.

The Court of Appeals for the Seventh Circuit thereafter applied its standards for claims recognition and discharge in *AM International, Inc. v. Datacard Corp.* ⁿ⁵¹ AM International sold its Holmesville, Ohio, site to DBS in 1981. Many employees of AMI became employees of DBS as the result of the sale. However, AMI retained an interest in and control over the tank farm on the property, and manufactured chemicals at the site until 1985. About one year later, Datacard decided to purchase DBS. In the course of its due diligence investigation, Datacard found soil contamination at the site, but concluded that the cost of redemption was relatively low and that it could assert a claim against AMI to recover remediation costs. Accordingly, Datacard consummated the purchase of DBS. AMI had filed a petition under chapter 11 in April 1982, and a plan of reorganization was confirmed in September 1984. AMI sought a judgment declaring that Datacard's claims had been discharged in AMI's chapter 11 case, and Datacard filed claims under CERCLA and RCRA.

The district court determined that an issue of fact existed as to whether DBS had sufficient information to give rise to a CERCLA claim before AMI's plan was confirmed in 1984. AMI argued that the holdings in *Chicago I* and *Chicago II* ⁿ⁵² mandated that Datacard's claim could have been asserted in AMI's chapter 11 case, and was therefore discharged. AMI asserted that its own employees had knowledge of the materials handling practices of AMI at the facility, that these employees had become employees of DBS, and that their knowledge therefore must be imputed to DBS and to Datacard. The court of appeals rejected AMI's position and found the claim was not discharged stating:

AMI's attempt to equate the data available to DBS with the information available to Union Pacific in *Chicago II* doesn't fly. Unlike in *Chicago II*, there had been no visible signs of contamination, no soil testing, no EPA involvement, and no publicized spills at the Holmesville site. In fact, before Datacard came on the scene in 1986, not even AMI realized it faced CERCLA liability As a result, the district court's factual finding that DBS did not have sufficient information to tie AMI to environmental contamination before AMI's bankruptcy was confirmed was not clearly erroneous. It follows, then, that the district court's conclusion that Datacard's CERCLA claims had not been discharged was not an abuse of discretion.ⁿ⁵³

The Court of Appeals for the Fifth Circuit appears to have adopted the formulation articulated in *Chicago I*. In

Louisiana Department of Environmental Quality v. Crystal Oil Co. (In re Crystal Oil Co.),ⁿ⁵⁴ the court was called on to determine whether the Louisiana Department of Environmental Quality ("LDEQ") could reopen Crystal's chapter 11 case in order to file a late claim arising from the contamination by a corporate predecessor of Crystal of an abandoned oil refinery known as the Shoreline site. In holding that LDEQ did have a prepetition claim against the debtor that was discharged upon confirmation of the chapter 11 case, the court stated:

The first question we address is whether LDEQ's environmental liability claim against Crystal arose prior to the confirmation of Crystal's reorganization plan for bankruptcy purposes. We have considered the various standards that have been suggested for the analysis of this question, and are persuaded that the analysis set forth in ... [*Chicago I*] is correct ... Under the test ultimately employed by the court in *Chicago I*, a regulatory environmental claim will be held to arise when "a potential claimant can tie the bankruptcy debtor to a known release of a hazardous substance." 974 F.2d at 786. In this case, then, the question is whether, at the time of bankruptcy, LDEQ could have ascertained through the exercise of reasonable diligence that it had a claim against Crystal for a hazardous release at the Shoreline site.ⁿ⁵⁵

The court went on to affirm the district court's findings that (1) LDEQ had actual knowledge of the presence of a hazardous substance at the Shoreline site, (2) LDEQ could have tied Crystal to the site as a corporate successor to the one-time owner thereof through a search of the records of the Louisiana Secretary of State, (3) LDEQ was not a reasonably ascertainable creditor of Crystal at the time of the filing of Crystal's chapter 11 petition and therefore Crystal was under no obligation to provide actual notice of the bankruptcy filing to LDEQ, (4) LDEQ held, and could have filed, a claim in Crystal's chapter 11 case, and (5) the confirmation of the plan in Crystal's chapter 11 case discharged all claims filed and which could have been filed against Crystal, including the claim of LDEQ.ⁿ⁵⁶

Although the *Chateaugay* "prepetition release or threatened release" standard, the *National Gypsum* "fair contemplation" standard and the similar *Chicago I* "tie in" standard are reasonable frameworks for analyzing environmental claims in light of national bankruptcy policy, one might question whether a bankruptcy court order that purported to discharge or limit a party's right to recover in respect of a reimbursement right that could not have been fairly contemplated at the time of the debtor's bankruptcy comports with the constitutional requirement that a party have adequate notice before its property rights may be impaired or terminated.ⁿ⁵⁷ Therefore, the *National Gypsum* and *Chicago I* approaches may have the advantage of avoiding some of the constitutional issues that might be raised against a strict application of the *Chateaugay* standard in specific cases.ⁿ⁵⁸

[4] Exception From Discharge for Penalties and Willful Injuries

The pre-*Kovacs II* case of *In re Daugherty* ⁿ⁵⁹ suggests that the exception from discharge for governmental fines and penalties under section 523(a)(7) of the Code may be applicable to permit postdischarge recovery for environmental damage. *Daugherty* involved an individual debtor who was fined \$60,000 by the state of Tennessee for environmental damage caused by unlawful surface mining operations. The debtor failed to pay the penalty and subsequently filed a chapter 7 petition. The state sued to prevent the judgment against him from being discharged. The court held that the judgment was excepted from discharge under section 523(a)(7). The critical factor for the court was that the judgment represented a fine or penalty for statutory violations, and was not compensation for pecuniary losses incurred by the state.ⁿ⁶⁰

In addition, *In re Daniels* ⁿ⁶¹ suggests that the exception from discharge for "willful and malicious injury by the debtor to another entity or to the property of another entity" under section 523(a)(6) is applicable to postdischarge recovery of environmental damages. *Daniels* involved an individual debtor in a chapter 7 case who had engaged in prepetition surface coal mining activities in defiance of an earlier injunction brought by the state of Kentucky. After the debtor filed for bankruptcy, the state commenced an adversary proceeding in the bankruptcy court to compel the debtor to pay for reclamation of the mining sites to their original condition and to determine whether such obligations were dischargeable. The bankruptcy court held (1) that the debtor's reclamation obligations were dischargeable to the extent

that they could only be accomplished by the postpetition expenditure of money and (2) that the debts were not excepted from discharge under section 523(a)(6) because the state lacked sufficient interest in the damaged properties to assert nondischargeability under the section.ⁿ⁶²

When the state appealed, the district court, reversing the bankruptcy court, held that although the debtor's reclamation obligation arose from a prepetition claim, that claim was excepted from discharge under section 523(a)(6). The district court cited a Kentucky statute, which expressed the conclusion that unregulated surface mining endangered the health and welfare of the state and its citizens, as evidence that the state was an entity harmed by one who mines coal in violation of state law. The court found that this interest was sufficient to provide the state with standing to assert nondischargeability under the section.ⁿ⁶³ Thus, *Daniels* suggests that general environmental damage may be sufficient to allow an entity, particularly a governmental entity, to assert that a claim is excepted from discharge under section 523(a)(6) even though the entity does not own the damaged property.

FOOTNOTES:

(n1)Footnote 1. 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649, 11 C.B.C.2d 1067 (1985) .

(n2)Footnote 2. Under section 727 an individual in a chapter 7 liquidation proceeding is discharged from all debts that arose prior to the order for relief. Any judgments pertaining to discharged debts are voided and any actions to collect a discharged debt are permanently enjoined. 11 U.S.C. § 524. Discharge under section 727 can be denied if the debtor is not an individual or if the debtor has fraudulently transferred or concealed assets, failed to keep adequate books and records, made false statements in connection with the case or has committed certain other specified actions. 11 U.S.C. § 727(a). The Code provides that ten categories of debts are "exceptions to discharge" and are thereby nondischargeable, including certain taxes, debts incurred by fraud, and fines or penalties owed to a government unit. 11 U.S.C. § 523(a). A discharge is available to corporations, partnerships or individual debtors in a chapter 11 reorganization proceeding. See 11 U.S.C. § 1141(d).

(n3)Footnote 3. 11 U.S.C. § 101(12).

(n4)Footnote 4. 11 U.S.C. § 101(5).

(n5)Footnote 5. 469 U.S. 274, 281, 105 S. Ct. 705, 709, 83 L. Ed. 2d 649, 657, 11 C.B.C.2d 1067, 1072 .

(n6)Footnote 6. 469 U.S. 274, 281 n.9, 105 S. Ct. 705, 709 n.9, 83 L. Ed. 2d 649, 657 n.9, 11 C.B.C.2d 1067, 1071 n.9 . For discussion of *Kovacs I*, see P 6.02[2] *supra*.

(n7)Footnote 7. 469 U.S. 274, 283, 105 S. Ct. 705, 710, 83 L. Ed. 2d 649, 658, 11 C.B.C.2d 1067, 1073 (footnotes omitted).

(n8)Footnote 8. 469 U.S. 274, 285-86, 105 S. Ct. 705, 711, 83 L. Ed. 2d 649, 660, 11 C.B.C.2d 1067, 1074-75 . For discussion of state statutory liens for cleanup costs, see P 6.06 *infra*.

(n9)Footnote 9. See generally Baird & Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 Stan. L. Rev. 1199 (1984).

(n10)Footnote 10. 46 B.R. 136, 12 C.B.C.2d 49 (Bankr. M.D. Fla.) , rev'd on other grounds, 55 B.R. 355 (M.D. Fla. 1985) .

(n11)Footnote 11. 46 B.R. 136, 138, 12 C.B.C.2d 49, 51 .

(n12)Footnote 12. 46 B.R. 136, 139, 12 C.B.C.2d 49, 52 .

(n13)Footnote 13. See also *United States v. Whizco, Inc.*, 841 F.2d 147 (6th Cir. 1988) (debtor discharged from

obligations under cleanup injunction to the extent that injunction requires expenditure of money, but debtor not discharged to the extent that debtor can comply without incurring expenses). *But see United States v. Hubler*, 117 B.R. 160 (W.D. Pa. 1990) (no discharge of debtor's obligation to take affirmative actions to remedy environmental conditions, notwithstanding fact that required actions would necessitate the expenditure of money).

(n14)Footnote 14. *See P 6.03[2] infra.*

(n15)Footnote 15. 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) .

(n16)Footnote 16. 944 F.2d 997, 1005, 25 C.B.C.2d 620, 630 .

(n17)Footnote 17. 944 F.2d 997, 1000, 25 C.B.C.2d 620, 623 .

(n18)Footnote 18. 944 F.2d 997, 1005, 25 C.B.C.2d 620, 629 .

(n19)Footnote 19. *Id.* The Second Circuit carefully pointed out that this holding did not go so far as to include CERCLA response costs attributable to *any* action of the debtor that occurred prepetition, using as an example of a "non-claim" LTV's prepetition conduct of placing hazardous substances in sealed containers, followed by release of the substances into the environment years after confirmation of a chapter 11 plan.

(n20)Footnote 20. The holding in *Chateaugay* was followed by the court in *In re New York Trap Rock Corp.*, 153 B.R. 642 (Bankr. S.D.N.Y. 1993) ; *see also Davenport v. Neely*, 7 F. Supp. 2d 1219, 1233 (M.D. Ala. 1998) , holding that cleanup obligations embodied in a postpetition agreement are not dischargeable where the claimants were seeking compliance with the agreement and not the payment of money.

(n21)Footnote 21. 944 F.2d 997, 1005, 25 C.B.C.2d 620, 629 .

(n22)Footnote 22. 11 U.S.C. § 101(5)(B).

(n23)Footnote 23. 944 F.2d 997, 1008, 25 C.B.C.2d 620, 633 .

(n24)Footnote 24. 944 F.2d 997, 1008, 25 C.B.C.2d 620, 633 .

(n25)Footnote 25. *Id.*

(n26)Footnote 26. 944 F.2d 997, 1009, 25 C.B.C.2d 620, 635 .

(n27)Footnote 27. 944 F.2d 997, 1008-09, 25 C.B.C.2d 620, 634 .

(n28)Footnote 28. 944 F.2d 997, 1009, 25 C.B.C.2d 620, 635 (quoting *Kovacs II*, 469 U.S. 274, 285, 105 S. Ct. 705, 711, 83 L. Ed. 2d 649, 660, 11 C.B.C.2d 1067, 1074) .

(n29)Footnote 29. 944 F.2d 997, 1009, 25 C.B.C.2d 620, 635 (quoting *Midlantic Nat'l Bank v. New Jersey Dept. of Env'tl. Prot.*, 474 U.S. 494, 507, 106 S. Ct. 755, 762, 88 L. Ed. 2d 859, 869, 13 C.B.C.2d 1355, 1362 (1986)) ; *see discussion of Midlantic at P 6.04 infra* .

(n30)Footnote 30. 966 F.2d 1143 (7th Cir. 1992) .

(n31)Footnote 31. 966 F.2d 1143, 1147 . The court cited the requirement in section 106(a) of CERCLA, which permits the EPA to seek an injunction, that there exist "an imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance from a facility." 42 U.S.C. § 9606(a).

(n32)Footnote 32. 966 F.2d 1143, 1146 .

(n33)Footnote 33. 966 F.2d 1143, 1147 .

(n34)Footnote 34. 966 F.2d 1143, 1148 .

(n35)Footnote 35. 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993) , cert. denied, 511 U.S. 1046, 114 S. Ct. 1576, 128 L. Ed. 2d 219 (1994) .

(n36)Footnote 36. 8 F.3d 146, 150, 30 C.B.C.2d 86, 92 .

(n37)Footnote 37. *But see In re Industrial Salvage, Inc.*, 196 B.R. 784 (Bankr. S.D. Ill. 1996) , holding that a chapter 11 debtor's obligation to close to landfills and remediate environmental damage did not constitute a claim and was not dischargeable. The debtor and debtor in possession retained possession and control of the subject property, and the state had not asserted any right to payment.

(n38)Footnote 38. 139 B.R. 397, 27 C.B.C.2d 199 (N.D. Texas 1992) .

(n39)Footnote 39. 139 B.R. 397, 409, 27 C.B.C.2d 199, 213 .

(n40)Footnote 40. 139 B.R. 397, 408, 27 C.B.C.2d 199, 212 .

(n41)Footnote 41. 995 F.2d 925, 29 C.B.C.2d 101 (9th Cir. 1993) (hereinafter *Chicago I*).

(n42)Footnote 41a. 253 F. Supp. 2d 1028 (W.D. Tenn. 2003) .

(n43)Footnote 41b. 253 F. Supp. 2d 1028, 1037-1040 .

(n44)Footnote 42. 974 F.2d 775 (7th Cir. 1992) .

(n45)Footnote 43. 974 F.2d 775, 786 .

(n46)Footnote 44. 974 F.2d 775, 787 .

(n47)Footnote 45. *In re Chicago, Milwaukee, St. Paul & Pac. R.R.*, 3 F.3d 200, 29 C.B.C.2d 705 (7th Cir. 1993) (hereinafter *Chicago II*).

(n48)Footnote 46. 3 F.3d 200, 207, 29 C.B.C.2d 705, 714-15 . For a case applying a standard similar to the "fair contemplation" approach but holding that an environmental claim was not discharged, see *Sylvester Bros. Dev. Co. v. Burlington N. R.R.*, 133 B.R. 648, 653 (D. Minn. 1991) ("[w]hen the debtor has not disclosed its potential [CERCLA] liabilities in long-since closed bankruptcy proceedings, and the governmental agency has not had actual knowledge of the potential claim in sufficient time to file a claim in those proceedings, the potential [CERCLA] liability is not discharged"); see also *United States v. Union Scrap Iron & Metal*, 123 B.R. 831, 836 (D. Minn. 1990) (distinguishing district court's opinion in *Chateaugay* and holding that EPA action arising from prepetition release had not been discharged by earlier plan of reorganization because the EPA had no knowledge of its potential CERCLA claims during the bankruptcy case).

(n49)Footnote 47. 78 F.3d 285 (7th Cir. 1996) .

(n50)Footnote 48. Wash. Rev. Code Ch. 70.105D.010 et seq.

(n51)Footnote 49. *In re Chicago, Milwaukee, St. Paul & Pac. R.R.*, 3 F.3d 200, 29 C.B.C.2d 705 (7th Cir. 1993) .

(n52)Footnote 50. 78 F.3d at 290-93 .

(n53)Footnote 51. 106 F.3d 1342 (7th Cir. 1997) .

(n54)Footnote 52. *See* 995 F.2d 925, 29 C.B.C.2d 101 (9th Cir. 1993); *In re Chicago, Milwaukee, St. Paul & Pac. R.R.*, 3 F.3d 200, 29 C.B.C.2d 705 (7th Cir. 1993) .

(n55)Footnote 53. 106 F.3d 1342, 1348 .

(n56)Footnote 54. 158 F.3d 291 (5th Cir. 1998) .

(n57)Footnote 55. 158 F.3d 291, 296 (5th Cir. 1998) .

(n58)Footnote 56. 158 F.3d 291, 296-98 . It is interesting to juxtapose the holdings in *Crystal Oil* that (a) LDEQ knew of the contamination of the Shoreline site and could have tied Crystal as a corporate successor to the one-time owner to it, and (b) it was not clearly erroneous to conclude that Crystal was not on notice that LDEQ had a potential claim against it. Thus, the governmental agency was deemed to know of the environmental hazard on the site and of Crystal's relationship to a one-time owner of the site, but Crystal was not deemed to know of the environmental issues at the site and its relationship to the same one-time owner. Implicit in these holdings is the proposition that a potential holder of an environmental claim against a debtor under the Code has a duty of inquiry as to the debtor's liability under environmental law, while the debtor in possession or trustee under the Code does not have such a duty in ascertaining the universe of its creditors. Such a proposition may be subject to debate given the supposition that debtors ordinarily have better information regarding environmental issues involving their past and present operation and facilities than outsiders.

(n59)Footnote 57. *See, e.g., In re Piper Aircraft Corp.*, 162 B.R. 619, 628 (Bankr. S.D. Fla. 1994) (suggesting that treating as claims the rights of persons who might bring future product liability actions based upon postconfirmation accidents involving defective products manufactured prepetition created "insurmountable due process requirements"); *In re Waterman S.S. Corp.*, 141 B.R. 552, 27 C.B.C.2d 247 (Bankr. S.D.N.Y. 1992) , *vacated on other grounds*, 157 B.R. 220 (S.D.N.Y. 1993) (potential future claims of persons who had not manifested detectable signs of asbestos diseases could not be discharged in bankruptcy case). *Cf. Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314, 70 S. Ct. 652, 657, 94 L. Ed. 865, 873 (1950) ("[a]n elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated under all the circumstances to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections").

(n60)Footnote 58. *See also Texaco Inc. v. Sanders (In re Texaco Inc.)*, 182 B.R. 937, 951 (Bankr. S.D.N.Y. 1995) (claim arises when "all of the physical events required to establish the elements of causation and damage" occur, even though existence of these events may not be known). However, the court also found that the condition could have been discovered. *Id.*

(n61)Footnote 59. 25 B.R. 158, 7 C.B.C.2d 918 (Bankr. E.D. Tenn. 1982) .

(n62)Footnote 60. *See also In re Jimmo*, 204 B.R. 655 (Bankr. D. Conn. 1997) , which held that an accrued and unpaid fine arising from debtor's prepetition failure to comply with the Connecticut Island Wetlands and Water Courses Act, was a nondischargeable fine under section 523(a)(7). That section excepts from discharge a debt "to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss" other than certain tax penalties. 11 U.S.C. § 523(a)(7). The fine had been imposed as a civil penalty in addition to the imposition of remediation costs. Although the acts giving rise to the fine occurred more than three years before the petition date, the three-year limitation set forth in section 523(a)(7) applies to tax penalties only. *In re Lee*, 40 C.B.C.2d, 222 B.R. 32 (Bankr. W.D.N.Y. 1998) , held to be nondischargeable under section 523(a)(7) a money judgment obtained by the state arising from the debtor's breach of a settlement stipulation involving violations of environmental laws.

(n63)Footnote 61. 130 B.R. 239, 241 (D. Ky. 1991) .

(n64)Footnote 62. 130 B.R. 239, 240 . Apparently, there was no dispute that the debtor's prepetition activities

constituted "willful and malicious injury" within the meaning of the statute.

(n65)Footnote 63. *130 B.R. 239, 241* .

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

1-6 Collier Real Estate Trans & Bankruptcy Code P 6.04

P 6.04 Abandonment

[1] *Midlantic National Bank v. New Jersey Department of Environmental Protection.*

In *Midlantic National Bank v. New Jersey Department of Environmental Protection*,ⁿ¹ the Supreme Court addressed the conflict between the trustee's right, set forth in section 554(a),ⁿ² to abandon property that is burdensome to the estate and the government's interest in requiring responsible parties to bear environmental cleanup costs. In the earlier *Kovacs II* case, the Court, in *dictum*, suggested that the trustee's power to abandon burdensome property was unqualified.ⁿ³ However, when faced with a case involving a dangerous environmental condition that abandonment clearly worsened, a divided Court concluded that in certain circumstances state environmental laws would supersede the provisions of the Code.

The debtor in the case was Quanta Resources Corp., a waste oil processor that operated one facility in New York and another in New Jersey. The New Jersey Department of Environmental Protection discovered that the New Jersey plant had accepted more than 400,000 gallons of oil contaminated with PCBs, and ordered the facility shut down. In the midst of negotiations regarding a cleanup of the site, Quanta filed a chapter 11 petition, which was soon converted to a chapter 7 case.

Subsequently, the New York facility was also found to contain over 70,000 gallons of contaminated oil. After unsuccessfully trying to sell the New York property, the trustee gave notice of his intent to abandon it pursuant to section 554(a). The bankruptcy court approved the abandonment of the site over the state's objections, and shortly thereafter approved the trustee's request to abandon the New Jersey property. The two states appealed the decisions of the bankruptcy court.

The Supreme Court noted that, upon abandonment, the trustee removed the 24-hour guard service and shut down the fire-suppression system at the New York site. The bankruptcy court did not require the trustee to "take even relatively minor steps" to reduce imminent danger at the New Jersey property, such as security fencing, sealing deteriorating tanks and removing explosive agents.ⁿ⁴ The Court observed that "the trustee's abandonment at both sites aggravated already existing dangers by halting security measures that prevented public entry, vandalism and fire."ⁿ⁵

Faced with these facts, the Court concluded that despite its unqualified language, section 554(a) was intended to incorporate "well-recognized" judicially created restrictions on a trustee's abandonment power.ⁿ⁶ The bankruptcy court,

it concluded, did not have the power to authorize abandonment without "formulating conditions that will adequately protect the public health and safety."ⁿ⁷ Therefore, the Court held, a trustee may not abandon property in contravention of a state statute or regulation reasonably designed to protect the public health or safety from identified hazards.ⁿ⁸

The Court found support for its holdings in the requirement of 28 U.S.C. § 959(b) that the trustee "manage and operate the property in his possession ... according to the requirements of the valid laws of the State in which the property is situated," and in Congress's "undisputed concern" over pollution from hazardous wastes.ⁿ⁹ In an important footnote, the Court emphasized that the exception to the abandonment power created by its holding was a narrow one that "does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment."ⁿ¹⁰ In addition, abandonment is not to be restricted by "laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm"ⁿ¹¹ or, the Court suggested, by "state laws imposing conditions on abandonment that may be so onerous as to interfere with bankruptcy adjudication itself."ⁿ¹²

Justice Rehnquist, in his dissent, sharply criticized the majority's analysis. He distinguished the pre-Code cases relied upon by the Court to limit the abandonment power and observed that Congress could easily have qualified section 554(a) if it had wished to do so. Justice Rehnquist concluded that the majority's holding prohibiting abandonment may be read to require the trustee to expend all of the debtor's available assets to conduct a cleanup, thereby forcing the debtor to incur expenses that otherwise would be borne by the state. Justice Rehnquist noted that "barring abandonment and forcing a cleanup would effectively place [the state's] interest in protecting the public fisc ahead of the claims of other creditors,"ⁿ¹³ a result that he did not believe Congress intended section 554(a) to have.

[2] Subsequent Cases

Several post-*Midlantic* cases have focused on the limitations expressed in the Supreme Court's holding to permit abandonment in cases presenting less extreme facts. These cases suggest that if the hazardous substances on the property do not pose immediate danger to the public, and if the trustee has promptly notified local environmental authorities of the contamination and cooperated with them, abandonment may be permitted.

In re Oklahoma Refining Co. ⁿ¹⁴ involved a crude oil refinery that a trustee sought to abandon in a chapter 11 case. The ground and open pits on the property were contaminated with acid, waste asphalt and other toxic substances. While a danger existed that the toxic wastes from the property would eventually threaten public water supplies, expert testimony indicated that no imminent threat to public health was present. Over the objections of the state environmental authorities, the court permitted the abandonment. The court rejected the view that the *Midlantic* holding prohibited abandonment of property not in strict compliance with state environmental laws, and concluded that *Midlantic* only requires the bankruptcy court to "take state environmental laws and regulations into consideration"ⁿ¹⁵ when faced with a request to abandon contaminated property.

The court was influenced by the fact that after the refinery operations had ceased, no additional contaminants had been generated on the site. The court also noted that in contrast with the actions of the trustee in *Midlantic*, the trustee in *Oklahoma Refining* removed certain hazardous materials from the premises, hired a consulting firm to investigate the extent of the pollution and took other steps to minimize additional hazards and cooperate with the state agencies. The court observed that the cleanup would cost over \$2.5 million, yet the property would be worth only \$100,000 upon its completion. The trustee did not have any cash that was not cash collateral and creditors would not agree to the expenditure of additional amounts for the cleanup. The court concluded that requiring strict compliance with environmental laws would "fetter the estate to a situation without resolve."ⁿ¹⁶ In light of the trustee's reasonable actions and the burden that compliance would impose on the estate, the court authorized abandonment. It observed that "the Oklahoma laws regarding environmental protection are not unreasonable but juxtaposed to the Bankruptcy Code cannot be reconciled to satisfy the strict compliance sought by the State agencies."ⁿ¹⁷

The bankruptcy court in *In re Franklin Signal Corp.* ⁿ¹⁸ likewise sought to avoid the consequences that would follow

from a strict application of the *Midlantic* holding. The case involved a chapter 7 trustee's attempt to abandon property on which 14 waste drums containing hazardous chemicals were located. The court acknowledged that "read literally" the *Midlantic* holding would appear to bar any abandonment that would contravene a state law reasonably designed to protect public health and safety. However, the court concluded that "the Supreme Court intended only to place limits on a trustee's power of abandonment by holding that the bankruptcy court cannot authorize the abandonment of property in contravention of state law *unless* conditions are formulated that will adequately protect the public health and safety."ⁿ¹⁹ The court suggested that a balancing approach be adopted when abandonment of contaminated property is proposed and that the following factors be considered: (1) the imminence of danger to the public health and safety; (2) the extent of probable harm; (3) the amount and type of hazardous waste; (4) the cost to bring the property in compliance with environmental laws; and (5) the amount and type of funds available for cleanup.

Addressing the specifics of the case, the court noted that the trustee had acted responsibly in hiring an environmental specialist to determine the extent of the contamination and in reporting the matter to the state environmental authorities. In addition, the state Department of Natural Resources had not acted after being notified by the trustee of the contamination problem, creating the "logical inference" that the waste drums did not pose an imminent public health threat.ⁿ²⁰ The court concluded that in light of these factors and given the estate's lack of unencumbered resources to fund the cleanup, abandonment was appropriate.

The confusion over the abandonment issue is evidenced by the bankruptcy court's discussion in *In re Peerless Plating Co.* ⁿ²¹ The court concluded that it must "respectfully disagree" with *Franklin Signal's* holding that *Midlantic* permits abandonment of hazardous waste sites that do not comply with applicable environmental law. Although the court conceded that "the narrow reading given to *Midlantic* by *Franklin Signal* is more in harmony with the Bankruptcy Code,"ⁿ²² it concluded that such a reading was inconsistent with *Midlantic*. The "clear impact" of *Midlantic*, according to the court, is that a trustee may not abandon a hazardous waste site unless (1) the environmental law in question is so onerous as to interfere with the bankruptcy adjudication; (2) the environmental law in question is not reasonably designed to protect the public health or safety from identified hazards; or (3) the violation caused by abandonment would be speculative or indeterminate.ⁿ²³

In re Stevens ⁿ²⁴ also adopted a more literal reading of *Midlantic*. At issue was whether a trustee had the right to abandon property on which drums of contaminated waste oil were stored. The trustee argued that *Midlantic* does not require compliance with state laws regulating the disposal of hazardous waste provided that reasonable measures are taken to protect the public. The court rejected this contention. It concluded that *Midlantic's* requirement that a court, prior to authorizing abandonment, establish conditions that will adequately protect the public's health and safety meant that the property to be abandoned must be in full compliance with state and local law.ⁿ²⁵

The issue of abandonment of an asset that is or may be contaminated is not limited to owners and may arise as well in the context of a proposed rejection of a lease by a debtor-lessee. Indeed, the concept of rejection of executory contracts and unexpired leases is sometimes viewed as an outgrowth under bankruptcy law of a trustee's power to abandon burdensome property.ⁿ²⁶ Section 365(a) provides that, subject to certain limitations "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." The generally applicable standard under which the court will approve a rejection or assumption of a contract or lease is the business judgment rule, which gives great weight to the judgment of the trustee or debtor in possession in dealing with contracts and leases under section 365(a).ⁿ²⁷

In re Circle K Corporation ⁿ²⁸ involved a debtor that operated as lessee numerous small retail stores and sold gasoline at many of these locations. The gasoline operation entailed the maintenance and use of underground storage tanks ("USTs"), some of which were leaking. The debtor in possession ceased operations at a number of the stores and sealed, locked and capped the tanks located at these sites. The debtor sought to reject the leases of the closed stores. The rejection motion was opposed by numerous landlords who argued, among other things, that *Midlantic* prohibited the rejections inasmuch as some of the USTs were or might be leaking, and that the debtor should first perform

environmental audits and cleanups as a condition to rejection. The court held that the lease rejections would be permitted without requiring the debtor to first perform all necessary environmental cleanups, subject to the right of any landlord to demonstrate the existence of imminent danger to public health or safety.ⁿ²⁹ The court left for another day the question of allowance of claims of the landlords arising from the existence of environmental problems, including the question whether claims would be classified as general unsecured claims or be given administrative expense priority.ⁿ³⁰

The narrowness of the *Midlantic* exception to abandonment and the requirement that there be an actual rather than speculative threat to the public was demonstrated by a bankruptcy court decision in Delaware. In *In re Unidigital, Inc.*,ⁿ³¹ the debtor operated a printing enterprise at leased premises. Although the debtor succeeded in selling most of its assets located at the leased premises, it was unable to sell one large piece, a "Champion printer." The printer was a very large piece of machinery, and its removal from the premises would require that it be dismantled and removed through the premises windows by crane. Removal of the equipment also required a licensed plumber to disconnect the water and drain the development chemicals and the removal of printing chemicals on the premises. There was evidence of possible seepage of chemicals. Not surprisingly, after rejecting the lease the debtor also sought to abandon the printer, and the landlord objected by asserting that *Midlantic* governed because of the presence of the chemicals. The court rejected the application of *Midlantic* by finding that there was no evidence of imminent harm to the public health and that any potential harm from the presence of printing chemicals could be alleviated by proper and professional disassembly and removal.ⁿ³² The court also rejected the landlord's request for administrative expense treatment for the removal costs because such expenditures did not arise from a postpetition transaction between the landlord and the debtor and were not actual and necessary to preserve the estate.ⁿ³³

The importance of a debtor's affirmatively addressing the status of its executory contracts in the environmental context was presented by a case involving the reorganized Texaco Oil Company. In *In re Texaco*,ⁿ³⁴ the court faced the issue of whether contractual environmental remediation obligations, including both obligations that are express in a contract and obligations that are deemed implied in the contract pursuant to local statutes and interpretive caselaw, arising under oil and gas leases that were neither assumed nor rejected in the case, were discharged in connection with the confirmation of Texaco's reorganization plan nearly 10 years earlier. The debtor argued that since the leases at issue had not been affirmatively assumed or rejected under the plan or otherwise during the case, the remediation obligations were discharged pursuant to *section 1141(d)(1)(A) of the Bankruptcy Code*.ⁿ³⁵

The court disagreed, noting that assumption or rejection of a contract is not mandated in a chapter 11 case, except in the case of certain types of leases,ⁿ³⁶ and ruling that so long as a debtor continues to receive benefits under a contract it must also bear the burdens or obligations imposed thereby. The court noted that although claims arising from any breach of the lease that occurred prior to confirmation may be subject to discharge, the claims at issue in the cases before it arose after confirmation because the leases were not breached before or during the bankruptcy but, rather, afterwards, when the debtor sought to avoid its remediation obligations. Thus, the court held that the subject oil and gas leases passed through the bankruptcy unaffected by *section 365 of the Code*, and, since the debtor had obtained the benefit of the leases, it was required to suffer the burdens and comply with the remediation provisions of the leases.

The *Texaco* case highlights the fact that in certain circumstances, environmental claims that are deemed to arise under a contract may have a longer "tail" than claims arising directly under statutes such as CERCLA or state laws of similar effect. For debtors, *Texaco* points out the importance of clearly addressing the status of each contract or lease during the bankruptcy case in order to maximize the opportunity to use the bankruptcy process to discharge potential environmental liabilities.

FOOTNOTES:

(n1)Footnote 1. 474 U.S. 494, 106 S. Ct. 755, 88 L. Ed. 2d 859, 13 C.B.C.2d 1355 (1986) .

(n2)Footnote 2. Section 554(a) provides that "after notice and a hearing, the trustee may abandon any property of

the estate that is burdensome to the estate or that is of inconsequential value to the estate." The property is abandoned to the person having a possessory interest in it. This may be the debtor, but it may also be another party in possession, such as a secured party, lessee, or successor in title. *See generally Collier on Bankruptcy*, P 554.02 (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. 469 U.S. 274, 284-85 n.12, 105 S. Ct. 705, 710 n.12, 83 L. Ed. 2d 649, 659 n.12, 11 C.B.C.2d 1067, 1073 n.12 ("If the property were worth less than the cost of cleanup, the trustee would likely abandon it to its prior owner ...").

(n4)Footnote 4. 474 U.S. 494, 499 n.3, 106 S. Ct. 755, 758 n.3, 88 L. Ed. 2d 859, 864 n.3, 13 C.B.C.2d 1355, 1357 n.3 .

(n5)Footnote 5. *Id.*

(n6)Footnote 6. 474 U.S. 494, 501, 106 S. Ct. 755, 759, 88 L. Ed. 2d 859, 865, 13 C.B.C.2d 1355, 1359 . To support this conclusion, the Court discussed the "few relevant cases." *See Ottenheimer v. Whitaker*, 198 F.2d 289 (4th Cir. 1952) (trustee could not abandon barges in violation of statute designed to ensure safe navigation); *In re Chicago Rapid Transit Co.*, 129 F.2d 1 (7th Cir. 1942) , cert. denied, 317 U.S. 683, 63 S. Ct. 205, 87 L. Ed. 547 (1942) (trustee of debtor transit company could not terminate operation of branch railway line when local law required continued operation); *In re Lewis Jones, Inc.*, 1 Bankr. Ct. Dec. (LRP) 277 (Bankr. E.D. Pa. 1974) (debtor public utility required to seal underground steam lines before abandoning them).

(n7)Footnote 7. 474 U.S. 494, 507, 106 S. Ct. 755, 762, 88 L. Ed. 2d 859, 869, 13 C.B.C.2d 1355, 1362 .

(n8)Footnote 8. *Id.*

(n9)Footnote 9. 474 U.S. 494, 505, 106 S. Ct. 755, 762, 88 L. Ed. 2d 859, 868, 13 C.B.C.2d 1355, 1361 .

(n10)Footnote 10. 474 U.S. 494, 507 n.9, 106 S. Ct. 755, 762 n.9, 88 L. Ed. 2d 859, 869 n.9, 13 C.B.C.2d 1355, 1362 n.9 .

(n11)Footnote 11. *Id.*

(n12)Footnote 12. *Id.*

(n13)Footnote 13. 474 U.S. 494, 516-17, 106 S. Ct. 755, 767, 88 L. Ed. 2d 859, 875, 13 C.B.C.2d 1355, 1368 .

(n14)Footnote 14. 63 B.R. 562, 15 C.B.C.2d 621 (Bankr. W.D. Okla. 1986) .

(n15)Footnote 15. 63 B.R. 562, 565, 15 C.B.C.2d 621, 625 .

(n16)Footnote 16. 63 B.R. 562, 565, 15 C.B.C.2d 621, 626 .

(n17)Footnote 17. 63 B.R. 562, 565, 15 C.B.C.2d 621, 626 . *Accord In re Smith-Douglass, Inc.*, 856 F.2d 12 (4th Cir. 1988) . The *Borden* case is significant for suggesting that stricter compliance with environmental laws should be required where the estate has unencumbered assets, (856 F.2d 12, 17) , a view which was questioned by *In re H.F. Radandt, Inc.*, 160 B.R. 323, 29 C.B.C.2d 1200 (Bankr. W.D. Wis. 1993) .

(n18)Footnote 18. 65 B.R. 268, 15 C.B.C.2d 869 (Bankr. D. Minn. 1986) .

(n19)Footnote 19. 65 B.R. 268, 270-71, 15 C.B.C.2d 869, 872 .

(n20)Footnote 20. Similarly, numerous other courts have viewed the relative inaction or lack of urgency exhibited

by the government as a significant fact suggesting that there was no imminent public health threat which would prevent the trustee's abandonment. *See, e.g., In re Heldor Indus., Inc.*, 131 B.R. 578, 587-88 (Bankr. D.N.J. 1991) , *appeal dismissed, motion to vacate denied*, 139 B.R. 290 (D.N.J. 1992) , *rev'd and vacated sub nom. New Jersey Dep't of Env'tl. Prot. & Energy v. Heldor Indus.*, 989 F.2d 702 (3d Cir. 1993) ; *In re Smith-Douglass*, 856 F.2d 12 (4th Cir. 1988) ; *New Jersey Dep't of Env'tl. Prot. v. North Am. Prods. Acquisition Corp.* 137 B.R. 8, 11-13, 27 C.B.C.2d 107, 110-12 (D.N.J. 1992) ; *In re H.F. Radandt, Inc.*, 160 B.R. 323, 29 C.B.C.2d 1200 (Bankr. W.D. Wis. 1993) . *In re Shore Co.*, 134 B.R. 572 (Bankr. E.D. Tex. 1991) ; *In re Better-Brite Plating, Inc.* 105 B.R. 912, 919 (Bankr. E.D. Wis. 1989) ; *In re FCX, Inc.* 96 B.R. 49, 55 (Bankr. E.D.N.C. 1989) .

(n21)Footnote 21. 70 B.R. 943 (Bankr. W.D. Mich. 1987) . The principal issue before the court was whether the federal Environmental Protection Agency was entitled to administrative expense priority for cleanup costs that it incurred. *See P 6.05 infra*; *see also In re Wall Tube & Metal Products Co.*, 831 F.2d 118 (6th Cir. 1987) ; *Environmental Waste Control, Inc.*, 125 B.R. 546, 550-52 (Bankr. D. Mass 1991) ; *In re Microfab, Inc.*, 105 B.R. 161, 169 (Bankr. D. Mass. 1989) ; *In re Stevens*, 68 B.R. 774, 780-81, 16 C.B.C.2d 253 (Bankr. D. Me. 1987)

(n22)Footnote 22. 70 B.R. 943, 15 Bankr. Ct. Dec. (LRP) 903, 905 n.1 .

(n23)Footnote 23. 70 B.R. 943, 15 Bankr. Ct. Dec. (LRP) 903, 905 .

(n24)Footnote 24. 68 B.R. 774, 16 C.B.C.2d 253 (D. Me. 1987) .

(n25)Footnote 25. The district court in *In re Brio Ref., Inc.*, CCH Bankr. L. Rep. P 72,551 (N.D. Tex. 1988), ratified an earlier abandonment where the chapter 7 trustee was unaware of the hazardous condition of the property at the time of abandonment. Courts in subsequent cases have generally interpreted *Midlantic* to permit abandonment when no risk of imminent harm exists but to require the trustee to take remedial measures prior to abandonment if the facility constitutes an imminent danger to the public health. *See, e.g., In re Smith-Douglass, Inc.*, 856 F.2d 12 (4th Cir. 1988) (abandonment permitted); *In re Anthony Ferrante & Sons, Inc.*, 119 B.R. 45 (D.N.J. 1990) (abandonment permitted); *In re St. Lawrence Corp.*, 239 B.R. 720 (Bankr. D. N.J. 1999) (abandonment permitted); *In re Better-Brite Plating, Inc.*, 105 B.R. 912 (Bankr. E.D. Wis. 1989) (abandonment permitted); *In re FCX, Inc.*, 96 B.R. 49 (Bankr. E.D.N.C. 1989) (abandonment not permitted).

(n26)Footnote 26. *See Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. of Col. L. Rev. 845, 863n. 80 (1988).

(n27)Footnote 27. *E.g., Lubrizol Enters. Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) .

(n28)Footnote 28. 1991 Bankr. LEXIS 1190 (Bankr. D. Ariz. 1991) .

(n29)Footnote 29. 1991 Bankr. LEXIS 1190 at *4 . It has been held that a debtor-lessor may not reject a lease of residential real property where the effect of the proposed rejection would be to deprive the tenant of the protections of local rent control laws. *Friarton Estates Corp. v. City of New York (In re Friarton Estates Corp.)*, 65 B.R. 586, 15 C.B.C.2d 779 (Bankr. S.D.N.Y. 1986) ; *see P 3.03[4] supra*.

(n30)Footnote 30. 1991 Bankr. LEXIS 1190 at *18 .

(n31)Footnote 31. 262 B.R. 283 (Bankr. D. Del. 2001) .

(n32)Footnote 32. 262 B.R. 283, 287 .

(n33)Footnote 33. 262 B.R. 283, 289 . Co-authors of an article have implicitly questioned the outcome of *Unidigital* and suggested that a rationale for administrative expense treatment of at least a portion of the removal costs is the fact that the abandonment of the equipment was tantamount to remaining in possession as a holdover tenant until

the removal. Therefore, the authors suggest, the debtor's use of that space, effectively for the purpose of storing the equipment, should be an administrative expense of the estate. See T. Berkowitz & J. Gitto, *Sec. 554: Who Pays for Abandonment*, 19 Bankruptcy Strategist (Oct. 2002).

(n34)Footnote 34. 254 B.R. 536, 150 O.&G.R. 53 (Bankr. S.D.N.Y. 2000) .

(n35)Footnote 35. 254 B.R. 536, 556, 150 O.&G.R. 53 .

(n36)Footnote 36. The court contrasted this general rule with the situation of unexpired leases of nonresidential real property which are "deemed rejected" unless the lease is affirmatively assumed or rejected within 60 days of the petition date, pursuant to section 365(d)(4). *Id.* at 557 .

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

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P 6.05 Priority of Cleanup Expenses

The immediacy of many hazardous waste problems and the unwillingness or inability of the property owner to take remedial action often results in the state or federal government, or other third parties, effecting a cleanup pursuant to statutory authority and later requesting reimbursement for its costs.ⁿ¹ When the property owner has filed a bankruptcy petition the issue that commonly arises is whether the reimbursement claim is granted administrative expense priority over claims of other unsecured creditors.ⁿ²

[1] Prepetition Conditions Remedied Postpetition--Governmental Claimants

One of the first cases in which cleanup costs incurred by a government agency were held to be administrative expenses is *In re T.P. Long Chemical, Inc.* ⁿ³ In that case, the debtor had operated a rubber recycling plant in Akron, Ohio. Subsequent to the debtor's filing of a chapter 11 petition,ⁿ⁴ the United States Environmental Protection Agency ("EPA") determined that hazardous wastes had been stored on the property during the prepetition period, and removed them pursuant to CERCLA during the postpetition period.

The EPA claimed that its costs incurred in the cleanup were administrative expenses. In addition, the EPA argued that it should be entitled to recover its costs out of secured creditors' collateral pursuant to section 506(c), which provides that "the trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such a claim."ⁿ⁵

After determining that an estate could be a party liable to the EPA under CERCLA, the court next addressed the issue of whether the cleanup involved "actual, necessary costs and expenses of preserving the estate," as required by section 503(b)(1)(A). The trustee argued that they were not because the trustee could have abandoned the property pursuant to section 554(a). The court disagreed, relying on the Third Circuit's holding in *Midlantic* to find that property subject to CERCLA violations may not be abandoned. Even if abandonment were permitted, the court added, the estate would be subject to CERCLA liability as a former "owner or operator" of the facility.ⁿ⁶ Since liability for the cleanup costs could not be avoided through abandonment, the court concluded that "the cost incurred by the EPA in discharging this liability is an actual, necessary cost of preserving the estate entitled to administrative expense priority."ⁿ⁷ Thus the bankruptcy court held that the EPA's costs were entitled to administrative expense priority.

However, the court rejected the EPA's contention that under section 506(c)ⁿ⁸ its claim should have priority over that of

a bank creditor that held a security interest in certain of the debtor's property sold by the trustee, including waste drums cleaned up by the EPA. The court concluded that since the drums were worthless as collateral, the EPA's cleanup action did not confer a benefit on the bank and that the cleanup expenses were not recoverable from the sale proceeds upon which the bank had a lien.ⁿ⁹

T.P. Long has been followed by a number of courts of appeals decisions that have articulated a majority rule that a governmental claimant will be granted administrative priority status for reimbursement of costs incurred during the postpetition period for the remediation of environmental hazards created by the debtor before the filing of its petition under the Code.

In *Lancaster v. Tennessee (In re Wall Tube Metal Products)*,ⁿ¹⁰ the Court of Appeals for the Sixth Circuit granted administrative priority to the claim of the state of Tennessee for response costs relating to the debtor's failure to dispose of hazardous wastes generated in the debtor's operations prior to the filing its chapter 7 petition. In reversing the holdings of the bankruptcy court and district court, the Sixth Circuit held that (1) under the Supreme Court's holding in *Midlantic*,ⁿ¹¹ the trustee could not abandon the affected site under section 554(a) if the effect would be to leave unremediated a "potentially disastrous" health hazard,ⁿ¹² (2) section 959(b)ⁿ¹³ applies to liquidating trustees as well as to debtors in possession and operating trustees,ⁿ¹⁴ (3) the liquidating trustee therefore had an obligation under section 959(b) and under state law to clean up the site during the postpetition period and (4) the failure or inability of the trustee to clean up the site during the postpetition period would necessitate a cleanup by the state, thereby mandating administrative priority status for the state's claim.ⁿ¹⁵ Inasmuch as section 959(b) compelled the trustee to take remedial action, the cost of this action would be deemed an actual, necessary cost and expense of preserving the estate.ⁿ¹⁶

The Court of Appeals for the Fourth Circuit, in *In re Smith-Douglass, Inc.*,ⁿ¹⁷ held on the facts before it that the operating trustee could abandon a fertilizer plant inasmuch as the bankruptcy court had found no threat of immediate harm.ⁿ¹⁸ The court viewed the *Midlantic* holding as authorizing abandonment of a site containing hazardous wastes in violation of nonbankruptcy law if, notwithstanding such violations, there is no need to protect the public health or safety from imminent and identifiable harm.ⁿ¹⁹ Abandonment would free the trustee from the requirements of section 959(b), and therefore eliminate the argument that remediation was a postpetition obligation of the estate and an actual and necessary cost of administration.

Although the *Smith-Douglass* holding may be viewed as a fact-based decision involving the absence of imminent harm and as therefore consistent with the holdings in *T.P. Long* and *Wall Tube*, the court, in *dictum*, added the following commentary concerning the absence of unencumbered assets in the estate that would otherwise be available to fund a cleanup:

The district court, contra to the bankruptcy court's conclusion, held that the financial condition of the debtor is irrelevant to the *Midlantic* analysis. This Court disagrees. Cleaning up environmental violations is properly considered an administrative expense within the meaning of 11 U.S.C. § 507(a). While such expense would be subordinate to secured claims, it would have priority over unsecured claims. Accordingly, where the estate has unencumbered assets, the bankruptcy court should require stricter compliance with state environmental law before abandonment is permitted. *Smith-Douglass*, however, had no unencumbered assets.ⁿ²⁰

In *In re Chateaugay Corp.*,ⁿ²¹ the Court of Appeals for the Second Circuit, in a brief portion of a lengthy opinion, granted administrative priority to the claims of the EPA for postpetition response costs to prepetition conditions, citing *Wall Tube* and additional precedents.ⁿ²²

Wall Tube and *Chateaugay* were followed in the Court of Appeals for the Third Circuit's 1994 decision in *Commonwealth of Pennsylvania v. Conroy*.ⁿ²³ In 1985, the Court of Appeals for the Third Circuit decided *Southern Railway Co. v. Johnson Bronze Co.*,ⁿ²⁴ holding that a private-party claimant, in seeking to be subrogated to the

environmental remediation claim of a governmental body, had no greater claim than the governmental body and that such claim for postpetition remediation of a prepetition condition was a general unsecured claim.ⁿ²⁵ *Midlantic* had not been decided by the Supreme Court at the time of issuance of the *Southern Railway* decision, and the Court of Appeals for the Third Circuit in *Southern Railway* viewed the Supreme Court's decision in *Ohio v. Kovacs* ⁿ²⁶ as holding that "Ohio's injunction directing the cleanup of a hazardous waste site was no more than a general unsecured claim."ⁿ²⁷ The court in *Conroy* refused to be bound by its decision in the *Southern Railway* case, stating that "Southern Railway said nothing about whether a bankruptcy court may grant administrative expense priority to the costs that an environmental agency incurs in cleaning up a hazardous waste site that could not be abandoned under state law."ⁿ²⁸ Although the court tried to distinguish *Southern Railway* as involving a state administrative order requiring cleanup of hazardous wastes that was not granted administrative priority under section 105(a),ⁿ²⁹ the court also cited to a number of authorities suggesting that the holding of *Southern Railway* did not survive *Midlantic*.ⁿ³⁰

In *H.L.S. Energy Company v. Lowe*,ⁿ³¹ the Court of Appeals for the Fifth Circuit granted administrative priority in a chapter 7 case to a claim for breach of a well plugging agreement between the state and the debtor in possession entered into during the pendency of the immediately preceding chapter 11 case. In the course of its opinion, the court dealt with the question whether such a claim constituted an actual necessary cost of administration of the chapter 7 case, and determined that the fulfillment by the estate of an obligation (the plugging of inactive wells), and the avoidance of fines and penalties arising from noncompliance, constituted a benefit to the estate.ⁿ³²

In one recent case from the District of Delaware, *In re Insilco Technologies, Inc.*,^{n32a} the bankruptcy court determined that even though the debtor was subject to a binding prepetition consent order with the state agency that required the entity to monitor and remediate ongoing pollution, the fact that the debtor was no longer the owner of the site was decisive in denying administrative expense status to the agency's request for reimbursement of future remediation costs. The court held that administrative priority would be denied because the debtor had sold the site four years prior to the bankruptcy, and, accordingly, any expenditures would not benefit or otherwise enhance property of the estate.^{n32b} The court distinguished *In re Torwico Electronics*,^{n32c} which held, among other things, that environmental remediation obligations "ran with the waste" rather than the subject property, by noting that, in the case before it, the agency was seeking to obtain reimbursement of future costs expected to be incurred by the agency rather than to compel the debtor's performance itself with a consent order. Given that both situations involve the expenditure of funds by the estate--on the one hand, reimbursement to the government for failure of the debtor to comply with its primary obligation under the consent order and, on the other hand, compliance with the debtor's primary obligation--the basis for distinguishing *Torwico* may be questionable. Nonetheless, the *Insilco* case points out that the form of relief sought by the plaintiff may be critical for determining whether it is ultimately a government agency or a debtor that pays for the costs of remediating ongoing environmental issues.

[2] Prepetition Conditions Remedied Postpetition--Nongovernmental Claimants

The allowance of administrative expense priority for governmental claims seeking reimbursement for postpetition cleanup of prepetition environmental hazards seems reasonably well established in the caselaw.ⁿ³³ However, the allowance standards for administrative priority claims, and the allowed amounts of those claims that are deemed to have administrative priority, are much less clear in the case of a private party seeking reimbursement or damage recoveries against an estate arising from prepetition conditions.

In *In re Dant & Russell, Inc.*, ⁿ³⁴ the Court of Appeals for the Ninth Circuit held that a lessor under postpetition leases with a debtor in possession would receive administrative priority treatment for its cleanup claim against the estate, but only to the extent of the fair and reasonable rental value of the premises. The court cited to numerous authorities dealing with postpetition use and occupancy of real property,ⁿ³⁵ and seemingly ignored the fact that the postpetition leases contained a provision obligating the estate to maintain the premises in good condition and in compliance with applicable law, and that a breach of a postpetition lease should give rise to a full state law damage claim having priority as an expense of administration.ⁿ³⁶ In addition, the court rejected the argument that the lessor was entitled to an

administrative expense priority for its cleanup claim inasmuch as it was jointly liable with the estate under CERCLA, and that *Midlantic* mandated the allowance of administrative priority status to claims for reimbursement of the costs of a postpetition remediation of a prepetition environmental hazard.ⁿ³⁷ The court cited to the *Southern Railway* case, *supra*,ⁿ³⁸ and to *Kovacs*,ⁿ³⁹ and argued that these cases were more apposite because they involved claims for the cost of cleaning up property that was not owned by the estate, and distinguished the cases that upheld administrative priority status for the claims arising from postpetition cleanup of property of the estate that had been polluted in the prepetition period.ⁿ⁴⁰ It appears that the court viewed the leased premises as solely the property of the lessor-claimant, with the cleanup thereof conferring no benefit upon the estate.

In re Kent Holland Die Casting & Plating, Inc. ⁿ⁴¹ presents in one case many of the issues that arise in connection with the prosecution of private party administrative claims for damages resulting from environmental contamination. The lessor and the debtor-lessee had entered into a prepetition lease of real property requiring the lessee to keep the property in a "clean and healthy" conditionⁿ⁴² and in good order and repair. Before the filing of the debtor-lessee's petition under chapter 11 of the Code, the debtor contaminated the property with wastewater from its operations, and also stored approximately 120 drums containing hazardous materials on it. The debtor continued in operation after the filing of its chapter 11 petition, a plan was confirmed, and the lease was assumed. Following confirmation, the debtor entered into a new lease with the same lessor. This lease also contained a provision requiring the lessee to maintain the premises in a clean and healthy condition and in accordance with applicable laws and governmental directives. Thereafter, the chapter 11 case was converted to a chapter 7 case. The wastewater contamination was not remediated during the pendency of the chapter 11 or the chapter 7 case, and the drums containing hazardous wastes were neither removed nor abandoned by the chapter 7 trustee.

The lessor removed the drums from the leased premises following the surrender of the premises by the trustee, but was later sued by the EPA under CERCLA to compel cleanup of the substances that had been spilled on the property during the course of the debtor's operations. The lessor sought, in the debtor's chapter 11 and chapter 7 cases, administrative expense priority status for the costs of removing the drums and for the cleanup of the property. The claim for the cost of the cleanup was based on (1) a right to contribution under CERCLA, (2) the claimant's rights under the assumed prepetition lease and (3) negligence of the representatives of the estate during the postpetition period. The court held that the trustee's failure to remove the drums of hazardous substances was a postpetition act that gave rise to an administrative claim of the lessor in the chapter 7 case.ⁿ⁴³ The court denied allowance of the lessor's CERCLA cleanup claim against the debtor on the basis that the EPA's suit against the lessor (joined by the state of Michigan) was pending, and that therefore the lessor's claim for contribution under CERCLA was contingent and disallowed.ⁿ⁴⁴

However, the lessor's administrative cleanup claim asserted in the chapter 11 case under the assumed real property lease was allowed. The trustee argued that allowance of administrative priority for damages under the lease arising out of a breach during the prepetition period was subject to satisfaction of the test articulated in *In re Mammoth Mart, Inc.*,ⁿ⁴⁵ to the effect that the debt must have (1) arisen from a transaction with the debtor in possession as opposed to the preceding entity (or, that the claimant gave consideration to the debtor in possession), and (2) directly and substantially benefited the estate.ⁿ⁴⁶ The trustee asserted that the cleanup of the property would not satisfy the second prong of this test, inasmuch as there could be no benefit to the estate from such cleanup. The court rejected this argument under the holding in *United Trucking Service, Inc. v. Trailer Rental Company, Inc. (In re United Trucking Service, Inc.)*,ⁿ⁴⁷ which found a postpetition benefit in the financial savings to the estate arising from the debtor-equipment lessee's postpetition failure to maintain and repair the leased equipment. Moreover, the court realized that the debtor in possession had assumed the prepetition lease and thereafter breached it, and therefore found that the actual, necessary costs of preserving the estate were equal to the damages to the lessor arising from the breach of the lease, to wit, the cleanup costs arising from the spillage occurring during the chapter 11 period.ⁿ⁴⁸

With respect to the spillage that occurred during the chapter 7 period, the court found that the lessor would be entitled to an administrative claim in the chapter 7 case equal to the actual value conferred on the estate by reason of the breach. The court determined that at most the amount of the claim would be equal to the rental value of the property (as

theretofore stipulated to by the parties).ⁿ⁴⁹

However, the court also found a ground for the lessor's recovery with administrative priority status under the lessor's negligence theory. In *Reading Co. v. Brown*,ⁿ⁵⁰ the Supreme Court decided under the former Bankruptcy Act that the negligence of a receiver during the pendency of a Chapter XI case, resulting in a fire and the destruction of the debtor's real and personal property as well as the destruction of the claimant's property, gave rise to an administrative claim. *Reading Co. v. Brown* therefore expanded the concept of an administrative claim beyond obligations incurred in the regular postpetition operations of an estate, and beyond benefits realized by an estate, holding that administrative claims could arise from the tortious acts or omissions of the representative of an estate notwithstanding the resulting detriment to general unsecured creditors.ⁿ⁵¹ Accordingly, the court in *Kent Holland* held that the negligence of the debtor in possession in permitting spills of hazardous materials during the pendency of the chapter 11 case and in failing to remove the drums of hazardous wastes would give rise to an administrative claim by the lessor, and that cleanup costs arising from any spills caused by the negligence of the trustee during the pendency of the chapter 7 case would also give rise to an administrative priority claim for the lessor for the cost of remediation thereof.ⁿ⁵²

Two private-party claimant cases have denied administrative priority status to the claim of a real property lessor for cleanup costs incurred in the postpetition period arising from prepetition conduct of the debtor lessee.ⁿ⁵³ In both *In re McCrory Corp.* and *In re Mahoney-Troast Construction Co.*,ⁿ⁵⁴ the debtor-lessee rejected a lease of nonresidential real property, and the post-rejection inspection of the property revealed ground contamination resulting from leaking fuel storage tanks. In each case, there was no action taken by any governmental authority to compel a cleanup, and no evidence that groundwater had been affected or that other substantial environmental hazard had been created. Accordingly, both courts, applying the *Midlantic* standard of a threat of imminent harm or danger to the public, reasoned that (1) *Midlantic* would permit the abandonment of the subject property, (2) the absence of any prohibition on abandonment removed any restraints on the rejection of the leases, (3) inasmuch as abandonment was permitted, there was no postpetition section 959(b) duty imposed on the lessees' estates to remediate the conditions and therefore (4) the lessors' claims for reimbursement of remediation costs were general, unsecured claims. The court in each case also noted that the rejection of the real property lease had occurred prior to any adjudication of liability for an environmental hazard, and that the subject property was no longer property of the estate following the lease rejection.ⁿ⁵⁵

Each court distinguished *Torwico Electronics, Inc. v. New Jersey Department of Environmental Protection (In re Torwico Electronics, Inc.)*,ⁿ⁵⁶ which held that because the lessor seeking reimbursement of environmental cleanup costs did not hold a "claim" within the meaning of the Bankruptcy Code, the debtor-lessee's liability to the lessor was not discharged, and that the lessee's liability "ran with the waste" and continued notwithstanding that the lease had terminated and the debtor had left the site years before the filing of its petition under the Code. *Torwico* was characterized as holding that the lessor therein had no claim, and was therefore deemed inapplicable to a case in which a lessor held a claim and was seeking administrative priority.ⁿ⁵⁷ In addition, one recent governmental party claimant case that also denied administrative priority because the debtor did not own the property in question at the time of bankruptcy case similarly distinguished *Torwico*.^{n57a} Of course, the financial consequences to an estate and its creditors of a nondischargeable claim and of an allowed administrative claim may be very similar, and hence the basis on which *Torwico* was distinguished is subject to question.

In re The Duplan Corp. ⁿ⁵⁸ further illustrates the importance of the issue concerning classification of prepetition events as giving rise to postpetition administrative liability. In that case, which was decided under the former Bankruptcy Act,ⁿ⁵⁹ a number of entities that had succeeded to the undischarged liabilities of a Chapter X debtor were the subject of environmental law claims by private parties. These claims were brought against the defendants under CERCLA and RCRA and on common law grounds.

The debtor's petition, originally under Chapter XI of the Bankruptcy Act, was filed on August 31, 1976. A plan in the case was confirmed on June 4, 1981, and a final decree closing the case was entered on June 27, 1983. The final decree exempted administrative claims from the discharge and permanent injunction against enforcement of claims. CERCLA

became effective as of December 11, 1980, which was after the date of filing of the debtor's petition but before the dates of entry of the confirmation order and the final decree. In 1987, The EPA found that property adjacent to the subject facility was contaminated, and in 1988 issued a contamination removal action for the subject site. The private party action against the debtor's successors was initiated thereafter.

The defendants asserted, among other things, that the debtor's liability had arisen in the prepetition period, when the pollution occurred, rather than during the postpetition period, when CERCLA was enacted.

The Court of Appeals for the Second Circuit held that the claims against the debtor's successors did not arise prior to the filing of the petition inasmuch as CERCLA did not exist until after the filing of the petition. The court determined that CERCLA did not codify an existing liability but instead "created a new scheme of liability geared toward cleaning-up contaminated property as quickly as possible."⁶⁰ The court held further that under *Reading Co. v. Brown*⁶¹ and *In re Chateaugay Corp.*⁶² the debtor's liability under CERCLA constituted an administrative claim. The court stated that "Any claim that arose during the reorganization, i.e., after the filing of the petition and before the reorganization was complete, in the ordinary course of ... [the debtor's] business, is an Administrative Claim under the Plan."⁶³ Inasmuch as administrative claims were not discharged or subject to the injunction in the final decree, the successor entities were found to be subject to private-party claims under CERCLA. Thus, even in the unusual circumstance in which a debtor in possession or trustee does not actively cause or permit pollution to occur during the postpetition period, or does not fail to remediate known pollution, administrative level liability may arise as the result of a postpetition change in the law that creates a new cause of action relating to a condition that arose in the prepetition period.

[3] Prepetition Conditions Remedied Postpetition--Claims for Contribution

As demonstrated above, recovery on an environmental hazard claim by a nongovernmental party against the estate of a Bankruptcy Code debtor may entail a proceeding that includes difficult issues of proof and complex issues of law.⁶⁴ These difficulties appear to be most pronounced when a claimant is seeking contribution from the estate of a debtor under CERCLA.

In *In re Hemingway Transport, Inc.*,⁶⁵ the claimant had purchased from a chapter 11 debtor in possession an industrial facility that contained seventeen corroded drums stored on the wetlands portion of the property leaking hazardous substances into the wetlands. Prior to the debtor's filing of a chapter 11 petition, the Massachusetts Department of Environmental Quality Engineering had given the debtor notice of the contents of the drums, and had received assurances from the debtor that the drums would be removed. Apparently, the debtor in possession did not disclose to the purchaser the existence of the environmental problem. Moreover, although the purchaser inspected the site prior to the purchase from the debtor in possession, it asserted that the drums and the area affected by them had been submerged at the time of inspection, and thus the drums could not have been found with the exercise of reasonable diligence.

After the chapter 11 case was converted to chapter 7, additional drums containing hazardous substances were found in the wetlands area. The EPA advised the purchaser that it was a potentially responsible party under CERCLA, and ordered it to remove the drums. The purchaser did so at its own expense and initiated an adversary proceeding against the estate to recover the past response costs as well as future response costs that might be incurred for additional remediation and cleanup. The claim for past response costs was allowed and given administrative priority status in the chapter 11 case.⁶⁶ Although this disposition was appealed to and affirmed by the Court of Appeals for the First Circuit, the principal issue before the court was the disallowance of the purchaser's contribution claim against the estate for future response costs.

Although the purchaser filed a claim in the chapter 7 case in the amount of \$6.2 million for future response costs, the claim was actually unliquidated and contingent. The EPA had not filed, and apparently had refused to file, a claim against the estate,⁶⁷ and may have been relying upon an ultimate recovery against the purchaser, a solvent enterprise, in the event that the expenditure of additional response costs became necessary and the purchaser was found liable

under CERCLA. Thus the purchaser could not fix and liquidate the amount of its liability, if any, to the EPA, and its claim against the estate on account of such potential liability was therefore likewise unfixed and contingent.

Section 502(e)(1)(B) of the Bankruptcy Code provides:

[T]he court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured, the claim of a creditor to the extent that--

...

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution.

Although section 502(c)(1) requires the court to estimate for purposes of claims allowance any contingent or unliquidated claim, the fixing or liquidation of which would unduly delay the administration of a case, section 502(e)(1)(B) does not permit the allowance of a contingent claim if it is for reimbursement or contribution.ⁿ⁶⁸ The purpose of this provision is to forestall a double recovery from an estate, first, by a primary creditor, such as the EPA in the *Hemingway* case, and, second, by a secondary creditor, such as the private-party claimant in the *Hemingway* case, seeking reimbursement under the contingency that it may be liable on the same debt or obligation to the primary creditor.ⁿ⁶⁹ In the case of a simple guarantee of a debt to a creditor, the guarantor can render its claim as fixed and not contingent by paying the debt and satisfying the primary creditor. In the *Hemingway* case, however, the EPA had not yet determined the cost, if any, for future response costs for the site, and therefore could not be satisfied by the payment of money by the private-party claimant.

As noted above, the EPA had refused to file a claim against the estate. The claimant argued that this fact rendered inapplicable to its claim the provisions of section 502(e)(1)(B), inasmuch as (1) the absence of a filed claim from the EPA meant that the EPA could not be a creditor of the estate, (2) the private-party claimant was not "liable with the debtor" to the EPA and (3) there could be no double recovery against the estate on the same claim.ⁿ⁷⁰ The court responded to this argument by requiring the trustee to file a claim on behalf of the EPA under section 501(c), failing which the purchaser would be required to file a claim on behalf of the EPA under section 501(b).ⁿ⁷¹ Any recovery realized by the EPA on this claim would reduce the liability of the purchaser to the EPA, and therefore create a single recovery against the estate.ⁿ⁷²

The complexity of the case was further compounded by the court's consideration of the claim for administrative priority for future response costs. The court held, under *Reading Co. v. Brown*,ⁿ⁷³ *Mammoth Mart*,ⁿ⁷⁴ and other leading cases, that, notwithstanding the absence of any direct benefit to the estate, the claimant's right of action arose from its postpetition purchase of the property from the chapter 11 estate, that the estate received monetary consideration for the purchase, and that the claim therefore was entitled to administrative priority.ⁿ⁷⁵ However, the court also literally applied the language of section 503(b)(1)(A) to the claim and noted that only actual administrative expenses, and not contingent claims, could be allowed. The claim for future response costs was contingent and not fixed.

Moreover, the court addressed once again the provisions of section 502(e)(1)(B), mandating the disallowance of contingent claims for contribution. The court then addressed the question whether the private party's CERCLA claim was a direct claim against the estate, or a claim for contribution, or both.ⁿ⁷⁶ The court determined that the viability of the contingent claim depended upon whether the purchaser was liable to the EPA, which turned on the availability to it of the "innocent landowner" defense under CERCLA.ⁿ⁷⁷ If the purchaser were found to be an innocent landowner, then it would not be liable to the EPA for remediation costs and would not have a claim for contribution against the estate. However, the purchaser might have a direct claim against the estate arising out of the contamination of the property by the debtor. This claim, if it became fixed prior to the time of allowance thereof, would be given administrative priority.ⁿ⁷⁸

The Court of Appeals for the Sixth Circuit dealt with similar issues in connection with the bankruptcy of Eagle-Picher Industries. In *In re Eagle-Picher Industries, Inc.*,ⁿ⁷⁹ Norpak, a purchaser of industrial property formerly owned by the debtor, filed a claim for potential future cleanup costs related to the debtor's previous activities on the site--namely, the operation of a lead smelting facility. Although Norpak had not yet incurred cleanup costs, it was concerned about future liability in connection with the parcel in light of the nature of the debtor's former operations and the fact that problems had emerged on adjacent properties.ⁿ⁸⁰ Since environmental response costs had not yet been incurred, the debtor contended that the claim was contingent, and because it might also be liable to the EPA or the New Jersey Department of Environmental Protection and Energy (NJDEP) for response costs, the debtor further asserted that Norpak's claim should be disallowed under section 502(e)(1)(B). In response, Norpak asserted: (1) that the debtor was not co-liable for the cleanup costs because neither the EPA nor the NJDEP had filed a proof of claim prior to the claims bar date and (2) that its claim was not one for "reimbursement or contribution" because it involved a direct claim against the debtor for diminution of value of the property due to the debtor's prepetition contamination.ⁿ⁸¹

With respect to the first argument, the court of appeals noted that even though the bar date for filing claims had passed four years earlier, the EPA and the NJDEP could still make a late filing if the tardiness was the result of excusable neglect. On this question, the court of appeals remanded the case with a request that the bankruptcy court make findings on whether a late claim from the EPA and NJDEP should be allowed under the standards of *Pioneer Investment Services Co. v. Brunswick Associated Ltd. Partnership* ⁿ⁸² and *Dix v. Johnson*.ⁿ⁸³ Those standards required analysis of several factors, including (1) the danger of prejudice to the debtor; (2) the length of the delay and its potential impact on the proceedings; (3) the reason for the delay; (4) whether the delay was within the reasonable control of the late party; and (5) whether the late party acted in good faith.ⁿ⁸⁴ The court of appeals also instructed the bankruptcy court to take into account a consent agreement entered into between the debtor and EPA during the bankruptcy case to examine whether such agreement had the effect of preserving the agency's claims against the debtor.ⁿ⁸⁵

With respect to Norpak's second argument, the court of appeals held that in substance, no matter what the theory:

Norpak's claims are for environmental cleanup costs associated with the Blanchard Street property, the very same costs for which Eagle-Picher may turn out to be co-liable. This is precisely the kind of contingent co-liability envisioned by § 502(e)(1)(B). If Norpak and Eagle-Picher are co-liable, then it is irrelevant that Norpak can also concoct an alternative theory on which to premise its claims against Eagle-Picher such as diminution of value of the property due to Eagle-Picher's contamination of that property.ⁿ⁸⁶

The *Eagle-Picher* decision can perhaps be criticized for stretching *section 502(e)(1)(B) of the Code* in a manner that would permit the disallowance of meritorious--albeit contingent--claims when there was little or no realistic chance that the debtor would in fact be subject to double claims, the situation which the section was intended to address. In a concurring opinion, Judge Martin expressed the concern that Eagle-Picher would succeed in disallowing the Norpak claim under section 502(e)(1)(B) and then defend against any claim ultimately brought by the EPA or NJDEP on the grounds of failure to comply with the claims bar date, and that such a result would have the effect of circumventing CERCLA's goal of holding those parties responsible for the release of environmental toxins liable for the costs of the cleanup.ⁿ⁸⁷

It is interesting to note that on appeal of the remand order of the bankruptcy court in the *Eagle-Picher* case, the Bankruptcy Appellate Panel of the Sixth Circuit explicitly directed that the bankruptcy court use its equitable powers to provide a resolution that would (1) enforce the debtor's responsibilities under applicable environmental laws and the consent agreement with the EPA, (2) protect the debtor from the double liability that section 502(e)(1)(B) was designed to prevent and (3) protect against a possible windfall to Norpak.ⁿ⁸⁸ The court also noted with approval one possible "creative solution"--that of requiring that distributions to Norpak be placed in a trust to be expended solely on any necessary remediation costs.ⁿ⁸⁹

In addition to the issues arising in connection with CERCLA claims for contribution against the estate of a Bankruptcy Code debtor, there are contribution issues engendered by the potential CERCLA liability of an estate found to be jointly and severally liable for cleanup costs. In the circumstance in which more than one entity may have contributed to or been liable for the remediation costs of an environmental hazard, an estate may be found to be jointly and severally liable for the entire cost of the cleanup (possibly on an administrative priority basis), and relegated to an action against one or more other parties for contribution.ⁿ⁹⁰ Under this approach, the estate may be subject to a very substantial claim and be constrained to pursue expensive and complex litigation against other parties to apportion the liability. Only when the debtor can establish that the environmental damage is capable of divisibility and a reasonable basis exists for apportionment can the debtor avoid an allowable claim against it for the full cost of the cleanup.ⁿ⁹¹

The process of environmental litigation is often lengthy, complex and expensive. On the other hand, one of the objectives of the Bankruptcy Code is to liquidate claims, and treat and discharge such claims as economically and expeditiously as possible. It is readily apparent, particularly in the area of private-party claims against Bankruptcy Code debtors relating to environmental cleanup liabilities, that at present there is no satisfactory resolution of the conflict between the two processes.

[4] Environmental Hazards Created Postpetition--Elements of the Damage Claim

Although it is well established that postpetition activity by a debtor in possession or trustee resulting in an environmental hazard will give rise to an administrative priority claim of a governmental entity or private party,ⁿ⁹² there are issues in such cases relating to the amount and types of damages that will be allowed. The principal issue in these cases appears to be whether the administrative claim will be limited to actual, necessary expenses of administration or will be expanded under *Reading Co. v. Brown* ⁿ⁹³ to include damages to nondebtor parties and other claims which result from torts or other wrongful acts. Thus in *In re Charlesbank Laundry, Inc.*, ⁿ⁹⁴ the Court of Appeals for the First Circuit held, in a postpetition nuisance case, that a compensatory civil fine would be accorded administrative priority status. Indeed, the Court of Appeals for the Eleventh Circuit has accorded administrative priority status to a noncompensatory civil fine against an estate relating to the period during which the business was in active operation.ⁿ⁹⁵ Moreover, even where an abandonment is not at issue and *Midlantic* is not involved in the analysis,ⁿ⁹⁶ postpetition activities are subject to 28 U.S.C. § 959(b) and noncompliance with laws dealing with public safety may result in allowed administrative claims for the benefit of governmental entities that expend funds to remove a hazardous condition.ⁿ⁹⁷ In some instances, however, prepetition conduct will carry through into the postpetition period, and those courts that will not accord administrative claim status for remediation costs incurred in the postpetition period arising from prepetition conditions require the claimant to bifurcate the costs in an allocation between the debtor's prepetition and postpetition activity.ⁿ⁹⁸

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, 42 U.S.C. § 9607(a).

(n2)Footnote 2. Administrative expenses are "the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A). Claims for administrative expenses are entitled to first priority among unsecured claims. 11 U.S.C. § 507(a).

(n3)Footnote 3. 45 B.R. 278, 11 C.B.C.2d 1246 (Bankr. N.D. Ohio 1985) .

(n4)Footnote 4. The case was subsequently converted to a chapter 7 proceeding.

(n5)Footnote 5. 11 U.S.C. § 506(c); *see* P 2.03[1][c][vii] note 75 *supra*.

(n6)Footnote 6. *See* P 6.07[1] *infra*.

(n7)Footnote 7. 45 B.R. 278, 286-87, 11 C.B.C.2d 1246, 1258 .

(n8)Footnote 8. Section 506(c) provides that "[t]he trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 U.S.C. § 506(c). In light of the Supreme Court's recent decision in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000) , which applied the plain language in the statute to limit the right to recover under section 506(c) to "the trustee," the EPA (nor any other person that is not the trustee) can no longer seek recovery of remediation costs pursuant to section 506.

(n9)Footnote 9. 45 B.R. 278, 11 C.B.C.2d 1246, 1260 . *Boyd v. Dock's Corner Assocs. (In re Great N. Forest Prods., Inc.)*, 135 B.R. 46, 62-71, 26 C.B.C.2d 411, 429-42 (Bankr. W.D. Mich. 1991) held that a nondebtor lessor does not have standing under section 506(c) to surcharge the personal property collateral of a secured lender for cleanup costs, and, if such standing existed, no surcharge would be ordered. *Accord In re Paris Indus. Corp.*, 80 B.R. 2 (Bankr. D. Me. 1987) (CERCLA reimbursement claim by state constitutes an administrative expense but does not have priority over claims of secured creditors); *In re Better-Brite Plating, Inc.*, 105 B.R. 912 (Bankr. E.D. Wis. 1989) , *vacated as moot*, 136 B.R. 526 (1990) ; *but see Environmental Waste Control, Inc.* 125 B.R. 546 (Bankr. N.D. Ind. 1991) , holding that cash collateral of a secured creditor may be expended where the debtor has insufficient funds to effect remediation and there is an imminent danger to health. *Cf. Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000) , holding that an administrative claimant has no right under section 506(c) to seek payment of its claim from property subject to the lien of a secured creditor.

(n10)Footnote 10. 831 F.2d 118 (6th Cir. 1987) .

(n11)Footnote 11. See P 6.04[1] *supra*.

(n12)Footnote 12. 831 F.2d 118, 122 .

(n13)Footnote 13. See P 6.02[2] n.16 *supra*.

(n14)Footnote 14. 831 F.2d 118, 122 .

(n15)Footnote 15. 831 F.2d 118, 123 .

(n16)Footnote 16. 831 F.2d 118, 124 .

(n17)Footnote 17. 856 F.2d 12 (4th Cir. 1988) .

(n18)Footnote 18. 856 F.2d 12, 16 .

(n19)Footnote 19. 856 F.2d 12, 15-16 .

(n20)Footnote 20. 856 F.2d 12, 17 . It appears that the court was articulating the view that a stricter standard should apply to the allowance of administrative claims when an estate is administratively insolvent. The issue of abandonment of contaminated property turns on matters of public health and not on a court's view of the ability of an estate or debtor to respond to claims. If an estate cannot pay its administrative expenses, a court need not reach the issue of administrative priority for environmental cleanup costs. See *In re Microfab, Inc.*, 105 B.R. 161, 170 (Bankr. D. Mass. 1989) , in which the court denied an administrative expense cleanup claim of the Commonwealth of Massachusetts pending incidence of the cleanup costs by the government and the determination of whether sufficient unencumbered assets existed to fund the cost thereof.

(n21)Footnote 21. 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) . In the same proceeding, the Court of Appeals for the Second Circuit held that claims against the estate under the Coal Act, enacted subsequent to the filing of the petition in *Chateaugay*, were entitled to administrative priority as a tax under section 503(b)(1)(B) of the Code

inasmuch as the cause of action was new and first created during the postpetition period. *In re Chateaugay Corp.*, 53 F.3d 478 (2d Cir. 1995) . See note 62 *infra*.

(n22)Footnote 22. 944 F.2d 997, 1009, 25 C.B.C.2d 620, 634-35 . A good review of the precedents to date as of 1992 is set forth in *In re National Gypsum Co.*, 139 B.R. 397, 412-13 (N.D. Tex. 1992) .

(n23)Footnote 23. 24 F.3d 568 (3d Cir. 1994) .

(n24)Footnote 24. 758 F.2d 137 (3d Cir. 1985) .

(n25)Footnote 25. 758 F.2d 137, 141-42 .

(n26)Footnote 26. 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985) ; see P 6.03[1] *supra*.

(n27)Footnote 27. 758 F.2d 137, 141 .

(n28)Footnote 28. 24 F.3d 568, 570 .

(n29)Footnote 29. 24 F.3d 568, 570 .

(n30)Footnote 30. 24 F.3d 568, 570 n.1 .

(n31)Footnote 31. 151 F.3d 434, 141 O.&G.R. 141 (5th Cir. 1998) .

(n32)Footnote 32. 151 F.3d 434, 438, 141 O.&G.R. 141 .

(n33)Footnote 32a. 309 B.R. 111 (Bankr. D. Del. 2004) .

(n34)Footnote 32b. 309 B.R. at 116 .

(n35)Footnote 32c. 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993) ; see P 6.03[2] *supra*.

(n36)Footnote 33. See P 6.05[1] *supra*.

(n37)Footnote 34. 853 F.2d 700, 20 C.B.C.2d 369 (9th Cir. 1988) .

(n38)Footnote 35. 853 F.2d 700, 706-07, 20 C.B.C.2d 369, 377-79 .

(n39)Footnote 36. See P 3.03[2] *supra*.

(n40)Footnote 37. 853 F.2d 700, 708-09, 20 C.B.C.2d 369, 379-81 .

(n41)Footnote 38. 758 F.2d 137 , *supra*.

(n42)Footnote 39. 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985) ; see P 6.03[1] *supra*.

(n43)Footnote 40. 853 F.2d 700, 708-09, 20 C.B.C.2d 369, 379-81 .

(n44)Footnote 41. 125 B.R. 493, 24 C.B.C.2d 1620 (Bankr. W.D. Mich. 1991) .

(n45)Footnote 42. 125 B.R. 493, 495, 24 C.B.C.2d 1620, 1621-22 .

(n46)Footnote 43. 125 B.R. 493, 501, 24 C.B.C.2d 1620, 1629-30 .

(n47)Footnote 44. 125 B.R. 493, 24 C.B.C.2d 1620 .

(n48)Footnote 45. 536 F.2d 950, 9 C.B.C. 159 (1st Cir. 1976)

(n49)Footnote 46. 125 B.R. 493, 502, 24 C.B.C.2d 1620, 1630-31 .

(n50)Footnote 47. 851 F.2d 159, 19 C.B.C.2d 542 (6th Cir. 1988) .

(n51)Footnote 48. 125 B.R. 493, 503, 24 C.B.C.2d 1620, 1631 .

(n52)Footnote 49. 125 B.R. 493, 24 C.B.C.2d 1620 .

(n53)Footnote 50. 391 U.S. 471, 88 S. Ct. 1759, 20 L. Ed. 2d 751 (1968) .

(n54)Footnote 51. See, e.g., *In re Charlesbank Laundry, Inc.*, 755 F.2d 200, 202-03 .

(n55)Footnote 52. 125 B.R. 493, 504, 24 C.B.C.2d 1620, 1633 .

(n56)Footnote 53. *In re McCrory Corp.*, 188 B.R. 763 (Bankr. S.D.N.Y. 1995) ; *In re Mahoney-Troast Constr. Co.*, 189 B.R. 57 (Bankr. D.N.J. 1995) .

(n57)Footnote 54. *In re McCrory Corp.*, 188 B.R. 763 (Bankr. S.D.N.Y. 1995) ; *In re Mahoney-Troast Constr. Co.*, 189 B.R. 57 (Bankr. D.N.J. 1995) .

(n58)Footnote 55. 188 B.R. 763, 766-67 ; 189 B.R. 57, 62 ; cf. *In re Wheeling-Pittsburgh Steel Corp.*, 59 B.R. 129 (Bankr. W.D. Pa. 1986) .

(n59)Footnote 56. 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993) ; see P 6.03[2] *supra*.

(n60)Footnote 57. 188 B.R. 763, 767 ; 189 B.R. 57, 62-63 .

(n61)Footnote 57a. *In re Insilco Techs., Inc.*, 309 B.R. 111 (Bankr. D. Del. 2004) .

(n62)Footnote 58. 212 F.3d 144 (2d Cir. 2000) .

(n63)Footnote 59. References to the Bankruptcy Act are to the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, as amended through August 31, 1976.

(n64)Footnote 60. 212 F.3d 144, 152 .

(n65)Footnote 61. 391 U.S. 471, 88 S. Ct. 1759, 20 L. Ed. 2d 751 (1968) .

(n66)Footnote 62. 53 F.3d 478 (2d Cir. 1995) . This case involved the priority of claims for health insurance premiums under the Coal Act, Pub. L. No. 102-486 (1993), codified at 26 U.S.C. §§ 9701-722. The debtor's petition was filed under chapter 11 of the Bankruptcy Code on July 17, 1986, and the Coal Act became effective in 1993. The court held that the obligations of the debtor in possession under the Coal Act were new and of statutory origin, rather than compensation for labor rendered in the prepetition period. 53 F.3d at 497 . The court further held that the premiums were in the nature of taxes incurred by the estate entitled to administrative priority under section 503(b)(1)(B) of the Code inasmuch as they constituted involuntary contributions. 53 F.3d 478, 498 . The court found a significant precedent in *In re Penn Cent. Transp. Co.*, 944 F.2d 164 (3d Cir. 1991) , cert. denied, 503 U.S. 906, 112 S. Ct. 1262, 117 L. Ed. 2d 491 (1992) , a case decided under the former Bankruptcy Act that held that a clean-up claim under CERCLA could not exist prior to the enactment of the statute, notwithstanding that the polluting activity occurred prior to the filing of the petition in that case. 53 F.3d 478, 497 . The finding of liability under the Coal Act in the *Chateaugay* case was overruled in *Eastern Enters. v. Apfel*, 524 U.S. 498, 118 S. Ct. 2131, 141 L.Ed2d 451 (1998) , which held that the Coal Act effected an unconstitutional taking.

(n67)Footnote 63. 212 F.3d 144, 155 .

(n68)Footnote 64. See P 6.05[2] *supra*; *Boyd v. Dock's Corner Assocs. (In re Great N. Forest Prods., Inc.)*, 135 B.R. 46, 26 C.B.C.2d 411 (Bankr. W.D. Mich. 1991) .

(n69)Footnote 65. 993 F.2d 915, 28 C.B.C.2d 1545 (1st Cir. 1993) , *cert. denied*, 510 U.S. 914, 114 S. Ct. 303, 126 L. Ed. 2d 251 (1993) .

(n70)Footnote 66. 993 F.2d 915, 920, 28 C.B.C.2d 1545, 1552-53 .

(n71)Footnote 67. 993 F.2d 915, 925, 28 C.B.C.2d 1545, 1559 .

(n72)Footnote 68. 993 F.2d 915, 923, 28 C.B.C.2d 1545, 1556-57 . It has been held that CERCLA contribution claims are not cognizable claims within the meaning of section 101(5) of the Code, and are therefore nondischargeable. *In re Allegheny Int'l, Inc.*, 126 B.R. 919, 923-24 (Bankr. W.D.Pa. 1991) , *aff'd without opinion sub. nom. Allegheny Int'l, Inc. v. Al Tech Specialty Steel Corp.*, 950 F.2d 721 (3d Cir. 1991) , *remanded*, 158 B.R. 361 (B.Ct., W.D.Pa. 1993) , *aff'd in part, rev'd in part and remanded sub. nom. Al Tech Specialty Steel Corp. v. Allegheny Int'l Credit Corp.*, 104 F.3d 601 (3d Cir. 1997) . The Third Circuit is subject to the questionable holding of *In re M. Frenville Co.*, 744 F.2d 332, 11 C.B.C.2d 491 (3d Cir. 1984) , *cert. denied*, 469 U.S. 1160, 105 S. Ct. 911, 83 L. Ed. 2d 925 (1985) , that a "claim" arises only when comprised of a cause of action existing under nonbankruptcy law. *But see Riverwood Int'l Corp. v. Olin Corp. (In re Manville Forest Prods. Corp.)*, 225 B.R. 862 (Bankr. S.D.N.Y. 1998) , holding that a contribution claim for remediation costs arising under a statute passed subsequent to confirmation of the debtor's chapter 11 plan was discharged because the debtor's contingent liabilities under a prepetition indemnification agreement on which the claim was based were fully discharged by confirmation.

(n73)Footnote 69. 126 B.R. 919, 923-24 .

(n74)Footnote 70. 126 B.R. 919, 925 .

(n75)Footnote 71. 126 B.R. 919 ; *In Norpak Corp. v. Eagle-Picher Indus., Inc. (In re Eagle-Picher Indus., Inc.)*, 131 F.3d 1185 (6th Cir. 1997) , the private-party claimant seeking contribution for cleanup costs argued that the EPA's failure to file a claim on or before the bar date rendered section 502(e)(1)(B) inapplicable to the private-party claim. The circuit court held this argument to be premature, and remanded to the bankruptcy court the question whether the EPA could file a claim that would be deemed timely under application of the excusable neglect standard or under a separate agreement between the debtor and the EPA.

(n76)Footnote 72. 126 B.R. 919 .

(n77)Footnote 73. 391 U.S. 471, 88 S. Ct. 1759, 20 L. Ed. 2d 751 . For discussion of administrative claims in the environmental law context, see P 6.05[2] *supra*.

(n78)Footnote 74. 536 F.2d 950, 9 C.B.C. 159 (1st Cir. 1976) .

(n79)Footnote 75. 993 F.2d 915, 929-30 ; *cf. Allen-Bradley Co., Inc. v. Commodore Bus. Machs., Inc. (In re Commodore Bus. Machs., Inc.)*, 180 B.R. 72 (Bankr. S.D.N.Y. 1995) , in which the private-party claimant sought the imposition of a constructive trust on the proceeds of sale of real property that the claimant had sold to a predecessor of the debtor and with respect to which the claimant and the debtor had incurred cleanup liability. The claimant had expended sums for remediation and asserted that these costs enhanced the value of the asset to the extent that the estate would be unjustly enriched absent reimbursement of these costs to the claimant. The court refused to impose a constructive trust on the sale proceeds, holding that the claimant was at most a general unsecured creditor with a claim for contribution.

(n80)Footnote 76. 993 F.2d 915, 931 . For a history of the CERCLA contribution provisions and a discussion of the nature of contribution claims, see *In re Reading Co.*, 115 F.3d 1111 (3d Cir. 1997) , holding in a railroad reorganization case that a private-party claim for contribution on account of future cleanup costs failed inasmuch as the EPA's claim against the debtor had been discharged. The court noted briefly that the actual expenditure of cleanup funds by the claimant might give rise to a direct claim. 115 F.3d 1111, 1126 ; see also *In re Allegheny Int'l, Inc.*, 126 B.R. 919, 923-24 *supra*, holding that the private party's claim for actual remediation costs and possible future costs was a direct and not a contingent contribution claim.

(n81)Footnote 77. 126 B.R. 919 ; see P 6.07[1] *infra*.

(n82)Footnote 78. 126 B.R. 919 .

(n83)Footnote 79. 131 F.3d 1185 (6th Cir. 1997) .

(n84)Footnote 80. 131 F.3d 1185, 1187 .

(n85)Footnote 81. 131 F.3d 1185, 1189 .

(n86)Footnote 82. 507 U.S. 380, 113 S. Ct. 1489, 123 L. Ed. 2d 74 (1993) .

(n87)Footnote 83. 95 B.R. 134 (B.A.P. 9th Cir. 1988) .

(n88)Footnote 84. 507 U.S. 380, 395, 113 S. Ct. 1489, 123 L. Ed. 2d 74 .

(n89)Footnote 85. 131 F.3d 1185, 1189 .

(n90)Footnote 86. 131 F.3d at 1185, 1190 .

(n91)Footnote 87. *Id.* (Martin, CJ, concurring).

(n92)Footnote 88. *In re Eagle-Picher Indus., Inc.*, 235 B.R. 876 (6th Cir. B.A.P 1999) .

(n93)Footnote 89. 235 B.R. 876, 879-80 .

(n94)Footnote 90. *In re National Gypsum Co.*, 139 B.R. 397, 413-15, 27 C.B.C.2d 199, 218-21 (N.D. Tex. 1992) .

(n95)Footnote 91. 139 B.R. 397, 27 C.B.C.2d 199 .

(n96)Footnote 92. See, e.g., *In re Security Gas & Oil, Inc.*, 70 B.R. 786, 795 n.6 (Bankr. N.D. Cal. 1987) .

(n97)Footnote 93. 391 U.S. 471, 88 S. Ct. 1759, 20 L. Ed. 2d 751 (1968) (damages resulting from negligence of receiver administering estate under Chapter XI of Bankruptcy Act afforded administrative expense treatment). For discussion of allowance of administrative claims in the environmental law context, see P 6.05[2] *supra*.

(n98)Footnote 94. *In re Charlesbank Laundry, Inc.*, 755 F.2d 200 (1st Cir. 1984) .

(n99)Footnote 95. *In re N.P. Mining Co., Inc.*, 963 F.2d 1449, 27 C.B.C.2d. 24 (11th Cir. 1992) .

(n100)Footnote 96. See PP 6.04[1] and 6.05[1] *supra* .

(n101)Footnote 97. *In re Vernon Sand & Gravel, Inc.*, 93 B.R. 580, 582 (Bankr. N.D. Ohio 1988) .

(n102)Footnote 98. *In re Pierce Coal & Constr., Inc.* 65 B.R. 521 (Bankr. N.D. W.Va. 1986) (prepetition conditions give rise to general unsecured claim, postpetition conditions give rise to administrative expense claim, with

total claim bifurcated accordingly); see *Boyd v. Dock's Corner Assocs. (In re Great N. Forest Prods., Inc.)*, 135 B.R. 46, 62, 26 C.B.C.2d 411, 429-30 (Bankr. W.D. Mich. 1991) .

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

1-6 Collier Real Estate Trans & Bankruptcy Code P 6.06

P 6.06 State "Superlien" Statutes

[1] Nature of Lien

In light of uncertainty about the ability of government agencies to obtain reimbursement for cleanup costs that they have incurred, several states have passed statutes modifying the priority of a state's reimbursement claim.ⁿ¹ While these statutes differ in their details, they grant the state a lien on some or all of the real or personal property owned by the party responsible for the pollution in the amount of the cleanup costs expended by the state. These liens are called "superliens" because, at least with respect to the contaminated property, they generally have priority over other liens and encumbrances on the property, including those that have been previously perfected.

For example, the New Jersey Spill Compensation and Control Act provides that contaminated property owned by the "discharger" is subject to a superlien that has priority "over all other claims or liens which are or have been filed against the property."ⁿ² The lien becomes effective when the state records a notice describing the property subject to the cleanup and indicating the costs incurred with the clerk of the superior court in the county in which the property is located. If the property is of insufficient value to satisfy the cleanup costs, the lien attaches to other real and personal property owned by the discharger but the lien on this other property is subordinate to all prior liens, claims or interests. The statute has been held to be retroactive, applying to environmental damage caused prior to the passage of the legislation.ⁿ³

The Connecticut superlien statute also creates a superpriority lien which affects the real property owned by the discharger that is subject to the cleanup, while a nonpriority lien is imposed upon the discharger's uncontaminated real property. As in New Jersey, the Connecticut lien becomes effective upon the state agency's payment for the cleanup and filing of a notice of lien. However, unlike the New Jersey statute, the Connecticut lien does not have retroactive effect and does not extend to personal property owned by the discharger.

The Massachusetts statute provides for a superpriority lien that affects real property owned by the discharger that is subject to the cleanup, while a nonpriority lien affects other real and personal property owned by such party. In New Hampshire, a superpriority lien is imposed upon the real property subject to the cleanup, the personal property located at the cleanup site and the business revenues of the site owner. A nonpriority lien affects all other real and personal property of the site owner. Arkansas imposes a superlien on the contaminated property, subject only to real estate tax liens, in the amount of cleanup costs incurred by the state and any additional increase in the property's value (as

determined by an appraisal) due to the cleanup. The Tennessee lien is limited to such increased market value arising from the cleanup and is also subject to tax liens.

The operation of the Massachusetts statute and its impact in a bankruptcy case was addressed in a recent decision of the United States Court of Appeals for the First Circuit. In *In re 229 Main Street Limited Partnership*,ⁿ⁴ the court held that the postpetition perfection of the lien created by the statute, in favor of the Massachusetts Department of Environmental Protection, was not subject to the automatic stay by reason of *sections 362(b)(3) and 546(b) of the Bankruptcy Code*.

[2] Avoidability of "Superliens."

The trustee is empowered by the Code to avoid liens in certain circumstances in order to maximize the value of the estate. Section 545(1) permits the trustee to avoid any statutory lien imposed on the debtor's property if the lien arises upon the advent of bankruptcy, insolvency or receivership cases or proceedings. In addition, section 545(2) provides that the trustee may avoid statutory liens against any property of the debtor that are not perfected or enforceable against a hypothetical bona fide purchaser who acquires the property at the time of the commencement of the case. Section 544(a)(3) applies a bona fide purchaser test to all liens affecting real estate (not just statutory liens). The avoidance power set forth in section 544(a)(3) is most often used by the trustee to defeat unrecorded real estate mortgages. If, however, state law provides for effectiveness of the lien in question against acquirers of intervening interests in the property notwithstanding delayed filing or recording by the statutory lienor, section 546(b) prohibits avoidance of the statutory lien by the trustee. As noted above, this later provision was decisive in the "superlien" situation addressed in the *229 Main Street* decision.

Superliens filed prior to bankruptcy would be effective against bona fide purchasers and therefore are not avoidable under section 545(2) or 544(a)(3). These liens generally arise upon the state's expenditure of cleanup costs and the filing of notice and not upon the bankruptcy or insolvency of the discharger, and thus would not run afoul of section 545(1).

An interesting question would be posed by a state's claim that it is entitled to a superlien for cleanup costs that it has expended prior to the bankruptcy filing of the discharger, if no notice of the lien had been filed prepetition. If the state law provides (as the New Jersey statute does) that the lien is ineffective until such notice is filed and that the lien can cover only property owned by the discharger, then the lien would not be enforceable against a bona fide purchaser at the time of the bankruptcy filing and would, therefore, be voidable by the trustee under sections 544(a)(3) and 545(2). However, if state law provides (as does CERCLA) that the lien may cover any contaminated property subject to a cleanup even if not then owned by the discharger, the lien, even if filed postpetition, would be valid against a bona fide purchaser and, therefore, would not be voidable under the trustee's "strong arm" power. In the latter circumstance, section 546(b) would preserve the lien's effectiveness and section 362(b)(3) provides for an exception to the automatic stay to permit the perfection of the lien.

[3] Constitutional and Policy Issues

The state superlien statutes, especially if retroactive in effect, raise some difficult constitutional issues concerning the impairment of secured creditors' rights. In *United States v. Security Industrial Bank*,ⁿ⁵ the Supreme Court held that perfected liens on household furnishings and appliances constituted property interests of secured creditors. The Court expressed concern that retroactive application of *section 522(f) of the Bankruptcy Code* to invalidate certain security interests perfected prior to the Code's enactment may violate the *Fifth Amendment's* proscription against the taking of private property without just compensation.ⁿ⁶ Commentators have suggested that the superlien statutes may be unconstitutional on grounds that they constitute not only a "taking" but an impairment of contractual rights.ⁿ⁷ In *Kessler v. Tarrats*,ⁿ⁸ however, a New Jersey court rejected a constitutional challenge to that state's superlien statute and held that the statute was a permissible exercise of the state's police power.

The superlien statutes also raise certain practical concerns. The inchoate nature of these environmental liens may create

a chilling effect on real estate transactions. One New Jersey court made the following observations about the commercial impact of the state superlien statute:

Seen, not from the clinical viewpoint of an environmentalist but from the coldly practical position of those whose interests involve the status of land titles in New Jersey, this statute, while highly commendable in its intent is, with respect to land titles, a hibernating time bomb. Our whole system of recordation of land titles depends upon the ability of one who seeks to acquire an interest in real property to ascertain beyond peradventure the true state of the title. The entire industry of title insurance depends on this. The willingness of lending institutions to finance the acquisition of real estate depends on it. The financial safety of myriad numbers of owners of real property depends on it. It is probably an understatement that the financial health of a great portion of our economy depends on the simple fact that anyone wishing to invest in real estate, or finance such investment, is able to go to the proper recording officer and be assured of the posture of the title, saving only forgery. ... Into this arena of crystal clarity, [the superlien statute] introduces doubt.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Ark. Stat. Ann. §§ 82-4708, 82- 4720; Conn. Gen. Stat. Ann. § 22a-452a; Mass. Gen. Laws Ann. ch. 21E § 13; N.H. Rev. Stat. Ann. § 147-B:10; N.J. Stat. Ann. § 58:10-23.11f; Tenn. Code Ann. § 68-46-209.

(n2)Footnote 2. *N.J. Stat. Ann. § 58:10-23.11(f)*.

(n3)Footnote 3. *State, Dep't of Environmental Protection v. Ventron Corp.*, 94 N.J. 473, 468 A.2d 150 (1983) .

(n4)Footnote 4. *262 F.3d 1 (1st Cir. 2001)* .

(n5)Footnote 5. *459 U.S. 70, 103 S. Ct. 407, 74 L. Ed. 2d 235, 7 C.B.C.2d 629 (1982)* .

(n6)Footnote 6. *459 U.S. 70, 78-79, 103 S. Ct. 407, 412-13, 74 L. Ed. 2d 235, 243, 7 C.B.C.2d 629, 634* .

(n7)Footnote 7. *See, e.g.*, Zarin, *State Recovery of Hazardous Waste Cleanup Costs and Bankruptcy: The Constitutionality of Retroactive State Superpriority Lien Statutes*, 90 Com. L.J. 346 (1985).

(n8)Footnote 8. *194 N.J. Super. 136, 476 A.2d 326 (App. Div. 1984)* .

(n9)Footnote 9. *Simon v. Oldmans Township*, 203 N.J. Super. 365, 373-74, 497 A.2d 204, 209 (Super. Ct. Ch. Div. 1985) . *See generally* Burkhart, *Lender/Owners and CERCLA: Title and Liability*, 25 Harv. J. on Legis. 317 (1988); Murphy, *The Impact of "Superfund" and Other Environmental Statutes on Commercial Lending and Investment Activities*, 41 Bus. Law 1133 (1986).

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

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P 6.07 CERCLA Issues

[1] Provisions of CERCLA

The Comprehensive Environmental Response, Compensation and Liability Act¹ ("CERCLA") authorized the federal and state governments to clean up hazardous waste sites and to undertake emergency responses to releases of hazardous substances. The statute created a "Superfund," comprising revenues from taxes on the petroleum and chemical manufacturing industries, to be used by the federal and state governments to pay for site cleanups where the responsible parties do not. The government can then sue the legally responsible parties for reimbursement of its costs. As an alternative to a cleanup and cost recovery action, the federal government may issue an administrative order directing a responsible party to clean up a contaminated site. The statute also provided for a private right of action for nongovernmental parties who are damaged by hazardous substance releases or who incur cleanup expenses.

Under CERCLA, the following persons are liable for cleanup and related costs: (1) the present owner or operator of a site where hazardous substances have been released; (2) the owner or operator of the site at the time the hazardous substances were disposed of; (3) any person who arranged for disposal or treatment at the site of hazardous substances owned or possessed by that person; and (4) any person who accepted hazardous substances for transport to the site, if that person selected the site.²

Liability under CERCLA is strict, and not based upon fault or causation.³ The statute is retroactive, imposing liability for environmental damage caused prior to its enactment.⁴ In addition, although a defendant is entitled to contribution from other responsible partners,⁵ CERCLA liability is joint and several⁶ and can reach the personal assets of corporate officers and directors.⁷ In addition to taking remedial actions at a site and subsequently recovering its costs, the federal government, through the Environmental Protection Agency may also require responsible parties to undertake cleanup measures at any site where there is an "imminent and substantial endangerment" to public health due to an actual or threatened release of hazardous substances.⁸

The Superfund Amendments and Reauthorization Act of 1986 amended CERCLA to provide for a lien in favor of the federal government, in the amount of cleanup costs that the government incurs, on all real property and rights to such property which (1) belong to the party liable for the cleanup costs and (2) are subject to or affected by a cleanup action.⁹ The lien arises when the costs are first incurred or when the property owner is notified in writing of its potential liability, whichever is later. In order to make the lien valid, the government must file a notice of lien in the

appropriate state or local office.ⁿ¹⁰ This lien differs from the state superliens in that it is subject to previously perfected security interests.ⁿ¹¹

Defenses to a CERCLA claim are limited. A defense is available if a party can establish that the contamination was caused solely by an act of God, an act of war or certain acts or omissions of third parties. The latter defense requires the potentially responsible party to show that it has no employment, agency or contractual relationship with the third party, and that the potentially responsible party exercised due care with respect to the hazardous substances (both before and after their discovery) and took reasonable precautions against foreseeable actions or omissions of the third party and the consequences that could foreseeably result from such actions or omissions.ⁿ¹² A "contractual relationship" includes, but is not limited to, land contracts, deeds, easements, leases, or other instruments transferring title or possession.

However, the 1986 amendments to CERCLA created some additional protections to potential defendants by adding an "innocent landowner" defense as an exception to the definition of "contractual relationship." The innocent landowner defense was subsequently amended in 2002.ⁿ¹³ This defense is available to a purchaser of contaminated property who shows that it (1) acquired the property after the disposal or placement of the hazardous substance took place; (2) did not know the property was contaminated; (3) had no reason to know that the property was contaminated after undertaking, on or before the date on which the property was acquired, "all appropriate inquiry ... into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices"; and (4) took reasonable steps to stop any continuing release, prevent any threatened future release and prevent or limit any human, environmental, or natural resource exposure to any previously released hazardous substance.ⁿ¹⁴ The statute, as amended in 2002, also provides standards and criteria for determining whether the purchaser carried out all "appropriate inquiry." For property purchased before May 31, 1997, the statute provides that "a court shall take into account any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if the property was not contaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination and the ability of the defendant to detect the contamination by appropriate inspection."ⁿ¹⁵

For property purchased on or after May 31, 1997, the statute provides that on or before January 11, 2004, the EPA administrator will promulgate regulations establishing standards and practices. The statute further provides guidance to the EPA administrator by stating that the following criteria shall be included in the standards and practices for "appropriate inquiry":

- I. The results of an inquiry by an environmental professional.
- II. Interviews with past and present owners, operators, and occupants of the facility for the purpose of gathering information regarding the potential for contamination at the facility.
- III. Reviews of historical sources, such as chain of title documents, aerial photographs, building department records, and land use records, to determine previous uses and occupancies of the real property since the property was first developed.
- IV. Searches for recorded environmental cleanup liens against the facility that are filed under Federal, State, or local law.
- V. Reviews of Federal, State and local government records, waste disposal records, underground storage tank records, and hazardous waste handling, generation, treatment, disposal, and spill records, concerning contamination at or near the facility.
- VI. Visual inspections of the facility and of adjoining properties.
- VII. Specialized knowledge or experience on the part of the defendant.

VIII. The relationship of the purchase price to the value of the property, if the property was not contaminated.

XI. Commonly known or reasonably ascertainable information about the property.

X. The degree of obviousness of the presence or likely presence of contamination at the property, and the ability to detect the contamination by appropriate investigation.ⁿ¹⁶

With respect to property purchased on or after May 31, 1997, the statute also provided, as a safe harbor, that until the contemplated regulations were promulgated by the EPA, the procedures of the American Society for Testing and materials, including the document known as "Standard E1527-97," entitled "Standard Practice for Environmental Site Assessment: Phase I Environmental Site Assessment Process," would satisfy the appropriate inquiry requirement.^{n16a}

In May 2003, the EPA enacted regulations contemplated by the statute. The permanent regulation essentially mirrored the temporary safe harbor described above and provided that the procedures of the American Society for Testing and Materials (ASTM) 1527-97 and the procedures of the American Society for Testing and Materials (ASTM) 1527-00, both entitled "Standard Practice for Environmental Site Assessment: Phase I Environmental Site Assessment Process," would satisfy the requirements for conducting "all appropriate inquiry" under section 101(35)(B)(i)(I) of CERCLA.^{n16b}

Because of the imprecise terms used to define the elements of the innocent landowner defense, there is very little certainty as to whether any particular conduct will meet the statutory standards. As one court noted, the use of terms such as "appropriate" and "reasonable" in the statute indicates that Congress did not intend to lay down a bright-line rule for applying the defense, but rather intended each case to stand on its own facts.ⁿ¹⁷

One case highlights the difficulty in meeting the standard and suggests that the absence of environmental representations and warranties in a contract of sale may increase the level of required due diligence, not only as a sound business practice, but also as a requirement for successfully raising the innocent landowner defense. In *In re Hemingway Transport, Inc.*ⁿ¹⁸ the bankruptcy court found that a purchaser of contaminated property from a debtor pursuant to a court approved sale failed to exercise "appropriate inquiry" at the time of purchase based upon the following facts:

(1) the failure of the purchaser to walk the perimeter of the property and visually inspect certain wetlands that were part of the purchased parcel, even though the purchaser testified that he had no reason to closely inspect the wetlands because they were an unusable component of the parcel's intended use as a truck terminal;

(2) the failure of the purchaser to contact the municipality or the local environmental agency even though the subject property was in "close proximity" to a superfund site and the city was receiving "national attention about its hazardous waste problems"; and

(3) that the contract of sale contained the following items, which the court characterized as "red flags":

(a) a provision stating that the conveyance of good and clean record and marketable title, free of encumbrances, was subject to "provisions of existing building, zoning laws, environmental and other applicable laws and ordinances";

(b) an absence of environmental representations in the contract of sale; and

(c) a provision in which the purchaser acknowledged that it had not relied on any warranties or representations of the seller and that it had made all the inspections it

wished to make.ⁿ¹⁹

The court also held that evidence that the purchaser's environmental due diligence procedures were customary at the time of the transaction in 1983 was not persuasive of whether the purchaser's inquiry was consistent with "good commercial or customary practices" as required by the statutory defense. In suggesting that purchasers must look beyond custom, the court noted that "just because the lack of due diligence may have been routine, it does not follow that the customary practices were either good or commercially reasonable."ⁿ²⁰ *Hemingway* emphasizes that the "innocent landowner defense" is just that, a defense, which, although potentially useful in litigation, does not provide safe harbors to protect an "innocent" party whose status as an "owner" of a facility makes such person potentially responsible for funding a cleanup by reason of CERCLA's strict liability framework.

[2] Lender Liability Under CERCLA

The CERCLA definition of a potentially liable "owner or operator" excludes "a person, who, without participating in the management of a ... facility, holds indicia of ownership primarily to protect his security interest in the ... facility."ⁿ²¹ Several cases have addressed the issue of under what circumstances CERCLA liability may be imposed upon a lender, both as an "operator" prior to foreclosure and as an "owner" after foreclosure.

In *United States v. Mirabile*,ⁿ²² the court summarized the issue of secured creditor liability under CERCLA:

[T]he [security interest] exemption plainly suggests that provided a secured creditor does not become overly entangled in the affairs of the actual owner or operator of a facility, the creditor may not be held liable for cleanup costs. The difficulty arises, of course, in determining how far a secured creditor may go in protecting its financial interests before it can be said to have acted as an owner or operator within the meaning of the statute.ⁿ²³

The case involved a CERCLA cost-recovery claim by the federal government against the Mirabiles, owners of property on which a prior owner had operated a paint manufacturing facility. The Mirabiles joined as third party defendants to the action two banks which had made secured loans to the former site owner. The contamination had occurred prior to the Mirabiles' acquisition of the property.

The court held that one lender, the American Bank and Trust Company, that had acquired the property at a foreclosure sale and reconveyed it four months later, was exempt from liability. This lender had not participated in operational, day-to-day aspects of the manufacturing company's business and had only undertaken limited activities with respect to the property, such as securing it against vandalism and showing it to prospective purchasers, subsequent to foreclosure.

The activities of another lender involved in this case, Mellon Bank, created more concern for the court. Mellon Bank had entered into a financing arrangement with the manufacturer and took a security interest in the inventory and assets. A Mellon loan officer was placed on an advisory board established to oversee the company's business. In addition, after the company filed for bankruptcy, a second Mellon officer made frequent site visits and became involved in monitoring cash collateral accounts, insuring that receivables went to the proper account, establishing a reporting system between the company and the bank, improving sales performance and other aspects of the company's day-to-day operations. The court concluded that Mellon's activities raised a sufficient question of "operator" liability under CERCLA to preclude the granting of summary judgment in its favor. Thus, the holding in *Mirabile* suggests a distinction between permissible participation in financial decisions relating to a facility and impermissible participation in day-to-day management of a facility.

United States v. Maryland Bank & Trust Co. ⁿ²⁴ involved the issue of CERCLA liability of a mortgagee that had, through foreclosure, acquired contaminated property that was subsequently subject to a government cleanup, and had retained title for four years preceding the suit. The court held that the "security interest" exemption relied upon in

Mirabile was not available once the security interest had been foreclosed upon and the lender held title to the property. The court distinguished *Mirabile* by noting that the mortgagee there had undertaken foreclosure only to protect its collateral and had transferred its interest in the site within four months of the foreclosure sale. The court suggested that lenders could protect themselves from CERCLA liability by making prudent loans, conducting environmental inquiries prior to making loans and by avoiding foreclosure.

Finally, in *In re T.P. Long Chemical, Inc.*,ⁿ²⁵ the court concluded that a bank that held a security interest in contaminated waste drums owned by the debtor was not liable for CERCLA cleanup costs. The bank had not repossessed the collateral, but even if it had, the court indicated that no liability would have resulted since the bank did not participate in the debtor's management.ⁿ²⁶

In *United States v. Fleet Factors Corp.*,ⁿ²⁷ the first federal appeals court case to address the scope of the secured creditor exemption under CERCLA, the Court of Appeals for the Eleventh Circuit departed from the approach in *Mirabile*. The court held that a lender may be liable for cleanup costs under CERCLA even though the lender did not participate in day-to-day management of the facility or in decisions regarding the disposal of hazardous wastes, provided that the lender had the power to influence those decisions. In *Fleet Factors*, the lender held a mortgage on the borrower's textile factory and a security interest in the furniture, fixtures and equipment located therein, in addition to a security interest in the borrower's accounts receivable. After the borrower's chapter 11 filing, the lender foreclosed on certain of the borrower's inventory and equipment and arranged for the auction of these items and for the removal of any unsold equipment. The lender did not foreclose on the real property itself. A subsequent EPA inspection revealed the presence of asbestos and other hazardous substances at the site, and the EPA incurred approximately \$400,000 in cleanup costs. The EPA alleged that the lender's liquidator had moved certain leaking chemical drums before the auction and that the lender's contractor or the auction purchasers had disturbed asbestos when the equipment was removed.

The EPA claimed that the lender was liable for cleanup costs under CERCLA as the owner or operator of the facility at the time of the discharge of hazardous wastes. The critical issue for the court was whether the lender could claim the benefit of the secured creditor exemption. The Eleventh Circuit, affirming the district court's denial of the lender's motion for summary judgment, held that the exemption would be lost, and the secured creditor could be liable under CERCLA without being an operator, if the creditor had the power to influence decisions regarding hazardous waste disposal. The court, in contrast to the *Mirabile* court, concluded:

a secured creditor may incur [CERCLA] liability, without being an operator, by participating in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable--although such conduct will certainly lead to the loss of the protection of the statutory exemption. Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal conditions if it so chose.ⁿ²⁸

In a subsequent decision, the Court of Appeals for the Ninth Circuit, in *In re Bergsoe Metal Corp.*,ⁿ²⁹ concluded that a municipal corporation that held nominal title to contaminated property but was not involved in any actual management of the facility was exempt from CERCLA liability. The court held that merely having the contractual right to participate in management was not sufficient to create CERCLA liability for an owner or secured creditor absent actual participation. This case involved the following structure common in industrial revenue bond financings:

- (1) The municipal corporation (in this case, a port authority) held title to a lead recycling plant and net leased it to the user;

- (2) The port authority issued bonds, the proceeds of which financed the construction of the facility by the user;
- (3) The rent under the net lease was equal to the principal and interest payable on the bonds;
- (4) The user had an option to purchase the facility for \$100 at the end of the lease term; and
- (5) The port authority granted the bondholders a mortgage on the facility and assigned to the bondholders all of its rights as lessor under the lease.

The court noted that while CERCLA holds the "owner" of a facility responsible for cleanup costs, the secured creditor exemption excludes from the definition of owner any "person who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility." The court concluded that the port authority's ownership of the plant arose only as a means to facilitate the financing, and that all meaningful indicia of ownership, such as the obligation to pay taxes and insurance and to bear the risk of loss with respect to the property, was transferred to the lessee. Most importantly, the port authority took no role in the actual management of the facility. The fact that the port authority had "negotiated and encouraged" the building of the plant or that, under the lease, it had rights of inspection of the premises and re-entry upon default, did not result in the loss of the secured creditor exemption, because the agency never in fact exercised any of these rights. Because the port authority exercised no management role, it was not necessary for the court to indicate whether it would follow *Mirabile* or *Fleet Factors* regarding the level of "participation" sufficient to create liability for a secured creditor under CERCLA.

In *Z&Z Leasing, Inc. v. Graying Reel, Inc.*,ⁿ³⁰ a federal district court refused to adopt the suggestion in *Fleet Factors* that mere capacity to influence hazardous waste treatment practices was sufficient to negate the secured creditor exemption. The court stated that "such a narrow interpretation of the statute ... would largely eviscerate the exemption Congress intended to afford secured creditors."ⁿ³¹ In *Z&Z Leasing*, the plaintiff borrower attempted to assert "operator" liability under CERCLA against a financial institution by arguing that the applicable loan documents effectively transferred financial management of its operations to the lender by reason of negative covenants that restricted mergers and sale of assets, the purchase of assets, the incurrence of liens and indebtedness, the payment of dividends and the making of investments.ⁿ³² In language that is likely to be comforting to lenders, particularly in light of the invalidation of the EPA secured lender regulations less than a year earlier,ⁿ³³ the court expressly held that these types of standard covenants are insufficient to impose "operator" liability:

The court is not persuaded that, by imposing these negative covenants on plaintiff, the Bank assumed "operator" status under CERCLA. Secured lenders frequently have some routine involvement in the financial affairs of their debtors in order to insure that their interests are being adequately protected. To impose liability on the Bank in this case for including these negative covenants in the Reimbursement Agreement would be to punish the Bank for engaging in its normal course of business. Such activity does not constitute the requisite participation in the management of the facility. A secured creditor must be permitted to monitor any aspect of a debtor's business relating to the protection of its security interest without incurring liability.ⁿ³⁴

The court also rejected the plaintiff's assertion that the lender was active in the environmental management of the facility as a result of the following facts: (1) the borrower's covenant to comply with all applicable environmental laws and regulations respecting the premises; (2) the lender's agreement to advance an amount for the specific purpose of financing the removal of an underground storage tank; and (3) the lender's retention of an environmental consultant to investigate possible contamination. The court characterized these facts as nothing more than evidence "that the Bank took prudent and routine steps to protect its security interest only" and stated that it "will not punish the bank for its insistence that plaintiff obey the law."ⁿ³⁵

Similarly, in *Bancamerica Commercial Corp. v. Trinity Industries, Inc.*,ⁿ³⁶ the United States District Court for the District of Kansas rejected the "capacity to influence" standard enunciated in *Fleet Factors*:

[A] secured lender does not participate in the management of a facility by taking actions related to the financial aspects of the facility. A lender crosses the "participating in management" line when it *actually* engages in activities related to the facility's operational management. *Liability should be based on a lender's activities relating to the facility, and not solely on the lender's capability to influence the decisions about disposal of hazardous substances.*ⁿ³⁷

Based on that standard of conduct, the court determined that none of the secured lender's acts prior to foreclosure--which included (1) quarterly site visits for the purpose of reviewing financial records and identifying inventory on hand, (2) inclusion in the loan agreement of negative covenants restricting asset sales, increases in executive compensation, material changes in management and material changes in the type of business, (3) institution of a lock box arrangement for customer remittances and (4) a requirement of lender approval before bidding on jobs over a set amount--"injected it into the day-to-day operations of [borrower] to such a degree as to preclude application of the secured creditor exception."ⁿ³⁸ In that regard, the court concluded that the rights of the lender retained and exercised under the loan agreement involved "monitoring only the financial aspects of [the borrower's] operations."ⁿ³⁹

While *Z&Z Leasing* addressed the question of lender liability in the context of the lender-borrower relationship prior to the enforcement of remedies, several courts of appeals decisions have addressed the liability of lenders which acquire "ownership" of contaminated property through foreclosure. *Waterville Industries v. Finance Authority of Maine* ⁿ⁴⁰ involved an industrial revenue bond financing structure similar to the one in *Bergsoe Metal*. In *Waterville*, the Finance Authority of Maine ("FAME") had held nominal title to the subject property which was leased to the operator of a textile mill at a time when hazardous wastes were improperly disposed of. The terms of the lease included total lease payments equal to the indebtedness owed to FAME and another lender and an option which entitled the lessee to purchase the property for \$1 at the end of the lease. After the operator defaulted under the lease, FAME ultimately acquired "real" title to the property and later sold the property to a predecessor of Waterville Industries, the plaintiff in the case. After Waterville incurred environmental response costs and sued FAME for contribution, the Court of Appeals for the First Circuit was faced with the issues of whether FAME was a former CERCLA "owner" during either (1) the period of its nominal ownership of the property at the time that the property was leased or (2) the period of its "real" ownership of the property, achieved after the operator defaulted on its lease obligations. With respect to the first period, the court, citing *Bergsoe Metal*, described the arrangement as an "ordinary lease financing arrangement" and concluded that while the lease was effective, FAME's interest was that of a security holder. The court viewed the nominal purchase price option as the critical factor which demonstrated that FAME held its interest while the lease was effective primarily to protect its security interest and noted that in enacting the security interest exception, "Congress had in mind not only the classic case of the bank mortgage but also equivalent devices serving the same function, such as lease financing arrangements."ⁿ⁴¹

The more difficult question for the court was whether the security interest exception protected FAME during a later period during which the debtor-lessee ceased operations and ultimately transferred full title to FAME pursuant to a stipulation entered in the bankruptcy case. In answering that question in the affirmative, the court noted the following facts: although the lessee-debtor ceased operations in October 1981, and FAME promptly filed an application in the bankruptcy case seeking an order declaring it the owner of the property and directing the debtor to surrender possession, the debtor initially opposed the application and FAME did not obtain "full title free of serious encumbrances" until October 1982. FAME contracted with an auctioneer to sell the property within six months of achieving full title, reached agreement with the successful bidder six months thereafter and ultimately conveyed title to the bidder two months later. The court held, based on those facts, that FAME's interest in the property was consistent with that of a person who holds indicia of ownership primarily to protect its security interest, notwithstanding the ultimate transformation of its security interest into full ownership of the property:

We think such a maturation of ownership does not divest the owner of protection under CERCLA's security interest exception so long as the owner proceeds within a reasonable time to divest itself of ownership ...

Admittedly, CERCLA itself does not explicitly provide any period for divestiture after collapse of a financing arrangement, but such a "safety zone" seems to us implicit in the statute. Were it otherwise, every sale and lease-back arrangement would subject the lender-lessor to the risk of sudden CERCLA liability whenever the lessee, by default or otherwise, lost its contractual rights to regain full ownership. So long as the lender-lessor makes a reasonably prompt effort to divest itself of unwelcome ownership, we think continued coverage under the exception serves its basic policy: to protect bona fide lenders and to avoid imposing liability on "owners" who are not in fact seeking to profit from the investment opportunity normally presented by prolonged ownership.ⁿ⁴²

In reaching its conclusion that FAME was not liable under CERCLA, it is noteworthy that the court refused to consider Waterville's allegation that FAME had failed to fully disclose the contamination when it sold the property. Although nondisclosure might be a basis for a separate misrepresentation or fraud suit against FAME by the purchaser, it was irrelevant to the issue of whether the purchaser had a right of contribution under CERCLA--a right which turned solely on the question of whether the defendant was an "owner" within the meaning of the statute.ⁿ⁴³ As noted, FAME was never an "owner" because the security interest exception applied.

In *United States v. McLamb*,ⁿ⁴⁴ the Court of Appeals for the Fourth Circuit followed *Waterville* and held that a bank was protected by the security interest exception after it purchased at a foreclosure sale real property in which it held a security interest, because the bank took prompt steps to market and sell the property after achieving ownership. As the court noted:

In the instant case, due to the lack of other potential buyers at the foreclosure sale, Wachovia purchased the property, in the language of the statute, "primarily to protect its security interest" after Skipper's default. The record reveals no investment or profit motive for acquiring the property. Wachovia did not, for example, engage in a bidding war at the foreclosure sale. Further, Wachovia almost immediately placed the property on the market, took no steps to use or manage the land during its ownership, and ultimately sold the property to the first able buyer. Such steps support its claim that it held title primarily, indeed exclusively, to protect its security interest.ⁿ⁴⁵

The court also followed *Waterville* in ruling that the plaintiff's allegations that the bank had failed to disclose its knowledge of possible contamination when it sold the property was irrelevant to the question of CERCLA liability even if such disclosure would have been "commercially reasonable."ⁿ⁴⁶

Thus, *Waterville* and *McLamb* appear to firmly establish the principle that a lender which acquires title to contaminated property in which it had a security interest will not lose the protection of the security interest exception so long as the lender makes a reasonably prompt effort to dispose of the property after foreclosure and does not act in a manner which indicates that the lender is seeking a profit from the sale in addition to having its debt repaid.ⁿ⁴⁷ It should be emphasized that the security interest exception is an exception to "owner" liability only and a lender may still be liable under CERCLA as an "operator" or "arranger" to the extent it operates a facility or arranges for the disposal of hazardous substances after foreclosure.

[3] The EPA Secured Lender Regulations and the 1996 CERCLA Amendments

On April 29, 1992, in response to concerns expressed by secured lenders because of the broad language in recent cases interpreting the secured creditor exemption, particularly *Fleet Factors*, the EPA published a final regulation (the "EPA Regulations") designed to interpret the statutory terms "indicia of ownership," "primarily to protect [a] security interest"

and "participating in the management." The complete text of the EPA Regulations, published at 40 C.F.R. Part 300, is included at the end of this chapter.ⁿ⁴⁸

The EPA Regulations implicitly rejected the suggestion in *Fleet Factors* that a lender's capacity to influence the hazardous waste policies of a borrower is alone sufficient to deprive a secured creditor from the protection of the exemption. In that regard, the regulations provided that "participation in the management of a facility" requires "actual participation in the management or operational affairs of the vessel or facility by the holder, and does not include the mere capacity to influence or the ability to influence, or the unexercised right to control facility operations."ⁿ⁴⁹

In addition, the EPA regulations provided that actions taken at the inception of a loan and prior to taking a security interest, such as undertaking an environmental inspection, and certain workout activities such as "providing specific or general financial or other advice" or "restructuring the terms of a security interest," whether or not the borrower was actually in default, would not in itself be considered participation in management. Significantly, the regulations provided that "[n]either the statute nor this regulation requires a holder to conduct or require an inspection to qualify for the exemption, and the liability of a holder cannot be based on or affected by the holder not conducting or not requiring an inspection."

The provisions referred to above attempted to define the actions *not* constituting "participating in the management." Perhaps the most important aspect of the EPA Regulations was a two-part test for determining whether a holder of a security interest, prior to foreclosure, is participating in management. The regulations stated:

A holder is participating in management, while the borrower is still in possession of the vessel or facility encumbered by the security interest, *only* if the holder either:

(i) exercises decisionmaking control over the borrower's environmental compliance, such that the holder has undertaken responsibility for the borrower's hazardous substance handling or disposal practices; or

(ii) exercises control at a level comparable to that of a manager of the borrower's enterprise, such that the holder has assumed or manifested responsibility for the overall management of the enterprise encompassing the day-to-day decisionmaking of the enterprise with respect to: (A) environmental compliance or (B) all or substantially all of the operational (as opposed to financial or administrative) aspects of the enterprise other than environmental compliance.ⁿ⁵⁰

The EPA Regulations also provided guidance with respect to activities that a lender may take subsequent to "foreclosure and its equivalents" without losing the protection of the secured creditor exemption from owner or operator liability. Significantly, a foreclosing lender could "maintain business activities" at a facility and is not required to wind up or shut down operations after taking possession. The general rule was that, after foreclosure, a lender could continue to maintain its indicia of ownership primarily to protect a security interest so long as it

undertakes to sell, re-lease property held pursuant to a lease financing transaction ... or otherwise divest itself of the property in a reasonably expeditious manner, using whatever commercially reasonable means are relevant or appropriate with respect to the vessel or facility, taking all facts and circumstances into consideration, and provided that the holder did not participate in management prior to foreclosure and its equivalents.ⁿ⁵¹

In addition to the general, somewhat nebulous, rule requiring disposal of property in a "reasonably expeditious manner," the EPA Regulations also established an alternative bright line test which a lender could meet in order to satisfy that standard: a lender which, within 12 months following foreclosure, either (1) lists the property with a broker who deals with the type of property in question or (2) advertises the property as being for sale in a trade publication or general circulation newspaper on a monthly basis establishes that it is still holding its indicia of ownership "primarily to protect

a security interest."⁵²

However, in order to insure that a lender would not hold property for investment purposes after foreclosure, the EPA Regulations provided that the lender loses the protection of the secured creditor exemption to CERCLA if it outbids, rejects or fails to act upon a "written, bona fide, firm offer"⁵³ of "fair consideration" that is received at any time after six months following foreclosure or its equivalents. Fair consideration was defined, in the case of the holder of a senior security interest, as the total amount owed to the holder (including "any unpaid interest" and all reasonable and necessary costs) and, in the case of the holder of a junior security interest, as the amount owed the holder plus the value of all outstanding higher priority security interests.

In 1994, in *Kelly v. EPA*,⁵⁴ a divided Court of Appeals for the District of Columbia Circuit vacated the EPA regulations on the grounds that the EPA exceeded the rule-making authority delegated to it by Congress when it promulgated the regulations. The court held that Congress intended that courts and not the Environmental Protection Agency should determine issues of liability under CERCLA.

The decision in *Kelly* arguably returned the law to the state of uncertainty that existed prior to the enactment of the EPA regulations, particularly in the Eleventh Circuit where *Fleet Factors* was decided. However, in one case decided less than a year after the EPA regulations were invalidated, a federal district court held that standard negative covenants in a loan agreement and the advance of funds to a borrower for the specific purpose of financing the removal of an underground storage tank were insufficient to remove the protection of the secured creditor exemption.⁵⁵ Similarly, at least two other federal court cases held in favor of the secured lenders in a manner consistent with the rationales set forth in the EPA regulations.⁵⁶

The invalidation of the EPA regulations also focused attention on the secured creditor exemptions in state environmental statutes, many of which contain more explicit exemptions than that contained in CERCLA.⁵⁷ For example, the Pennsylvania Hazardous Sites Cleanup Act secured creditor exemption specifically protects lenders that satisfy the following three conditions: (1) the site was acquired by foreclosure as a result of enforcing a mortgage or security interest held by the institution; (2) the site was acquired before the lender had knowledge that the site was on the EPA's National Priorities List or its state counterpart; and (3) the lender did not manage or control site activities that contributed to the release of hazardous substances.⁵⁸

In 1995, the EPA and the Department of Justice issued a policy statement (the "EPA/DOJ Policy Statement") announcing that they would follow, as a matter of agency discretion, the interpretations and rationales set forth in the EPA regulations in determining whether to pursue CERCLA enforcement actions against secured lenders.⁵⁹ More specifically, the EPA/DOJ Policy Statement "reaffirms EPA's and DOJ's intentions to follow the provisions of the Lender Liability Rule as enforcement policy."⁶⁰ Because the federal government is a major, if not *the* major, plaintiff in CERCLA cost recovery actions (including the action in *Fleet Factors*), this statement of policy had the practical effect of minimizing significantly the risks faced by lenders following the standards and safe-harbors provided in the EPA regulations.⁶¹ The complete text of the EPA/DOJ Policy Statement, published at 60 *Fed. Reg.* 63,517, is included at the end of this chapter, following the full text of the EPA regulations.⁶²

In 1996, as part of a lengthy Omnibus Consolidated Appropriations Act,⁶³ Congress enacted the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996,⁶⁴ which amended CERCLA (the "CERCLA Lender Liability Amendments") by adopting in many respects the judgments reflected in the *Bergsoe* case⁶⁵ and in the 1992 EPA lender liability rule. The salient parts of the amendments relating to lender liability, which are codified at 42 U.S.C. § 9601(20)(D)-(G), are included at the end of this chapter.^{65a}

The CERCLA Lender Liability Amendments added a new subparagraph (E) to section 101(20) of CERCLA, excluding from the definition of an "owner or operator" lenders that do not participate in the management of a vessel or facility.⁶⁶ Under these provisions, a lender may, if it does not participate in management of a vessel or facility, avoid

owner or operator status, if it (1) holds indicia of ownership primarily to protect its security interest in the vessel or facility or (2) forecloses on the asset and, after foreclosure, sells, re-leases (in the case of a finance lease transaction), or liquidates the asset, or maintains business activities, winds-up operations, undertakes a response action accordance with CERCLA or takes any other measure to preserve, protect or prepare the vessel or facility prior to sale or disposition. In addition, the lender may avoid owner or operator liability under CERCLA while maintaining business activities, winding up operations, undertaking a CERCLA response action or otherwise acting to preserve, protect or prepare the vessel or facility prior to sale or other disposition, provided that the lender seeks to sell, re-lease or otherwise divest the asset at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements.

A new subparagraph (F) of section 101(20) defines the term "participate in management." The definition generally requires "actually participating in the management or operational affairs of a vessel or facility" but expressly excludes "merely having the capacity to influence, or the unexercised right to control, vessel or facility operations."ⁿ⁶⁷ If the borrower is still in possession of the collateral, the lender is deemed to be participating in management only if it exercises decisionmaking control over environmental compliance to the extent of undertaking responsibility for hazardous substance handling or disposal practices, or exercises overall management responsibility. The term "participate in management" does not include monitoring or enforcing the provisions of a credit agreement, requiring the borrower to undertake a response action during the term of the credit agreement, or exercising remedies under a credit agreement.ⁿ⁶⁸ The provision broadly defines the term "lender" to include insured depository institutions, governmentally chartered or authorized institutions and private lenders.ⁿ⁶⁹ In addition, the term "lender" includes a person that insures or guarantees against a default, or acts as a surety, so long as the principal is a nonaffiliated person, and also includes a person that provides title insurance and acquires a vessel or facility as a result of assignment or conveyance in the course of underwriting claims and claims settlement.^{n69a} The CERCLA Lender Liability Amendments also include definitions of the terms "extension of credit," "foreclosure," "security interest," and other terms employed therein.

The CERCLA Lender Liability Amendments extend liability protections for lenders under RCRA with respect to contamination from underground storage tanks.ⁿ⁷⁰

The CERCLA Lender Liability Amendments also contain an extensive provision limiting the liability of fiduciaries under any provision of CERCLA arising from the release or threatened release of a hazardous substance from a vessel or facility held in a fiduciary capacity, with the liability limited to the value of the asset so held.ⁿ⁷¹ Fiduciaries are not released from liability for their own negligence.ⁿ⁷² The definition of a "fiduciary" under the amendments includes a trustee, custodian, receiver, conservator and indenture trustee, but excludes a fiduciary with respect to a trust or other fiduciary estate that was organized for the primary purpose of or is actively engaged in a trade or business for profit other than to facilitate an estate plan or because of the incapacity of a natural person.ⁿ⁷³

Section 2504 of the Act deals with the EPA's rulemaking authority under CERCLA and appears to address the ruling in the *Kelly* caseⁿ⁷⁴ by stating: "Effective on the date of enactment of this Act, the portion of the ... [1992 lender liability rule] prescribing section 300.1105 of title 40 [dealing with involuntary acquisition of contaminated property by the government] ... shall be deemed to have been validly issued under authority of [CERCLA] and to have been effective according to the terms of the final rule" The provision goes on to state that "no court shall have jurisdiction to review the portion of the final rule ... that prescribed *section 300.1105 of title 40, Code of Federal Regulations*." The provision also states that it shall not be construed as limiting the authority of the President or a delegatee of the President to amend the portion of the 1992 rule prescribing section 300.1105, consistent with the amendments made by the Act and other applicable law, or as precluding judicial review of any amendment of section 300.1105 made after the enactment of the Act. These cryptic provisions may constitute an effort by the EPA to resurrect its authority to issue regulations under CERCLA notwithstanding the *Kelly* case.ⁿ⁷⁵

[4] Bankruptcy Issues Under CERCLA

The application of CERCLA in the bankruptcy context raises several interesting issues.ⁿ⁷⁶

There seems little doubt, in the wake of the Supreme Court's decision in *Kovacs II*, that a CERCLA claim by the EPA or other governmental agency for reimbursement of cleanup costs incurred prepetition is a dischargeable debt. It should be noted that CERCLA imposes joint and several liability on potentially responsible parties, thereby giving the CERCLA plaintiff an opportunity to pursue a more solvent defendant than the debtor.

It is less clear whether a cleanup order under CERCLA survives a discharge. The *Kovacs II* analysis indicates that the issue would turn on whether the debtor personally retained control over the site and was able to supervise the cleanup work. If not, the cleanup obligation would be dischargeable. However, *In re Torwico Electronics, Inc.* ⁿ⁷⁷ suggests that the cleanup obligations would not be dischargeable if the debtor still had access to the site even though it was no longer in possession. *In re Chateaugay* ⁿ⁷⁸ suggests that any cleanup order that seeks to end or ameliorate current pollution is not dischargeable, and under this standard most environmental injunctions will not be dischargeable. By contrast, *In re Robinson* ⁿ⁷⁹ suggests that even if the debtor remained in possession of the property, the incurrence of any expenses in connection with the cleanup would render the cleanup order dischargeable. It should also be noted that fines imposed by the EPA upon a potentially liable party for failure to comply with a CERCLA cleanup order may be nondischargeable under section 523(a)(7) as a "fine, penalty or forfeiture payable to and for the benefit of a governmental unit."

Kovacs II raises the related issue of when a CERCLA obligation "arises" in the bankruptcy context. In a chapter 7 liquidation proceeding, only those debts that arise prior to the filing of the bankruptcy petition are subject to discharge. With respect to a cleanup order issued under CERCLA, it could be argued that the claim arose upon the initial discharge of hazardous wastes, since the EPA can issue a cleanup order at that point. However, a claim for cleanup cost reimbursement under CERCLA can arise only when the government has "incurred" such costs. Therefore, at least one court has held that the EPA will only have a "claim" to the extent that it has incurred prepetition costs.ⁿ⁸⁰

CERCLA's imposition of liability on the current owner of a facility as well as on the owner of the facility at the time hazardous substances were discharged raises the question of whether abandonment of contaminated property by the trustee will enable it to escape CERCLA liability. If the estate holds title to the property when a reimbursement claim arises or when any contamination occurred then it would appear to remain liable under CERCLA notwithstanding a subsequent abandonment. One court, in considering whether a trustee who abandons contaminated waste drums would thereby avoid CERCLA liability, adopted this view, observing:

If the drums were abandoned they would cease to be property of the estate and the estate's interest therein would revert to the debtor. It does not necessarily follow, however, that the estate's liability for the environmental damage would also be transferred to the debtor. Although the drums are the source of the estate's liability under CERCLA, that liability cannot simply be transferred with the drums.ⁿ⁸¹

The trustee could avoid CERCLA liability only through abandonment if the government's claim arises after the abandonment and no contamination occurred during the period that the estate held title to the property.

[5] Parent/Subsidiary Liability Issues, Successor Liability Issues and the *Bestfoods* Decision

Given the many obstacles to pursuing a claim for reimbursement of cleanup costs against an entity in bankruptcy, parties will often seek to reach the assets of a solvent entity not in bankruptcy--particularly parent corporations. In these situations, a question arose concerning the circumstances under which a parent corporation could be held responsible for the environmental obligations of its subsidiary. Similarly, questions have arisen on whether the purchaser of assets from a responsible party that later becomes insolvent can be held responsible for the environmental liabilities of the seller under doctrines of successor liability. Given the remedial purpose of CERCLA, Courts had expanded successor liability in the CERCLA context to be broader than the scope of general (non-CERCLA) successor liability principles and

created a federal rule of successor liability under CERCLA which expanded the potential liability of asset purchasers.ⁿ⁸²

In an important decision interpreting the reach of liability under CERCLA, the Supreme Court held that a parent corporation could not be derivatively liable for the environmental damages caused by its 100 percent--owned subsidiary unless the parent was itself the responsible party under CERCLA or the corporate veil could be pierced under traditional principles of corporate law.ⁿ⁸³ That decision has also had a significant effect in other CERCLA contexts including the scope of successor liability, where the decision has called into question earlier decisions of appellate courts that construed CERCLA liability in a manner that was arguably more expansive than general common law doctrines. The decision in *United States v. Bestfoods* is notable outside the CERCLA context for its general discussion of veil-piercing law and the recognition--by the nation's highest court--that common attributes of parent/subsidiary relationships, such as election of directors, commonality of officers and directors and the exercise of economic control, are not sufficient to make a parent liable for the acts of its subsidiary.

As noted, under CERCLA, any "owner or operator" of a "facility" containing hazardous materials can be strictly liable for cleanup costs, whether or not such person was responsible for the release of the hazardous materials or was an owner or operator at the time of such release. Before the decision in *Bestfoods*, a number of federal courts, including the Court of Appeals for the Second Circuit, had held that a parent corporation could be deemed the "operator" of a facility owned by its subsidiary if the parent was actively involved in the general activities of the subsidiary, including such matters as control of cash management and budgeting.ⁿ⁸⁴ These courts justified this expansive view of liability based on the remedial congressional purposes underlying CERCLA, including the purpose of providing a source of funding for the disposal of hazardous substances and environmental clean up.

In a unanimous opinion written by Justice Souter, the Supreme Court explicitly rejected this broad interpretation of CERCLA and held that derivative liability could only inure to the parent if the corporate veil would be pierced under general principles of applicable corporate law, such as when the corporate form has been "misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf." The Court also held that the parent could be directly liable under CERCLA for its own acts as "operator" of the facility (as distinguished from the subsidiary), if the parent in fact managed, directed or conducted operations specifically related to pollution, including making decisions about compliance with environmental regulations.

Although the Supreme Court remanded the case to the district court for specific fact-finding on the parent's status as an operator of the facility, the opinion is notable for its extensive references to the long-standing principles of corporate law that respect the separate corporate form in the context of wholly owned subsidiaries. For example:

[I]t is hornbook law that the exercise of the control which stock ownership gives to the stockholders will not create liability beyond the assets of the subsidiary. That control includes the election of directors, the making of by-laws and the doing of all other acts incident to the legal status of stockholders. Nor will a duplication of some or all of the directors or executive officers be fatal Although this respect for corporate distinctions when the subsidiary is a polluter has been severely criticized in the literature, nothing in CERCLA purports to reject this bedrock principle, and against this venerable common-law backdrop, the congressional silence is audible.ⁿ⁸⁵

The opinion specifically recognized that "directors and officers holding positions with a parent and its subsidiary can and do change hats to represent two corporations separately, despite their common ownership"ⁿ⁸⁶ and cited the general presumption that "directors are wearing their 'subsidiary' hats and not their 'parent' hats when acting for the subsidiary."ⁿ⁸⁷ To the Supreme Court, the relevant inquiry is whether the dual officer or director has departed so far from the norms of parental influence exercised through dual office holdings as to serve the parent, even when ostensibly acting on behalf of the subsidiary. This may be the case if, for example, the dual officer's acts were "plainly contrary to the interests of the subsidiary yet nonetheless advantageous to the parent."ⁿ⁸⁸

Outside of CERCLA, the *Bestfoods* opinion reiterates the principle that the general body of state corporate law continues to apply—even in the context of a remedial federal body of law—unless Congress specifically states otherwise in the statute itself (for example, "controlling person" liability under the securities laws). More generally, although the decision is not binding on state courts with respect to causes of action based on state environmental laws, the opinion may be viewed as a reminder that the traditional attributes of parent/subsidiary relationships, including economic and governance control, are generally appropriate and should not, in and of themselves, be deemed inconsistent with respecting the separate corporate form. At the same time, *Bestfoods* highlights the importance of observing corporate formalities in situations such as environmental practices where the financial problems of a liable entity make the search for solvent deep pockets attractive to plaintiffs.

By applying general corporate law principles to CERCLA liability, and elevating such principles above a result oriented "remedial purpose" underlying CERCLA, the Supreme Court's decision in *Bestfoods* has had an impact outside the parent/subsidiary context. For example, the ruling has strengthened the argument that in the CERCLA arena, general principles of successor liability are appropriate rather than a CERCLA-specific, liability enhancing, federal rule.

In *New York v. Natational Services Industries*,ⁿ⁸⁹ the Court of Appeals for the Second Circuit overruled its earlier decision in *B.F. Goodrich v. Betkoski* ⁿ⁹⁰ and held that in light of *Bestfoods*, successor liability for CERCLA liabilities could only be imposed under common law principles rather than a CERCLA specific rule. In the *Betkoski* decision, rendered only seven years earlier, the same court of appeals rejected the "traditional common law rule" for successor liability, which the court there described as providing that:

a corporation acquiring the assets of another corporation only takes on its liabilities if any of the following apply: the successor expressly or impliedly agrees to assume them; the transaction may be viewed as a de facto merger or consolidation; the successor is the "mere continuation" of the predecessor; or the transaction is fraudulent.ⁿ⁹¹

The *Betkoski* court declined to adopt the "mere continuation" leg of the common law rule, which "requires the existence of a single corporation after the transfer of assets, with an identity of stock, stockholders, and directors between the successor and predecessor corporations."ⁿ⁹² Instead, given the remedial purposes of CERCLA and citing Supreme Court precedents in the labor law context, the *Betkoski* court adopted a "substantial continuation test," which, rather than considering ownership, focuses on the continuity of the business and whether the "successor maintains the same business, with the same employees doing the same jobs, under the same supervisors, working conditions, and production processes, and produces the same products for the same customers."ⁿ⁹³

The *National Services Industries* decision arose when New York state sued National Service Industries, Inc. ("NSI") under CERCLA for remediation liabilities of Serv-All Uniform Rental Corporation ("Serv-All").ⁿ⁹⁴ The basis of such suit was the following. In 1978, Serve-All, a company in the industrial garment rental and cleaning business, had arranged for the disposal to a landfill of several 55 gallon drums of liquid waste. The parties stipulated that such disposal in 1978 made Serv-All a potentially responsible party under CERCLA for the cleanup costs related to the landfill. In 1988, pursuant to an asset purchase agreement, NSI purchased all of Serv-All's customer contracts, customer lists, service inventory, accounts receivable, trucks, insulated jackets bearing the name Serv-All and the right to use or retire Serv-All's name. In the asset purchase agreement, Serv-All warranted that the asset transfer would be sufficient to meet the needs of Serv-All's customers and the owners of Serv-All covenanted that they would not compete with NSI for seven years. On the date of the purchase, Serv-All adopted a plan of liquidation, which it carried out shortly thereafter. NSI tried to make the transition from Serv-All to NSI as seamless as possible by employing the Serv-All drivers, using trucks which still bore the name Serv-All, using Serv-All on its letterhead and taking over the Serv-All telephone number. In 1999, New York State sued NSI for the cleanup of the landfill. The district court granted summary judgment for the State, determining that "NSI's operations were a substantial continuation of Serv-All's business," and thus holding, under the binding precedent of *Betkoski*, that "NSI was subject to successor liability for Serv-All's

environmental infractions" and was thereby liable under CERCLA for the clean-up cost at the landfill.ⁿ⁹⁵

On appeal, the court of appeals acknowledged that it was facing squarely "the question of whether, in the context of CERCLA, the substantial continuity rule for successor liability that [it] adopted in *Betkoski* remains good law after the Supreme Court's decision in *Bestfoods*." After describing and analyzing the *Bestfoods* decision, the court accepted as an underlying principle from the case that "when determining whether liability under CERCLA passes from one corporation to another, we must apply common law rules and not create CERCLA-specific rules." After rejecting several arguments from New York State that tried to distinguish *Bestfoods*, including the argument that the "substantial continuity" test was simply a refined version of the traditional mere continuation exception,ⁿ⁹⁶ the court expressly overruled *Betkoski* "because the substantial continuity test adopted [there] departs from the common law rules of successor liability."ⁿ⁹⁷

The *National Services Industries* decision can be viewed as putting a brake on both judicial expansion of CERCLA liabilityⁿ⁹⁸ and the premise that because of the general remedial purposes of CERCLA, that statute should necessarily trump or otherwise take precedence over other established bodies of law. One such established body of law is of course the Bankruptcy Code. As described in this Chapter, in certain contexts (*i.e.* abandonment, automatic stay, claim priority), bankruptcy law principles and specific provisions of the Bankruptcy Code often conflict or at least clash with the purposes and provisions of CERCLA and other environmental laws. It remains to be seen whether other courts will cite *Bestfoods* by analogy to give additional weight to the bankruptcy policies in the many contexts in which bankruptcy law goals and objectives intersect with CERCLA and other environmental laws.

FOOTNOTES:

(n1)Footnote 1. 42 U.S.C. §§ 9601-9657.

(n2)Footnote 2. 42 U.S.C. § 9607(a); see *In re Reading Co.*, 115 F.3d 1111, 1118 (3d Cir. 1997) .

(n3)Footnote 3. See, *e.g.*, *In re Bell Petroleum Servs., Inc.*, 3 F.3d 889 (5th Cir. 1993) ; *United States v. Alcan Aluminium Corp.*, 990 F.2d 711 (2d Cir. 1993) ; *United States v. Alcan Aluminium Corp.*, 964 F.2d 252 (3d Cir. 1992) ; *Dedham Water Co. v. Cumberland Farms Dairy*, 889 F.2d 1146 (1st Cir. 1989) ; *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985) .

(n4)Footnote 4. See, *e.g.*, *Combined Properties/Greenbrier Ltd. Pshp. v. Morrow*, 58 F. Supp. 2d 675 (E.D. Va. 1999) ; *United States v. Dickerson*, 640 F. Supp. 448 (D. Md. 1986) .

(n5)Footnote 5. 42 U.S.C. § 9613(f); *In re Reading Co.*, 115 F.3d 1111, 1118 (3d Cir. 1997) .

(n6)Footnote 6. Courts have recognized an exception to joint and several liability where there is a reasonable basis for apportioning a defendant's conduct among divisible harms. *United States v. Alcan Aluminium Corp.*, 964 F.2d 252 (3d Cir. 1992) . In *United States v. Rohm & Haas Co.*, 2 F.3d 1265 (3d Cir. 1993) , the Court of Appeals for the Third Circuit refused to apportion the full liability asserted against a 10% owner of a facility because the owner failed to meet its burden of showing that part of the overall harm was caused by other responsible parties. By contrast, in *In re Bell Petroleum Servs., Inc.*, 3 F.3d 889 (5th Cir. 1993) , the Court of Appeals for the Fifth Circuit held that the former owner of a chrome-plating facility met its burden of demonstrating a reasonable basis for apportioning liability between it and other former owners of the facility by presenting volumetric evidence based upon expert testimony as to the total amount of chromium produced and discharged by each former owner.

(n7)Footnote 7. See, *e.g.*, *United States v. Northeastern Pharm. & Chem. Co.*, 579 F. Supp. 823 (W.D. Mo. 1984) .

(n8)Footnote 8. 42 U.S.C. § 9606.

(n9)Footnote 9. 42 U.S.C. § 9607(l).

(n10)Footnote 10. 42 U.S.C. § 9607(l)(3). *United States v. M. Genzale Plating, Inc.*, 723 F. Supp. 877 (E.D.N.Y. 1989) .

(n11)Footnote 11. 42U.S.C. § 9607(l)(3).

(n12)Footnote 12. 42 U.S.C. § 9607(b).

(n13)Footnote 13. Pub L. 107-118 (2002).

(n14)Footnote 14. 42 U.S.C. § 9601(35)(A)-(B); *In re Hemingway Transp., Inc.*, 993 F.2d 915, 932-33, 28 C.B.C.2d 1545, 1567-68 (5th Cir. 1993) .

(n15)Footnote 15. 42 U.S.C. § 9601(35)(B)(iv)(I).

(n16)Footnote 16. 42 U.S.C. § 9601(35)(B)(iii).

(n17)Footnote 16a. 42 U.S.C. § 9601(35)(B)(iv)(II).

(n18)Footnote 16b. 40 C.F.R. Part 312.2 (68 FR 24891 (May 9, 2003)) .

(n19)Footnote 17. *United States v. Pacific Hide & Fur Depot, Inc.*, 716 F. Supp. 1341, 1348-49 (D. Idaho 1989) .

(n20)Footnote 18. *Juniper Dev. Group v. Kahn (In re Hemingway Transp., Inc.)*, 174 B.R. 148 (Bankr. D. Mass. 1994) , on remand from, 993 F.2d 915, 28 C.B.C.2d 1545 (3d Cir. 1993) .

(n21)Footnote 19. 174 B.R. 148, 169 .

(n22)Footnote 20. *Id.*

(n23)Footnote 21. 42 U.S.C. § 9601(20)(A).

(n24)Footnote 22. 1985 U.S. Dist. LEXIS 15411 (E.D. Pa. 1985).

(n25)Footnote 23. 15 Env'tl. L. Rep. 20,994 at 20,995 (E.D. Pa. 1985) .

(n26)Footnote 24. 632 F. Supp. 573 (D. Md. 1986) .

(n27)Footnote 25. 45 B.R. 278 (Bankr. N.D. Ohio 1985) . This case is also discussed at P 6.05[1] *supra*.

(n28)Footnote 26. See also *Guidice v. BFG Electroplating & Mfg. Co., Inc.*, 732 F.Supp. 556 (W.D. Pa. 1989) (secured creditor exemption held applicable prior to foreclosure but not applicable subsequent to foreclosure); *United States v. Nicolet, Inc.*, 712 F. Supp. 1193 (E.D. Pa. 1989) (citing *Mirabile* with approval). The question of control over the management of a hazardous waste site and the imputation of CERCLA liability also arises in cases involving parent corporation liability for CERCLA violations of subsidiaries or shareholder liability in their capacity as "operators." See *Redwing Carriers, Inc. v. Saraland Apartments*, 94 F.3d 1489 (11th Cir. 1996) ; *Schiavone v. Pearce*, 79 F.3d 248 (2d Cir. 1996) ; *Nurad, Inc. v. William E. Hooper & Sons Co.*, 966 F.2d 837 (4th Cir.) , cert. denied, 506 U.S. 940, 113 S. Ct. 377, 121 L. Ed. 2d 288 (1992) ; *United States v. Kayser-Roth Corp.*, 910 F.2d 24 (1st Cir. 1990) , cert. denied, 498 U.S. 1084, 111 S. Ct. 957, 112 L. Ed. 2d 1045 (1991) ; *Joslyn Mfg. Co. v. T.J. James & Co.*, 893 F.2d 80 (5th Cir. 1990) .

(n29)Footnote 27. 901 F.2d 1550 (11th Cir. 1990) , cert. denied, 498 U.S. 1046, 111 S. Ct. 752, 112 L. Ed. 2d 772 (1991) .

(n30)Footnote 28. 901 F.2d 1550, 1557-58 .

(n31)Footnote 29. 910 F.2d 668 (9th Cir. 1990) .

(n32)Footnote 30. 873 F. Supp. 51 (E.D. Mich. 1995) .

(n33)Footnote 31. 873 F. Supp. 51, 55 .

(n34)Footnote 32. *Id.*

(N35)Footnote 33. See P 6.07[3] *infra*.

(n36)Footnote 34. 873 F. Supp. 51, 55 .

(n37)Footnote 35. 873 F. Supp. 51, 55-56 .

(n38)Footnote 36. 900 F. Supp. 1427 (D. Kan. 1995) .

(n39)Footnote 37. 900 F. Supp. 1427, 1456 (emphasis added).

(n40)Footnote 38. 900 F. Supp. 1427, 1457 .

(n41)Footnote 39. *Id.*

(n42)Footnote 40. 984 F.2d 549 (1st Cir. 1993) .

(n43)Footnote 41. 984 F.2d 549, 552 . For discussion of lease recharacterization issues, see P 2.02[3] *supra*.

(n44)Footnote 42. 984 F.2d 549, 553 .

(n45)Footnote 43. 984 F.2d 549, 554 .

(n46)Footnote 44. 5 F.3d 69 (4th Cir. 1993) .

(n47)Footnote 45. 5 F.3d 69, 72 .

(n48)Footnote 46. 5 F.3d 69, 73-74 .

(n49)Footnote 47. See also *Northeast Doran, Inc. v. Key Bank of Maine*, 15 F.3d 1 (1st Cir. 1994) (following *Waterville*). In *Bancamerica Commercial Corp. v. Trinity Indus., Inc.*, 900 F. Supp. 1427 (D. Kan. 1995) , the court concluded that the lender made "adequately prompt" efforts to resell the property after taking a deed in lieu of foreclosure and specifically noted that the lender's rejection of three offers that were all less than the outstanding debt was insufficient to strip the lender of the protections of the security interest exception.

(n50)Footnote 48. See P 6.51 *infra*.

(n51)Footnote 49. 40 C.F.R. § 300.1100(c)(1) (emphasis added).

(n52)Footnote 50. 40 C.F.R. § 300.1100(c) (emphasis added). The EPA Regulations define "operational aspects of the enterprise" to include functions "such as that of facility or plant manager, operations manager, chief operating officer, or chief executive officer" and "financial or administrative aspects" to include functions "such as that of credit manager, accounts payable/receivable manager, personnel manager, controller, chief financial officer, or similar functions." *Id.*

(n53)Footnote 51. 40 C.F.R. § 300.1100(d).

(n54)Footnote 52. 40 C.F.R. § 300.1100(d).

(n55)Footnote 53. A "written, bona fide, firm offer" means "a legally enforceable, commercially reasonable, cash offer solely for the foreclosed vessel or facility, including all material terms of the transaction, from a ready, willing, and able purchaser who demonstrates to the holder's satisfaction the ability to perform." 40 C.F.R. § 300.1(d)(2)(ii).

(n56)Footnote 54. 15 F.3d 1100, 304 U.S. App. D.C. 369, reh'g denied, 25 F.3d 1088, 306 U.S. App. D.C. 382 (D.C. Cir. 1994), cert. denied, 513 U.S. 1110, 115 S. Ct. 900, 130 L. Ed. 2d 784 (1995).

(n57)Footnote 55. *Z&Z Leasing, Inc. v. Graying Reel, Inc.*, 873 F. Supp. 51 (E.D. Mich. 1995); see text accompanying notes 30-35 *supra*.

(n58)Footnote 56. See *Bancamerica Commercial Corp. v. Trinity Indus., Inc.*, 900 F. Supp. 1427 (D. Kan. 1995); *DuFrayne v. FTB Mortg. Servs. (In re DuFrayne)*, 194 B.R. 354 (Bankr. E.D. Pa. 1996); see also notes 36-38 *supra*.

(n59)Footnote 57. See 6 Real Est./Env'tl Liability News 1 (June 2, 1995).

(n60)Footnote 58. Schnapf, *Lender Liability Statutes*, 6 Real Est./Env'tl Liability News 8 (June 2, 1995).

(n61)Footnote 59. See CERCLA Enforcement Actions Against Lenders and Government Entities that Acquire Property Involuntarily, 60 Fed. Reg. 63,517 (Dec. 11, 1995).

(n62)Footnote 60. 60 Fed. Reg. 63,517, 63,518-63,519.

(n63)Footnote 61. As a caveat, however, it should be pointed out that the EPA/DOJ Policy Statement specifically notes that the announced policies and procedures do not constitute agency rulemaking and are not intended to create an enforceable right in favor of any person. Moreover, both agencies reserved the right to act at variance with the announced policy or its internal implementing procedures. 60 Fed. Reg. 63,517, 63,519.

(n64)Footnote 62. See P 6.51 *infra*.

(n65)Footnote 63. Pub. L. No. 104-208 (Sept. 30, 1996) [hereinafter the Act].

(n66)Footnote 64. The Act comprised Subtitle E of Pub. L. No. 104-208.

(n67)Footnote 65. 910 F.2d 668 (9th Cir. 1990); see P 6.07[2] *supra*.

(n68)Footnote 65a. See P 6.52 *infra*.

(n69)Footnote 66. Act § 2502(b). This portion of the Act is codified at 42 U.S.C. § 9601(20)(D)-(G). The above summary of the provisions of the Act is not complete and is qualified by reference to the full text thereof. See P 6.52 *infra*.

(n70)Footnote 67. CERCLA § 101(20)(F)(I),(II). This formulation overrules the *Fleet Factors* holding. See P 6.07[2] *supra*.

(n71)Footnote 68. CERCLA § 101(20)(F)(iv).

(n72)Footnote 69. CERCLA § 101(20)(G)(iv).

(n73)Footnote 69a. CERCLA § 101(20)(G)(vii)-(viii).

(n74)Footnote 70. Act § 2503.

(n75)Footnote 71. CERCLA § 107(n)(1). The principal case involving the liability of a trustee in a case under the Bankruptcy Code is *State v. Better Brite Plating*, 168 Wis. 2d 363, 483 N.W.2d 574 (Wisc. 1992) ; see also *Tennsco Corp. v. Estey Metal Prods.*, 200 B.R. 542 (D.N.J. 1996) .

(n76)Footnote 72. CERCLA § 107(n)(3).

(n77)Footnote 73. CERCLA § 107(n)(5).

(n78)Footnote 74. 15 F.3d 1100, 304 U.S. App. D.C. 369 , *reh'g denied*, 25 F.3d 1088, 306 U.S. App. D.C. 382 (D.C. Cir. 1994) , *cert. denied*, 513 U.S. 1110, 115 S. Ct. 900, 130 L. Ed. 2d 784 (1995) .

(n79)Footnote 75. For a review of the sparse legislative history of the Act, including post-enactment colloquy concerning the import of section 2504 of the Act with respect to the EPA's rulemaking authority under CERCLA, see Buzbee, *CERCLA's New Safe Harbors for Banks, Lenders and Fiduciaries*, 26 Env'tl. L. Rep. 10,656 (Dec.1996).

(n80)Footnote 76. For an excellent discussion of these issues, see Drabkin, Moorman & Kirsch, *Bankruptcy and the Cleanup of Hazardous Waste: Caveat Creditor*, 15 Env'tl. L. Rep. 10,168 (1985).

(n81)Footnote 77. 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993) ; see P 6.05[2] *supra*.

(n82)Footnote 78. 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) .

(n83)Footnote 79. 46 B.R. 136, 12 C.B.C.2d 49 (Bankr. M.D. Fla. 1985) .

(n84)Footnote 80. See, e.g., *United States v. Union Scrap Iron & Metal*, 123 B.R. 831 (D. Minn. 1990) (no discharge of CERCLA obligations where government had not incurred any prepetition response costs). But see *United States v. Chateaugay Corp. (In re Chateaugay Corp.)*, 112 B.R. 513, 522 (S.D.N.Y. 1990) , *aff'd*, 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) ("so long as there is a pre-petition triggering event, i.e., the release or threatened release of hazardous waste, the claim is dischargeable, regardless of when the claim for relief may be in all respects ripe for adjudication"); *In re National Gypsum Co.*, 139 B.R. 397, 409 (N.D. Tex. 1992) ("all future response and natural resource damages cost based on pre-petition conduct that can be fairly contemplated by the parties at the time of Debtors' bankruptcy are claims under the Code"); see also P 6.03[1] *supra*.

(n85)Footnote 81. *In re T.P. Long Chem., Inc.*, 45 B.R. 278, 284-85 (Bankr. N.D. Ohio 1985) .

(n86)Footnote 82. See, e.g., *B.F. Goodrich v. Betkoski*, 99 F.3d 505 (2d Cir. 1996) (applying substantial continuity or continuity of enterprise test rather than common law mere continuation test which requires the existence of a single corporation after the transfer of assets, with an identity of stock, stockholders, and directors between the successor and predecessor corporations); *United States v. Carolina Transformer Co.*, 978 F.2d 832, 837 (4th Cir. 1992) (same); *United States v. Mexico Feed & Seed Co.*, 980 F.2d 478 (8th Cir. 1992) (same).

(n87)Footnote 83. *United States v. Bestfoods*, 524 U.S. 51, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (1998) .

(n88)Footnote 84. See, e.g., *Schiavone v. Pearce*, 79 F.3d 248 (2d Cir. 1996) ; *Lansford-Coaldale Joint Water Auth. v. Tonolli Corp.*, 4 F.3d 1209 (3d Cir. 1993) ; *United States v. Kayser-Roth Corp.*, 910 F.2d 24 (1st Cir. 1990) .

(n89)Footnote 85. 524 U.S. 51, 62, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (citations omitted).

(n90)Footnote 86. 524 U.S. 51, 69, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (citations omitted).

(n91)Footnote 87. *Id.*

(n92)Footnote 88. 524 U.S. 51, 70 n.13, 118 S. Ct. 1876, 141 L. Ed. 2d 43 .

(n93)Footnote 89. 352 F.3d 682 (2d Cir. 2003) .

(n94)Footnote 90. 99 F.3d 505 (2d Cir. 1996) .

(n95)Footnote 91. 99 F.3d 505, 519 (citations omitted).

(n96)Footnote 92. *Id.* One court of appeals decision stated:

[T]he "mere continuation" exception to the general rule of no liability for the purchasing corporation turns on a five-prong test. An acquiring corporation will be deemed a mere continuation of the old corporation if: (1) a corporation transfers its assets; (2) the acquiring corporation pays less than adequate consideration for the assets; (3) the acquiring corporation continues the selling corporation's business; (4) both corporations share at least one common officer who was instrumental in the transfer; and (5) the selling corporation is left incapable of paying its creditors.

IBC Mfg. Co. v. Velsicol Chem. Corp., 1999 U.S. App. LEXIS 15140 (6th Cir. 1999) (citing *Ed Peters Jewelry Co. v. C & J Jewelry Co.*, 124 F.3d 252, 268 (1st Cir. 1997)) .

(n97)Footnote 93. *Id.*

(n98)Footnote 94. The following relevant facts in this paragraph are taken from the opinion of the court of appeals. 352 F.3d 682, 683-84 .

(n99)Footnote 95. 352 F.3d 682, 684 (citing district court decision).

(n100)Footnote 96. The court also acknowledged that the doctrine had been adopted by some courts in the product liability context and that a handful of states had adopted a substantial continuity exceptions in other successor liability contexts; however, such adoption was not sufficient to conclude that it had spread into the federal common law. 352 F.3d at 687-88 .

(n101)Footnote 97. 352 F.3d 682, 685 .

(n102)Footnote 98. *See also United States v. Davis*, 261 F.3d 1, 54 (1st Cir. 2001) (noting that *Bestfoods* "left little room for the creation of a federal rule of liability under the statute").

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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CHAPTER 6 Environmental Issues in Bankruptcy *

1-6 Collier Real Estate Trans & Bankruptcy Code P 6.08

P 6.08 Minimizing Lenders' Risks Under Environmental Protection Laws

Lenders must recognize that the presence of toxic wastes on mortgaged property creates the risk of collateral impairment as well as the possibility that their security interest may be subordinated to or consumed by a governmental claim for cleanup costs. In addition, in spite of the safe harbors provided by the 1996 amendments to CERCLA,ⁿ¹ lenders who fail to carefully consider their response to environmental problems arising during the term of a mortgage loan will face issues that are not present in the case of uncontaminated collateral. Lenders can minimize these problems by taking certain precautionary measures.ⁿ²

Lenders should be wary of making loans to a borrower whose business suggests that environmental risks may be present. Obvious examples are mortgagors involved in the use, manufacture, transport, storage or disposal of hazardous substances or operators of industrial plants or other manufacturing facilities that may generate hazardous wastes. Even if the particular property to be mortgaged appears to involve minimal environmental risk (*e.g.*, an office building owned by a manufacturing company), a borrower may be rendered insolvent by environmental liability arising from operations elsewhere.

The prospective lender should attempt to obtain as much information as possible about the environmental condition of the property to be mortgaged and about the borrower's other activities. The lender should:

- (1) Make inquiries of federal, state and local environmental agencies as to the property's past and present use and compliance with environmental laws and building, zoning, fire and health codes. Agency records should also be examined for any permits for hazardous waste treatment, storage or disposal, underground storage tanks and similar uses obtained by a past or present owner or operator.
- (2) Obtain disclosure about past and present use and legal compliance from current and past owners, operators, tenants, industrial or residential neighbors and others through the use of interviews, file reviews, questionnaires, disclosure statements, tenant estoppel certificates and legal opinions.
- (3) Examine title records for statutory environmental liens and restrictive covenants or other matters of record indicating ownership or use by businesses that may have caused environmental damage.
- (4) Investigate any past or present insurance claims or litigation affecting the mortgaged property.

(5) Require that an environmental audit of the mortgaged property be conducted by a reputable environmental consulting firm. This should involve the testing and analysis of soil and groundwater samples from the property to determine if hazardous substances are present. Lenders and their counsel should be aware that discovery of hazardous substance contamination could create the obligation under CERCLA to report this information to the federal government.

(6) Conduct an inquiry into the borrower's past and present activities unrelated to the property to be mortgaged.

Provisions in the loan documentation should be included to assist the lender in identifying environmental problems during the course of the loan and minimize a lender's liability if such problems arise. Suggested provisions include:

(1) Representations and warranties from the borrower regarding the present and, to the best of the borrower's knowledge, past use, storage and handling of hazardous substances on the mortgaged property, the presence of underground storage tanks (whether currently in use or abandoned) on the mortgaged property, compliance of the property with state and federal environmental laws, the presence of contamination on the mortgaged property and environmental liability of the borrower with respects to other properties.

(2) Covenants that the borrower will promptly remedy any future environmental contamination affecting the mortgaged property or any of the borrower's other properties, that it will comply with all state and federal environmental laws and that it will not use, generate, store or dispose of hazardous materials on the property.

(3) A provision entitling the lender to periodically test the property and otherwise monitor environmental compliance.

(4) An indemnification by the borrower (and a parent corporation, affiliate or individuals, if appropriate) in favor of the lender for any environmental liability that the lender may incur in connection with the mortgage. CERCLA provides that indemnification provisions will not affect the liability of any responsible party to the government but that such agreements are enforceable between private parties. The lender must consider the financial capability of the indemnitor in light of the potentially enormous liability for cleanup costs or tort damage arising from contamination. The lender should consider a separate indemnity agreement to ensure that these provisions will survive foreclosure. In addition, lenders should consider making nonrecourse provisions inapplicable in the event of a breach by the borrower of representations or covenants regarding environmental law compliance.

(5) A restriction on the borrower's ability to lease any portion of the property to tenants for environmentally hazardous uses.

(6) A provision requiring the borrower to send the lender copies of all correspondence or notices sent by or to any state or federal environmental authority.

Prior to foreclosure, lenders should conduct an environmental audit, an investigation of state records, a determination of any ongoing environmental enforcement proceedings, a title search and the other measures that were suggested be taken prior to making the loan. If contamination is found to be present, lenders should consider whether foreclosure is economically sensible in light of potential cleanup costs and other liabilities which may be greater than the collateral value. If the lender does foreclose, it should restrict its post-foreclosure activities to only those which protect the collateral value, should promptly commence efforts to market and sell the property and should retain title to the property only long enough to ensure an adequate resale price. The cases and the 1996 CERCLA Amendments suggest that it may be inadvisable for the lender to reject a price from an able buyer that would be sufficient to repay the loan

and all reasonable costs or engage in other acts or practices which indicate the lender had a "profit motive" in connection with the disposal of the subject property.

In the case of a recourse loan in which the borrower's credit is a significant underwriting consideration apart from the value of any real property collateral, perhaps the most important problem is the possibility that a lender's claim on such a debt against the estate of a borrower that has become a debtor under the Bankruptcy Code may be subject to the priority of an administrative expense claim against the estate arising from the costs of a postpetition cleanup of a prepetition condition.ⁿ³ This prospect will exist in the case of a borrower subject to liability under CERCLA regardless of whether a lender has extended credit on a secured or unsecured basis. Accordingly, the due diligence checklist for lenders set forth above, although seemingly relevant only in the case of secured transactions, is also relevant to the underwriting for an unsecured loan to a borrower that may own contaminated property.

FOOTNOTES:

(n1)Footnote 1. *See P 6.07[3] supra.*

(n2)Footnote 2. *See generally, Klotz and Siakotos, Lender Liability Under Federal and State Environmental Law: Of Deep Pockets, Debt Defeat and Deadbeats, 92 Com. L.J. 275 (1987); Leo, Identifying Environmental Risks in Real Estate Transactions, Environmental Risks for Lenders and Owners (Infocast 1987).*

(n3)Footnote 3. *See P 6.05[1]-[2] supra*

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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CHAPTER 6 Environmental Issues in Bankruptcy *

1-6 Collier Real Estate Trans & Bankruptcy Code P 6.51

P 6.51 Statutes--EPA Secured Lender Regulations

40 C.F.R. Part 300

Subpart L--National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA

§ 300.1100. Security Interest Exemption.

A person who maintains indicia of ownership primarily to protect a security interest in a vessel or facility, and who does not participate in the management of the vessel or facility, is not an "owner or operator" of such vessel or facility under CERCLA section 107(a)(1) or section 107(a)(2). The plaintiff bears the burden of establishing that the defendant is liable as an owner or operator.

(a) "Indicia of ownership" as used in section 101(20)(A) of CERCLA means evidence of a security interest, evidence of an interest in a security interest, or evidence of an interest in real or personal property securing a loan or other obligation, including any legal or equitable title to real or personal property acquired incident to foreclosure and its equivalents. Evidence of such interests includes, but is not limited to, mortgages, deeds of trust, liens, surety bonds and guarantees of obligations, title held pursuant to a lease financing transaction in which the lessor does not select initially the leased property (hereinafter "lease financing transaction"), legal or equitable title obtained pursuant to foreclosure, and their equivalents. Evidence of such interests also includes assignments, pledges, or other rights to or other forms of encumbrance against property that are held primarily to protect a security interest. A person is not required to hold title or a security interest in order to maintain indicia of ownership.

(1) A holder is a person who maintains indicia of ownership (as defined in 40 C.F.R. 300.1100(a)) primarily to protect a security interest (as defined in 40 C.F.R. 300.1100(b)(1)). A holder includes the initial holder (such as a loan originator), any subsequent holder (such as a successor-in-interest or subsequent purchaser of the security interest on the secondary market), a guarantor of an obligation, surety, or any other person who holds ownership indicia primarily to protect a security interest, or a receiver or other person who acts on behalf or for the benefit of a holder.

(2) A borrower, debtor, or obligor is a person whose vessel or facility is encumbered by a security interest. These terms are used interchangeably.

(b) "Primarily to protect a security interest" for the purposes of section 101(20)(A) of CERCLA means that the holder's indicia of ownership are held primarily for the purpose of securing payment or performance of an obligation.

(1) "Security interest" as used in section 101(20)(A) of CERCLA means an interest in a vessel or facility created or established for the purpose of securing a loan or other obligation. Security interests include, but are not limited to, mortgages, deeds of trusts, liens, and title pursuant to lease financing transactions. Security interests may also arise from transactions such as sale and leasebacks, conditional sales, installment sales, trust receipt transactions, certain assignments, factoring agreements, accounts receivable financing arrangements, and consignments, if the transaction creates or establishes an interest in a vessel or facility for the purpose of securing a loan or other obligation.

(2) "Primarily to protect a security interest" does not include indicia of ownership held primarily for investment purposes, nor ownership indicia held primarily for purposes other than as protection for a security interest. A holder may have other, secondary reasons for maintaining indicia of ownership, but the primary reason why any ownership indicia are held must be as protection for a security interest.

(c) *Participation in Management Defined.* The term "participating in the management of a vessel or facility" means that the holder is engaging in acts of facility or vessel management, as defined herein.

(1) *Actions That Are Participation in Management:* Participation in the management of a facility means, for the purpose of section 101(20)(A), actual participation in the management or operational affairs of the vessel or facility by the holder, and does not include the mere capacity to influence, or ability to influence, or the unexercised right to control facility operations. A holder is participating in management, while the borrower is still in possession of the vessel or facility encumbered by the security interest, only if the holder either:

(i) exercises decisionmaking control over the borrower's environmental compliance, such that the holder has undertaken responsibility for the borrower's hazardous substance handling or disposal practices; or

(ii) exercises control at a level comparable to that of a manager of the borrower's enterprise, such that the holder has assumed or manifested responsibility for the overall management of the enterprise encompassing the day-to-day decisionmaking of the enterprise with respect to (A) environmental compliance or (B) all, or substantially all, of the operational (as opposed to financial or administrative) aspects of the enterprise other than environmental compliance. Operational aspects of the enterprise include functions such as that of facility or plant manager, operations manager, chief operating officer, or chief executive officer. Financial or administrative aspects include functions such as that of credit manager, accounts payable/receivable manager, personnel manager, controller, chief financial officer, or similar functions.

(2) *Actions That Are Not Participation in Management:*

(i) *Actions at the Inception of the Loan or Other Transaction.* No act or omission prior to the time that indicia of ownership are held primarily to protect a security interest constitutes evidence of participation in management within the meaning of section 101(20)(A). A prospective holder who undertakes or requires an environmental inspection of the vessel or facility in which indicia of ownership are to be held, or requires a prospective borrower to clean up a vessel or facility or to comply or come into compliance (whether prior or subsequent to the time that indicia of ownership are held primarily to protect a security interest) with any applicable law or regulation, is not by such action considered to be participating in the vessel's or facility's management. Neither the statute nor this regulation requires a

holder to conduct or require an inspection to qualify for the exemption, and the liability of a holder cannot be based on or affected by the holder not conducting or not requiring an inspection.

(ii) *Policing and Workout.* Actions that are consistent with holding ownership indicia primarily to protect a security interest do not constitute participation in management for purposes of section 101(20)(A) of CERCLA. The authority for the holder to take such actions may, but need not, be contained in contractual or other documents specifying requirements for financial, environmental, and other warranties, covenants, conditions, representations or promises from the borrower. Loan policing and workout activities cover and include all activities up to foreclosure and its equivalents, as provided in 40 C.F.R. 300.1100(d)(1).

(A) *Policing the Security Interest or Loan.* A holder who engages in policing activities prior to foreclosure will remain within the exemption provided that the holder does not by such actions participate in the management of the vessel or facility as provided in 40 CFR 300.1100(c)(1). Such actions include, but are not limited to, requiring the borrower to clean up the vessel or facility during the term of the security interest; requiring the borrower to comply or come into compliance with applicable federal, state, and local environmental and other laws, rules and regulations during the term of the security interest; securing or exercising authority to monitor or inspect the vessel or facility (including on-site inspections) in which indicia of ownership are maintained, or the borrower's business or financial condition during the term of the security interest; or taking other actions to adequately police the loan or security interest (such as requiring a borrower to comply with any warranties, covenants, conditions, representations or promises from the borrower).

(B) *Work Out.* A holder who engages in work out activities prior to foreclosure and its equivalents will remain within the exemption provided that the holder does not by such action participate in the management of the vessel or facility as provided in 40 CFR 300.1100(c)(1). For purposes of this rule, "work out" refers to those actions by which a holder, at any time prior to foreclosure and its equivalents, seeks to prevent, cure, or mitigate a default by the borrower or obligor; or to preserve, or prevent the diminution of, the value of the security. Work out activities include, but are not limited to, restructuring or renegotiating the terms of the security interest; requiring payment of additional rent or interest; exercising forbearance; requiring or exercising rights pursuant to an assignment of accounts or other amounts owing to an obligor; requiring or exercising rights pursuant to an escrow agreement pertaining to amounts owing to an obligor; providing specific or general financial or other advice, suggestions, counseling, or guidance; and exercising any right or remedy the holder is entitled to by law or under any warranties, covenants, conditions, representations or promises from the borrower.

(iii) *Actions Taken Under CERCLA Section 107(d)(1).* Notwithstanding 40 C.F.R. 300.1100(c)(1), a holder does not participate in the management of a vessel or facility by taking any response action under section 107(d)(1) of CERCLA or under the direction of an on-scene coordinator.

(d) *Foreclosure on Property and Post-Foreclosure Activities:*

(1) *Foreclosure.* Indicia of ownership that are held primarily to protect a security interest include legal or equitable title acquired through or incident to foreclosure and its equivalents. For purposes of this Subpart, the term "foreclosure and its equivalents" includes purchase at foreclosure sale; acquisition or assignment of title in lieu of foreclosure; termination of a lease or other repossession; acquisition of a right to title or possession; an agreement in satisfaction of the obligation; or any other formal or informal manner (whether pursuant to law or under warranties, covenants, conditions, representations or promises from the borrower) by which the holder acquires title to or possession of the secured property. The indicia of ownership held after foreclosure continue to be maintained primarily as protection for a security interest provided that the holder undertakes to sell, re-lease property held pursuant to a lease

financing transaction (whether by a new lease financing transaction or substitution of the lessee), or otherwise divest itself of the property in a reasonably expeditious manner, using whatever commercially reasonable means are relevant or appropriate with respect to the vessel or facility, taking all facts and circumstances into consideration, and provided that the holder did not participate in management (as defined in 40 CFR 300.1100(c)) prior to foreclosure and its equivalents. For purposes of establishing that a holder is seeking to sell, release property held pursuant to a lease financing transaction (whether by a new lease financing transaction or substitution of the lessee), or divest a vessel or facility in a reasonably expeditious manner, the holder may use whatever commercially reasonable means as are relevant or appropriate with respect to the vessel or facility, or may employ the means specified in 40 CFR 300.1100(d)(2)(i). A holder that outbids, rejects or fails to act upon a written bona fide, firm offer of fair consideration for the property, as provided in 40 CFR 300.1100(d)(ii), is not considered to hold indicia of ownership primarily to protect a security interest.

(2) *Holding Foreclosed Property for Disposition and Liquidation.* A holder, who did not participate in management prior to foreclosure and its equivalents, may sell, re-lease property held pursuant to a lease financing transaction (whether by a new lease financing transaction or substitution of the lessee), liquidate, maintain business activities, wind up operations, undertake any response action under section 107(d)(1) of CERCLA or under the direction of an on-scene coordinator, and take measures to preserve, protect or prepare the secured asset prior to sale or other disposition. The holder may conduct these activities without voiding the exemption, subject to the requirements of 40 CFR 300.1100(d)(1) and 300.1100(d)(2).

(i) A holder establishes that the ownership indicia maintained following foreclosure and its equivalents continue to be held primarily to protect a security interest by, within twelve months following foreclosure, listing the vessel or facility with a broker, dealer, or agent who deals with the type of property in question, or by advertising the vessel or facility as being for sale or disposition on at least a monthly basis in either a real estate publication or a trade or other publication suitable for the vessel or facility in question, or a newspaper of general circulation (defined as one with a circulation over 10,000, or one suitable under any applicable federal, state, or local rules of court for publication required by court order or rules of civil procedure) covering the area where the property is located. For purposes of this provision, the twelve-month period begins to run from the time that the holder acquires marketable title, provided that the holder, after the expiration of any redemption or other waiting period provided by law, was acting diligently to acquire marketable title. If the holder fails to act diligently to acquire marketable title, the twelve-month period begins to run on the date of foreclosure and its equivalents.

(ii) A holder that outbids, rejects, or fails to act upon an offer of fair consideration for the vessel or facility establishes that the ownership indicia in the secured property was not held primarily to protect the security interest, unless the holder is required, in order to avoid liability under federal or state law, to make a higher bid, to obtain a higher offer, or to seek or obtain an offer in a different manner.

(A) "Fair consideration," in the case of a holder maintaining indicia of ownership primarily to protect a senior security interest in the vessel or facility, is the value of the security interest as defined in this section. The value of the security interest is calculated as an amount equal to or in excess of the sum of the outstanding principal (or comparable amount in the case of a lease that constitutes a security interest) owed to the holder immediately preceding the acquisition of full title (or possession in the case of property subject to a lease financing transaction) pursuant to foreclosure and its equivalents, plus any unpaid interest, rent or penalties (whether arising before or after foreclosure and its equivalents), plus all reasonable and necessary costs, fees, or other charges incurred by the holder incident to work out, foreclosure and its equivalents, retention, maintaining the business activities of the enterprise, preserving, protecting and preparing the vessel or facility prior to sale, re-lease of property held pursuant to a lease financing transaction (whether by a new lease financing transaction or substitution of the lessee) or other

disposition, plus response costs incurred under section 107(d)(1) of CERCLA or at the direction of an on-scene coordinator; less any amounts received by the holder in connection with any partial disposition of the property, net revenues received as a result of maintaining the business activities of the enterprise, and any amounts paid by the borrower subsequent to the acquisition of full title (or possession in the case of a lease financing transaction) pursuant to foreclosure and its equivalents. In the case of a holder maintaining indicia of ownership primarily to protect a junior security interest, fair consideration is the value of all outstanding higher priority security interests plus the value of the security interest held by the junior holder, each calculated as set forth in the preceding sentence.

(B) "Outbids, rejects, or fails to act upon an offer" of fair consideration means that the holder outbids, rejects or fails to act upon within 90 days of receipt of a written, bona fide, firm offer of fair consideration for the property received at any time after six months following foreclosure and its equivalents. A "written, bona fide, firm offer" means a legally enforceable, commercially reasonable, cash offer solely for the foreclosed vessel or facility, including all material terms of the transaction, from a ready, willing, and able purchaser who demonstrates to the holder's satisfaction the ability to perform. For purposes of this provision, the six-month period begins to run from the time that the holder acquires marketable title, provided that the holder, after the expiration of any redemption or other waiting period provided by law, was acting diligently to acquire marketable title. If the holder fails to act diligently to acquire marketable title, the six-month period begins to run on the date of foreclosure and its equivalents.

(3) Holder's Basis of CERCLA Liability Independent of Status as Owner or Operator:

(i) Provided that the holder did not participate in management prior to foreclosure and its equivalents and complies with the requirements of 40 C.F.R. 300.1100(d)(1)-(d)(2), during the period following foreclosure and its equivalents a holder in possession of a vessel or facility can incur liability under CERCLA in connection with its activities at such foreclosed vessel or facility only by arranging for disposal or treatment of a hazardous substance, as provided by CERCLA section 107(a)(3), or by accepting for transportation and disposing of hazardous substances at a facility selected by the holder, as provided by CERCLA section 107(a)(4).

(ii) Following foreclosure and its equivalents, a foreclosing holder that directs or undertakes activities under CERCLA section 107(d)(1) or at the direction of an on-scene coordinator at the foreclosed vessel or facility does not incur liability for such activities.

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Notices

ENVIRONMENTAL PROTECTION AGENCY (EPA)

[FRL-5341-3]

CERCLA Enforcement Against Lenders and Government Entities That Acquire Property Involuntarily

60 FR 63517

DATE: Monday, December 11, 1995

ACTION: Announcement and publication of policy.

SUMMARY: This policy memorandum sets forth the Environmental Protection Agency ("EPA") and the Department of Justice's ("DOJ") policy regarding the government's enforcement of the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") against lenders and against government entities that acquire property involuntarily. As an enforcement policy, EPA and DOJ intend to apply as guidance the provisions of the "Lender Liability Rule" promulgated in 1992, thereby endorsing the interpretations and rationales announced in the Rule. See "Final Rule on Lender Liability Under CERCLA," *57 Fed. Reg. 18344 (April 29, 1992)*. This rule was vacated by the Circuit Court of Appeals for the District of Columbia in 1994.

The purpose of the memorandum is to provide guidance within EPA and DOJ on the exercise of enforcement discretion in determining whether particular lenders and government entities that acquire property involuntarily may be subject to CERCLA enforcement actions. The memorandum advises EPA and DOJ personnel to consult both the regulatory text of the Rule and the accompanying preamble language in exercising their enforcement discretion under CERCLA as to lenders and government entities that acquire property involuntarily.

FOR FURTHER INFORMATION CONTACT: Laura Bulatao, Office of Site Remediation Enforcement, 401 M St. SW. (Mail Code 2273A), Washington, DC 20460 (202-564-6028), or the RCRA/Superfund Hotline at 800-424-9346 (in the Washington, DC area at 703-412-9810).

Dated: November 30, 1995.

Jerry Clifford,

Director, Office of Site Remediation Enforcement, U.S. Environmental Protection Agency.

Memorandum

Subject: Policy on CERCLA Enforcement Against Lenders and Government Entities That Acquire Property Involuntarily

From: Steven A. Herman, Assistant Administrator, Office of Enforcement and Compliance Assurance, United States Environmental Protection Agency

Lois J. Schiffer, Assistant Attorney General, Environment and Natural Resources Division, United States Department of Justice

To: Regional Administrators, Regions I-X, EPA, Regional Counsel, Regions I-X, EPA, Waste Management Division Directors, Region I-X, EPA, Chief, Environmental Enforcement Section, DOJ, Assistant Section Chiefs, Environmental Enforcement Section, DOJ

This memorandum sets forth the Environmental Protection Agency's ("EPA") and the Department of Justice's ("DOJ") policy regarding the government's enforcement of the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") against lenders and against government entities that acquire property involuntarily. As an enforcement policy, EPA and DOJ intend to apply as guidance the provisions of the "Lender Liability Rule" promulgated in 1992, thereby endorsing the interpretations and rationales announced in the Rule. See "Final Rule on Lender Liability Under CERCLA," *57 Fed. Reg. 18,344 (April 29, 1992)*.¹ (This rule has been vacated by a court, as described below in the "Background" section).

FOR FURTHER INFORMATION CONTACT: Laura Bulatao, Office of Site Remediation Enforcement (Mail Code

2273A), U.S. Environmental Protection Agency, 401 M Street, SW, Washington, DC 20460 (202-564-6028), or the RCRA/Superfund Hotline at 800-424-9346 (in the Washington, DC area at 703-412-9810).

I. Background

This policy guidance establishes EPA's and DOJ's position regarding possible enforcement actions against lenders and government entities who are associated with property that may be subject to a CERCLA response action. EPA and DOJ recognize CERCLA's unintended effects on lenders and government entities and the relative concern from these parties regarding the consequences of potential enforcement. In light of these concerns, lenders may refuse to lend money to an owner or developer of a contaminated or potentially contaminated property or they may hesitate in exercising their rights as secured parties if such loans are made. Additionally, government entities that involuntarily acquire property may be reluctant to perform certain actions related to contaminated or potentially contaminated property.

The language of section 101(20)(A) leaves lenders and other interested parties uncertain as to which types of actions--such as monitoring vessel or facility operations, requiring compliance with applicable laws, and refinancing or undertaking loan workouts--they may take to protect their security interests without risking EPA enforcement under CERCLA. Courts have not always agreed on when a lender's actions are "primarily to protect a security interest," and what degree of "participation in the management" of the property will forfeit the lender's eligibility for the exemption. This uncertainty was heightened by dicta in the *Fleet Factors* n2 opinion, where the circuit court suggested that a lender participating in the management of a vessel or facility "to a degree indicating a capacity to influence the corporation's treatment of hazardous waste" could be considered liable under CERCLA.n3

The lack of legislative history on and consistent court treatment of the CERCLA Section 101(20)(A) security interest exemption prompted EPA to address potential lender liability for cleanup costs at CERCLA sites in the Lender Liability Rule, which was promulgated in April 1992.

Regarding the exemption for government entities, neither the legislative history of CERCLA Sections 101(20)(D) and 101(35)(A) nor the caselaw provide sufficient explanation of when a property acquisition or transfer is considered involuntary. Thus, in the Rule, EPA also clarified the language of these sections, describing when a government entity was exempted from CERCLA enforcement as an owner or operator or was protected from third party actions.

However, in *Kelley v. EPA*,n4 the Circuit Court of Appeals for the District of Columbia vacated the Rule on the ground that EPA lacked authority to issue the Rule as a binding regulation. Nevertheless, the *Kelley* decision did not preclude EPA and DOJ from following the provisions of the Rule as enforcement policy, and the agencies have generally done so.

II. Policy Statement

This memorandum reaffirms EPA's and DOJ's intentions to follow the provisions of the Lender Liability Rule as enforcement policy. EPA and DOJ endorse the interpretations and rationales announced in the Rule and its preamble. The purpose of this memorandum is to provide guidance within EPA and DOJ on the exercise of enforcement discretion in determining whether particular lenders and government entities that acquire property involuntarily may be subject to CERCLA enforcement actions. In making such determinations, EPA and DOJ personnel should consult both the regulatory text of the Rule and the accompanying preamble language in exercising their enforcement discretion under CERCLA as to lenders and government entities that acquire property involuntarily.n5

After the promulgation of the Lender Liability Rule, but prior to its invalidation, several district and circuit courts adhered to the terms of the Rule or interpreted the statute in a manner consistent with the Rule.n6 Moreover, notwithstanding the Rule's invalidation in *Kelley*, since that decision several courts have also interpreted the statute in a way that is consistent with the Rule.n7 EPA and DOJ believe that this caselaw is further evidence of the reasonableness

of the agencies' interpretation of the statute, as embodied formerly in the Rule and now in this policy statement.

III. Use of This Policy

The policies and procedures established in this document and any internal procedures adopted for its implementation are intended solely as guidance for employees of EPA and DOJ. They do not constitute rulemaking and may not be relied on to create a right or benefit, substantive or procedural, enforceable at law, or in equity, by any person. EPA and DOJ reserve the right to act at variance with this guidance or its internal implementing procedures.

[FR Doc. 95-29842 Filed 12-8-95; 8:45 am]

FOOTNOTES:

(n1)Footnote 1. This guidance does not address lender liability under any statutory or regulatory authority, rule, regulation, policy, or guidance, other than CERCLA. Specifically, this guidance does not cover lender liability determinations as they relate to the Resource Conservation and Recovery Act ("RCRA") and RCRA's Underground Storage Tank program.

(n2)Footnote 2. *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1557 (11th Cir. 1990) , cert. denied, 498 U.S. 1046, 111 S. Ct. 752, 112 L. Ed. 2d 772 (1991) .

(n3)Footnote 3. *Fleet*, 901 F.2d at 1557 .

(n4)Footnote 4. 15 F.3d 1100, 304 U.S. App. D.C. 369 (D.C. Cir. 1994) , reh'g denied, 25 F.3d 1088, 306 U.S. App. D.C. 382 (D.C. Cir. 1994) , cert. denied, *American Bankers Ass'n v. Kelley*, 513 U.S. 1110, 115 S. Ct. 900, 130 L. Ed. 2d 784 (1995) .

(n5)Footnote 5. See Fed. Reg. 18, 344 (April 29, 1992) (text and preamble).

(n6)Footnote 6. See *Northeast Doran, Inc. v. Key Bank of Maine*, 15 F.3d 1 (1st Cir. 1994) ; *United States v. McLamb*, 5 F.3d 69 (4th Cir. 1993) ; *Waterville Indus., Inc. v. Finance Auth. of Maine*, 984 F. 2d 549 (1st Cir. 1993) ; *United States v. Fleet Factors*, 901 F.2d 1550 (11th Cir. 1990) , on remand, 821 F. Supp. 707, (S.D. Ga. 1993) ; *Kelley v. Tiscornia*, 810 F. Supp. 901 (W.D. Mich. 1993) ; *Grantors to Silresim Site Trust v. State St. Bank & Trust Co.*, 23 ELR 20428 (D. Mass. Nov. 24, 1992) .

(n7)Footnote 7. See *Z & Z Leasing, Inc. v. Graying Reel, Inc.*, 873 F. Supp. 51 (E.D. Mich. 1995) ; *Kemp Indus., Inc. v. Safety Light Corp.*, 857 F. Supp. 373 (D.N.J. 1994) .

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.



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Collier Real Estate Transactions and the Bankruptcy Code

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CHAPTER 6 Environmental Issues in Bankruptcy *

1-6 Collier Real Estate Trans & Bankruptcy Code P 6.52

P 6.52 Statutes--CERCLA Lender Liability Amendments

42 U.S.C. § 9601(20)(D)-(G)

**Added as part of the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996
Pub. L. No. 104-208 (September 30, 1996)**

(20) (D) The term "owner or operator" does not include a unit of State or local government which acquired ownership or control involuntarily through bankruptcy, tax delinquency, abandonment, or other circumstances in which the government involuntarily acquires title by virtue of its function as sovereign. The exclusion provided under this paragraph shall not apply to any State or local government which has caused or contributed to the release or threatened release of a hazardous substance from the facility, and such a State or local government shall be subject to the provisions of this Act in the same manner and to the same extent, both procedurally and substantively, as any nongovernmental entity, including liability under section 107 [42 U.S.C.S. § 9607].

(E) Exclusion of lenders not participants in management.

(i) *Indicia of ownership to protect security.* The term "owner or operator" does not include a person that is a lender that, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect the security interest of the person in the vessel or facility.

(ii) *Foreclosure.* The term "owner or operator" does not include a person that is a lender that did not participate in management of a vessel or facility prior to foreclosure, notwithstanding that the person--

(I) forecloses on the vessel or facility; and

(II) after foreclosure, sells, re-leases (in the case of a lease finance transaction), or liquidates the vessel or facility, maintains business activities, winds up operations, undertakes a response action under section 107(d)(1) [42 U.S.C.S. § 9607(d)(1)] or under the direction of an on-scene coordinator appointed under the National Contingency Plan, with respect to the vessel or facility, or takes any other measure to preserve, protect, or prepare the vessel or facility prior to sale or disposition,

if the person seeks to sell, re-lease (in the case of a lease finance transaction), or otherwise divest the

person of the vessel or facility at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements.

(F) *Participation in management.* For purposes of subparagraph (E)--

(i) the term "participate in management"--

(I) means actually participating in the management or operational affairs of a vessel or facility; and

(II) does not include merely having the capacity to influence, or the unexercised right to control, vessel or facility operations;

(ii) a person that is a lender and that holds indicia of ownership primarily to protect a security interest in a vessel or facility shall be considered to participate in management only if, while the borrower is still in possession of the vessel or facility encumbered by the security interest, the person--

(I) exercises decisionmaking control over the environmental compliance related to the vessel or facility, such that the person has undertaken responsibility for the hazardous substance handling or disposal practices related to the vessel or facility; or

(II) exercises control at a level comparable to that of a manager of the vessel or facility, such that the person has assumed or manifested responsibility--

(aa) for the overall management of the vessel or facility encompassing day-to-day decisionmaking with respect to environmental compliance; or

(bb) over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the vessel or facility other than the function of environmental compliance;

(iii) the term "participate in management" does not include performing an act or failing to act prior to the time at which a security interest is created in a vessel or facility; and

(iv) the term "participate in management" does not include--

(I) holding a security interest or abandoning or releasing a security interest;

(II) including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty, or other term or condition that relates to environmental compliance;

(III) monitoring or enforcing the terms and conditions of the extension of credit or security interest;

(IV) monitoring or undertaking 1 or more inspections of the vessel or facility;

(V) requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the vessel or facility prior to, during, or on the expiration of the term of the extension of credit;

(VI) providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or diminution in the value of the vessel or facility;

(VII) restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or security interest, exercising forbearance;

(VII) exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of credit or security agreement; or

(IX) conducting a response action under section 107(d) [42 U.S.C.S. § 9607(d)] or under the direction of an on-scene coordinator appointed under the National Contingency Plan,

if the actions do not rise to the level of participating in management (within the meaning of clauses (i) and (ii)).

(G) *Other terms.* As used in this Act:

(i) *Extension of credit.* The term "extension of credit" includes a lease finance transaction--

(I) in which the lessor does not initially select the leased vessel or facility and does not during the lease term control the daily operations or maintenance of the vessel or facility; or

(II) that conforms with regulations issued by the appropriate Federal banking agency or the appropriate State bank supervisor (as those terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813) or with regulations issued by the National Credit Union Administration Board, as appropriate.

(ii) *Financial or administrative function.* The term "financial or administrative function" includes a function such as that of a credit manager, accounts payable officer, accounts receivable officer, personnel manager, comptroller, or chief financial officer, or a similar function.

(iii) *Foreclosure; foreclose.* The terms "foreclosure" and "foreclose" mean, respectively, acquiring, and to acquire, a vessel or facility through--

(I) (aa) purchase at sale under a judgment or decree, power of sale, or nonjudicial foreclosure sale;

(bb) a deed in lieu of foreclosure, or similar conveyance from a trustee; or

(cc) repossession,

if the vessel or facility was security for an extension of credit previously contracted;

(II) conveyance pursuant to an extension of credit previously contracted, including the termination of a lease agreement; or

(III) any other formal or informal manner by which the person acquires, for subsequent disposition, title to or possession of a vessel or facility in order to protect the security interest of the person.

(iv) *Lender.* The term "lender" means--

(I) an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));

(II) an insured credit union (as defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752));

(III) a bank or association chartered under the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.);

(IV) a leasing or trust company that is an affiliate of an insured depository institution;

(V) any person (including a successor or assignee of any such person) that makes a bona fide extension of credit to or takes or acquires a security interest from a nonaffiliated person;

(VI) the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Agricultural Mortgage Corporation, or any other entity that in a bona fide manner buys or sells loans or interests in loans;

(VII) a person that insures or guarantees against a default in the repayment of an extension of credit, or acts as a surety with respect to an extension of credit, to a nonaffiliated person; and

(VIII) a person that provides title insurance and that acquires a vessel or facility as a result of assignment or conveyance in the course of underwriting claims and claims settlement.

(v) *Operational function.* The term "operational function" includes a function such as that of a facility or plant manager, operations manager, chief operating officer, or chief executive officer.

(vi) *Security interest.* The term "security interest" includes a right under a mortgage, deed of trust, assignment, judgment lien, pledge, security agreement, factoring agreement, or lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation by a nonaffiliated person.

* This chapter was originally prepared by Stephen G. Gellman, Esq. of Wachtell, Lipton, Rosen & Katz. Recent revisions are the work of Steven M. Abramowitz, Esq. of Vinson & Elkins llp.