Recent Developments in Executory Contracts

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The past year saw significant developments in the field of executory contracts under the Bankruptcy Code. The developments underscore the complexity of the subject and the difficulty that courts continue to experience in interpreting what has become the longest and most unwieldy provision of the Bankruptcy Code.

This article reviews the significant recent developments in the law relating to executory contracts under § 365 of the Bankruptcy Code. In summary, the following recent developments have occurred:

- The Ninth Circuit wrestled with the question of whether § 365(c)(1) prevents a debtor from assuming a patent license over the objection of the licensor.
- The Fourth Circuit considered whether to grant administrative priority to a claim for future rent on an abandoned post-petition lease.
- Courts continued to disagree over the proper interpretation of § 365(d)(3), including the questions of how to allocate certain post-petition, pre-rejection obligations of the debtor-in-possession, and whether to grant ''super-priority'' to § 365(d)(3) claims.
- The Ninth Circuit Bankruptcy Appellate Panel considered whether a debtor could exercise a lease's renewal option during the post-petition period in the face of post-petition defaults and a lease term prohibiting renewal in the event of default.
- California and New York bankruptcy courts considered whether a debtor could separately reject a lease that was part of a larger overall transaction.
- A Kentucky bankruptcy court considered a debtor's request to modify a radius restriction clause in a shopping center lease in the context of its assumption and assignment.

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I. EXECUTORY CONTRACTS THAT CANNOT BE ASSUMED

The most talked about case was *In re Catapult Entertainment, Inc.*[1] In *Catapult*, the Ninth Circuit was the latest U.S. Court of Appeals to tackle the question of whether a debtor-in-possession is precluded from assuming certain contracts even if the debtor does not intend to assign the contract. The Ninth Circuit held that § 365(c)(1) of the Bankruptcy Code barred assumption of a nonexclusive patent license over the objection of the licensor. In reaching its decision, the Court recognized a split in the circuits as to the appropriate interpretation of § 365(c)(1), and sided with the courts following the plain language or ''hypothetical test'' approach.

A. Facts of *Catapult*

In 1994, Catapult Entertainment, Inc. entered into two license agreements whereby the licensor granted Catapult the right to exploit certain patented technologies. In 1996, Catapult filed a Chapter 11 petition. Catapult's reorganization plan called for a corporate reorganization in which it would become a wholly owned subsidiary of Mpath Interactive, Inc. As part of its reorganization plan, Catapult filed a motion to assume 140 executory contracts and leases, including the patent licenses. The Bankruptcy Court granted Catapult's motion over the licensor's objection. The District Court affirmed. The Ninth Circuit reversed.

B. Analysis

As a general rule, § 365(a) allows a trustee to assume or reject any executory contract or unexpired lease of the debtor regardless of any contrary contractual provisions. Section 365(c)(1), however, provides an exception to this rule. It states that the trustee may not ''assume or assign'' any executory contract or unexpired lease without the consent of the non-debtor party if applicable law excuses such party from ''accepting performance from or rendering performance to an entity other than the debtor or debtor in possession.'' In other words, the statute by its terms bars a debtor-in-possession from assuming an executory contract without the non-debtor's consent when applicable law precludes assignment of the contract to a third party. The apparent purpose of this provision is to protect the non-debtor party when the contract is premised on expected performance by a specific individual or entity.[2]

The Ninth Circuit found that federal patent law provided the ''applicable law'' for purposes of § 365(c) and that this law precluded the assignment of

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[1] In re Catapult Entertainment, Inc., 165 F.3d 747, 33 Bankr. Ct. Dec. (CRR) 1058, 41 Collier Bankr. Cas. 2d (MB) 858, Bankr. L. Rep. (CCH) ¶ 77886 (9th Cir. 1999), cert. denied, 120 S. Ct. 369, 145 L. Ed. 2d 248 (U.S. 1999).

[2] *2* NORTON BANKRUPTCY LAW AND PRACTICE 2D § 39:20, at 39-69 (1998).

the patent license in question absent the consent of the licensor.[3] Since the licensor did not consent, the Court held that § 365(c)(1) prevented Catapult from assuming the patent license.

1. The Circuit Split: ''Hypothetical Test'' vs. ''Actual Test''

In reaching its decision, the Ninth Circuit recognized the circuit split over the proper interpretation of § 365(c)(1). Specifically, the Eleventh, Third, and, after *Catapult*, Ninth Circuits, and a minority of lower courts, adhere to the plain language of the statute, following the so-called ''hypothetical test.'' Under this approach, a debtor-in-possession may not assume an executory contract over the non-debtor's objection if applicable law excuses the non-debtor from accepting performance from a hypothetical third party, even if the debtor-in-possession has no intention of assigning the contract to a third party.[4]

The First Circuit and a majority of lower courts and commentators, however, follow the ''actual test.'' Under this approach, § 365(c)(1) bars assumption by the debtor-in-possession only when the non-debtor actually would be forced to accept performance from a third party—for example, when the debtor intends to assign the contract.[5]

Courts following the ''actual test'' generally provide three reasons for their interpretation. They contend that a strict literal reading of the statute: (1) creates inconsistencies within § 365; (2) represents unsound bankruptcy policy; and (3) conflicts with Congressional intent. In *Catapult*, the debtor made each of these arguments.

First, Catapult argued that the literal ''hypothetical test'' would create internal inconsistencies within § 365. For example, a literal reading of § 365(c)(1) precludes assumption or assignment when applicable law bars assignment. On the other hand, § 365(f)(1) allows assignment notwithstand-

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[3] *Catapult*, 165 F.3d at 750.

[4] *See*, *e.g.*, In re James Cable Partners, L.P., 27 F.3d 534, 537, 25 Bankr. Ct. Dec. (CRR) 1499, 31 Collier Bankr. Cas. 2d (MB) 1104 (11th Cir. 1994); Matter of West Electronics Inc., 852 F.2d 79, 83, 18 Bankr. Ct. Dec. (CRR) 287, Bankr. L. Rep. (CCH) ¶ 72351, 34 Cont. Cas. Fed. (CCH) ¶ 75526 (3d Cir. 1988); *Catapult*, 165 F.3d at 750.

[5] *See*, *e.g.*, Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493, 30 Bankr. Ct. Dec. (CRR) 221, 37 Collier Bankr. Cas. 2d (MB) 588, 41 U.S.P.Q.2d (BNA) 1503, Bankr. L. Rep. (CCH) ¶ 77242 (1st Cir. 1997), *citing* Summit Inv. and Development Corp. v. Leroux, 69 F.3d 608, 28 Bankr. Ct. Dec. (CRR) 200, 34 Collier Bankr. Cas. 2d (MB) 1351, Bankr. L. Rep. (CCH) ¶ 76695 (1st Cir. 1995); In re Cardinal Industries, Inc., 116 B.R. 964, 976-82, 20 Bankr. Ct. Dec. (CRR) 1264, Bankr. L. Rep. (CCH) ¶ 73586 (Bankr. S.D. Ohio 1990); In re Hartec Enterprises, Inc., 117 B.R. 865, 871-73 (Bankr. W.D. Tex. 1990), judgment vacated pursuant to settlement, 130 B.R. 929 (W.D. Tex. 1991); In re Fastrax, Inc., 129 B.R. 274, 277, Bankr. L. Rep. (CCH) ¶ 74086 (Bankr. M.D. Fla. 1991).

ing a provision in applicable law that precludes assignment, except as provided in subsection (c). Since assumption is a prerequisite of assignment, a literal reading of the exception in § 365(c)(1) swallows the rule in § 365(f)(1), rendering the ''applicable law'' language in subsection (f)(1) superfluous. But the Ninth Circuit rejected this argument, finding that a literal reading of subsection (c)(1) does not ''inevitably set it at odds with subsection (f)(1).''[6] While the Ninth Circuit's ''hypothetical test'' is certainly a reasonable interpretation of the statute, the Court's denial of any internal inconsistencies appears to be somewhat disingenuous.[7]

Catapult also argued that a literal reading of § 365(c)(1) contravenes the bankruptcy goal of promoting successful reorganization by preventing the debtor-in-possession from using assets of the estate.[8] The purpose of § 365(c)(1) is to protect the non-debtor party when the contract is premised on expected performance by a specific individual or entity, such as personal service contracts. The ''actual test'' is consistent with this purpose, and it better promotes the bankruptcy policy favoring successful reorganizations. As a policy matter, both *Collier* and *Norton* favor the ''actual test.''[9] Unmoved by Catapult's policy argument, the Ninth Circuit held that policy arguments cannot displace the plain language of a statute.[10]

Finally, Catapult argued that the ''hypothetical test'' conflicts with Congress' intent in adopting the present version of § 365(c)(1).[11] Rejecting this argument, the Ninth Circuit held that the evidence of Congressional intent was not sufficient to justify circumventing the plain language of the statute.[12]

2. Implications of *Catapult*

Catapult reinforces the dominance of the ''hypothetical test'' among

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[6] *Catapult*, 165 F.3d at 752.

[7] *See*, *e.g.*, In re TechDyn Systems Corp., 235 B.R. 857, 863, 34 Bankr. Ct. Dec. (CRR) 825 (Bankr. E.D. Va. 1999) (recognizing conflict with §§ 365(b)(2) and (e)(1), but finding that the inconsistencies do not lead to absurd result).

[8] *See also TechDYN Systems Corp.*, 235 B.R. at 863.

[9] *2* NORTON BANKRUPTCY LAW AND PRACTICE 2D § 39:20, at 39-71 (1998) (arguing that sound bankruptcy policy supports the actual test); *3* COLLIER ON BANKRUPTCY § 365.06(l)(d), at 365-61 (Lawrence P. King, ed., 15th ed. rev. 1999) (same).

[10] *Catapult*, 165 F.3d at 754 (the plain language of § 365(c)(1) may be bad policy but it does not justify a judicial rewrite).

[11] *Id*. at 753-54. *See also* Summit Inv. and Development Corp. v. Leroux, 69 F.3d 608, 613, 28 Bankr. Ct. Dec. (CRR) 200, 34 Collier Bankr. Cas. 2d (MB) 1351, Bankr. L. Rep. (CCH) ¶ 76695 (1st Cir. 1995) (Congress intended to make clear that the prohibition against the trustee's power to assume an executory contract does not apply when the debtor is to perform the contract and the performance is to be the same as if no petition had been filed).

[12] *Catapult*, 165 F.3d at 753-54.

circuit courts. Preliminary indications suggest that *Catapult* is likely to be persuasive in jurisdictions that have not yet decided the issue. For example, a bankruptcy court in the Fourth Circuit recently adopted the ''hypothetical test'' following *Catapult*, despite expressing sympathy with arguments similar to those urged by the debtor in *Catapult*.[13] Indeed since *Catapult* was decided, no reported decision has followed the First Circuit's ''actual test.''

The practical impact of the ''hypothetical test'' is to give non-debtor parties to certain types of contracts overwhelming leverage in negotiating reorganization plans. Debtors whose primary assets consist of contracts that are not assignable under applicable law, such as certain government contracts or patent licenses, will not, as a practical matter, be able to avail themselves of the benefits of Chapter 11 because they will not be able to assume these contracts without the consent of the non-debtor parties.[14] The rule, in effect, gives the non-debtor party in such a situation a veto over any reorganization. The result may be that certain kinds of debtors may be simply incapable of reorganizing under the Bankruptcy Code.

II. CLAIMS FOR FUTURE RENT ON POST-PETITION LEASES

In *In re Merry-Go-Round Enterprises, Inc.*,[15] the Fourth Circuit became the first circuit court to decide what administrative priority, if any, to grant a claim for future rent on a post-petition lease that was breached after the case was converted to Chapter 7. In *Merry-Go-Round*, the Fourth Circuit, relying heavily on the Second Circuit's earlier decision *In re Klein Sleep Products, Inc.*,[16] awarded the landlord's claim Chapter 11 administrative priority. Understanding *Merry-Go-Round*, however, requires familiarity with the Second Circuit's decision in *Klein Sleep*.

In *Klein Sleep*, a Chapter 11 debtor-in-possession assumed a nonresidential real estate lease with court approval. After its reorganization efforts failed, a Chapter 11 trustee was appointed. The Chapter 11 trustee rejected the lease and surrendered the premises. The landlord filed an administrative claim for future rent under the rejected lease. The Bankruptcy Court disallowed the claim for administrative rent but allowed it as a general unsecured claim

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[13] *TechDYN Systems Corp.*, 235 B.R. at 864 (Bankr. E.D. Va. 1999) (concluding that ''bad policy does not justify a judicial rewrite of the Bankruptcy Code'').

[14] *See 3* COLLIER ON BANKRUPTCY § 365.06(l)(d) at 365-61 (15th ed. rev. 1999).

[15] In re Merry-Go-Round Enterprises, Inc., 180 F.3d 149, 34 Bankr. Ct. Dec. (CRR) 623, 42 Collier Bankr. Cas. 2d (MB) 218, Bankr. L. Rep. (CCH) ¶ 77938 (4th Cir. 1999).

[16] In re Klein Sleep Products, Inc., 78 F.3d 18, 28 Bankr. Ct. Dec. (CRR) 816, Bankr. L. Rep. (CCH) ¶ 76922 (2d Cir. 1996).

subject to the cap under § 502(b)(6).[17] The District Court affirmed.[18] The District Court reasoned that, since the leased premises were surrendered, there could be no benefit to the estate, and, accordingly, the claim could not be given administrative priority.[19] The Second Circuit reversed.[20] The Second Circuit agreed with the District Court that an administrative claim must result in a benefit to the estate but found that assumed leases do in fact benefit the estate.[21] The Second Circuit held that the assumption of the lease was a judicial finding of benefit to the estate since assumption requires a showing of benefit to the estate.[22] The Second Circuit reasoned that the fact that the lease was no longer of value to the estate does not mean that assumption did not benefit the estate. ''Acquisition of the lease rights constituted a benefit to the estate even if, later, the benefit turned to dust.''[23] Therefore, the Second Circuit held that the landlord's claim for future rent was an administrative claim. The Second Circuit also held that the landlord's administrative claim for future rent was not subject to the § 502(b)(6) cap because § 502(b)(6) does not apply to administrative claims.[24]

A. Facts of *Merry-Go-Round*

Merry-Go-Round addressed the situation of a post-petition lease that had lost its value to the subsequently appointed Chapter 7 trustee. Merry-Go-Round Enterprises, Inc., a retail clothing concern, filed a voluntary Chapter 11 petition. While under reorganization, Merry-Go-Round entered into a ten-year lease of nonresidental real estate with a landlord. The Bankruptcy Court approved the lease pursuant to § 363(c)(1). Merry-Go-Round was unable to reorganize. The case was converted to Chapter 7. Two months later, the Chapter 7 Trustee breached the lease and returned the premises to the landlord.

The landlord filed a Chapter 7 administrative claim for $1.3 million for future rent under the lease. The Trustee objected to treating this claim as a Chapter 7 administrative expense, arguing that the claim for future rent should be treated as a pre-petition general unsecured claim. The Bankruptcy

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[17] *Klein Sleep*, 78 F.3d at 20. Under § 502(b)(6) of the Bankruptcy Code, a landlord's claim for damages resulting from the termination of a lease of real property is basically capped at the greater of the rent for one year or 15% of the balance of the term of the lease not to exceed three years' rent.

[18] *Id*. at 22.

[19] *Id*.

[20] *Id*. at 30.

[21] *Id*. at 25.

[22] *Id*.

[23] *Id*. at 26.

[24] *Id*. at 30.

Court held that the landlord was entitled to a Chapter 11 administrative claim, rather than a Chapter 7 administrative claim.[25] Both sides appealed. The District Court affirmed. The Trustee appealed to the Fourth Circuit.

B. Analysis

The Trustee contended that the landlord's claim was not entitled to administrative priority because: (1) it was not an ''actual and necessary'' § 503(b) administrative expense; (2) it was rejected pursuant to § 365; (3) it should be treated as a pre-petition claim pursuant to §§ 348 and 365(g); and (4) it was subject to the § 502(b)(6) rent cap even if it were entitled to administrative priority. The Fourth Circuit rejected these arguments and awarded the landlord a Chapter 11 administrative claim, affirming the lower court's decision.

1. Future Rent is an Actual and Necessary Expense

Under § 503(b)(1)(A), ''the actual, necessary costs and expenses of preserving the estate'' constitute administrative expenses. For a claim to qualify as an administrative expense, it must therefore (1) arise from an actual post-petition transaction, and (2) benefit the debtor-in-possession.[26] In *Merry-Go-Round,* the parties did not dispute that the lease arose post-petition. The Trustee argued, however, that the lease was not beneficial to the Chapter 7 estate because Merry-Go-Round surrendered the premises post-conversion.

The Fourth Circuit first reviewed the relevant authority as to the status of future rent claims from post-petition leases. The Court noted that a lease entered post-petition is functionally analogous to a pre-petition lease that is assumed post-petition. The debtor-in-possession undergoes the same deliberative process when it enters into a new lease as when it decides whether to assume an old one, and either transaction requires the approval of the bankruptcy court.[27] Accordingly, the Fourth Circuit gave equal weight to cases involving post-petition leases as to cases involving pre-petition leases that were assumed post-petition, including the Second Circuit's decision in *Klein Sleep*.

The Fourth Circuit noted that a majority of courts to consider the issue have granted administrative priority status to claims for future rent from

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[25] In re Merry-Go-Round Enterprises, Inc., 208 B.R. 637, 30 Bankr. Ct. Dec. (CRR) 1094, 37 Collier Bankr. Cas. 2d (MB) 1791 (Bankr. D. Md. 1997), subsequently aff'd, 180 F.3d 149, 34 Bankr. Ct. Dec. (CRR) 623, 42 Collier Bankr. Cas. 2d (MB) 218, Bankr. L. Rep. (CCH) ¶ 77938 (4th Cir. 1999).

[26] *Merry-Go-Round*, 180 F.3d at 157.

[27] *Merry-Go-Round*, 180 F.3d at 155-56. *See also* In re Lamparter Organization, Inc., 207 B.R. 48, 51-53 (E.D.N.Y. 1997).

post-petition or assumed leases. The issue causes two competing bankruptcy policies—promoting parity among creditors and granting priority to the claims of creditors who continue to do business with an insolvent debtor—to collide.[28]

The Fourth Circuit followed the reasoning of *Klein Sleep*, finding that the lease represented an actual and necessary expense of the estate.[29] Unlike the *Klein Sleep* court, the Fourth Circuit held that whether future rent under a particular lease is entitled to administrative priority is to be determined on a case-by-case basis just like any other administrative claim.[30] The landlord has the burden of proving that its claim for future rent is an actual and necessary expense of preserving the estate.[31] According to the Fourth Circuit, there are two tests to determine if the claim for future rent satisfies the ''actual and necessary'' standard. First, was the lease an actual cost of preserving the estate? Second, was the lease a necessary cost of preserving the estate?

The answer to the first question is ''yes'' if the lease arose from a post-petition transaction. In other words, it is an actual cost of preserving the estate if the lease is a post-petition lease.[32] The answer to the second question is ''yes'' if the lease was supplied to and benefited the debtor. In other words, it is a necessary cost of preserving the estate if the lease was supplied to and benefited the debtor.

There was no question that the Merry-Go-Round lease arose from a post-petition transaction. There also was no dispute that the lease was beneficial before conversion. The dispute centered on whether the lease was beneficial to the debtor after conversion of the case to Chapter 7. The Trustee argued there was no benefit after conversion since she surrendered the premises. The Fourth Circuit found this argument flawed because it focuses solely on the tenant. According to the Fourth Circuit, one must examine both the landlord's and the tenant's sides of the transaction to determine whether the lease was a ''necessary expense'' of the estate.[33] The Court found that the future rent was a ''necessary expense'' to preserve the estate because, by treating future rent as an administrative claim, it provides an incentive to landlords to deal with debtors in bankruptcy.[34] In addition, the Court found that such treatment would benefit debtors enabling debtors to get leases from

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[28] *Klein Sleep,* 78 F.3d at 20; *Lamparter,* 207 B.R. at 51.

[29] *Merry-Go-Round*, 180 F.3d at 156-58.

[30] *Id*. at 156.

[31] *Id*. at 157.

[32] *Id*.

[33] *Id*.

[34] *Id*. at 158.

landlords motivated to deal with debtors-in-possession.[35] Accordingly, it granted administrative priority to the landlord's claim for future rent.

What's wrong with the Fourth Circuit's case-by-case approach to determining whether future rent is entitled to administrative expense status? The problem is that the case-by-case approach is illusory. After applying its case-by-case approach to the Merry-Go-Round lease, the Fourth Circuit concluded that the future rent was entitled to administrative expense status because it provided an incentive to landlords to deal with debtors in bankruptcy and enabled debtors to get leases that landlords otherwise may be unwilling to provide. But these are not features unique to the Merry-Go-Round lease. These features can be found in every post-petition lease. Why not simply state the rule, as the Second Circuit did in *Klein Sleep,* that the future rent under either post-petition leases or assumed leases will be an administrative claim? The application of the Fourth Circuit's case-by-case approach is an unnecessary step, which, by definition, must arrive at the same conclusion as the *Klein Sleep* rule.

2. Trustee Cannot Reject a Post-Petition Lease

Even if the lease otherwise would constitute an administrative expense, the Trustee argued that the lease was not valid because she rejected it. Specifically, the Trustee asserted that she rejected the lease pursuant to § 365(d)(4) by not assuming or rejecting it within 60 days of conversion. The Fourth Circuit disagreed, finding that § 365 does not give a trustee authority to reject a post-petition lease.[36] The landlord therefore had an administrative claim for the post-petition breach of a post-petition lease.

In finding that a trustee lacks the ability to reject a post-petition lease pursuant to § 365, the Fourth Circuit relied on cases holding that § 365 does not permit a trustee to reject a post-petition contract before the case converted to Chapter 7. In *Merry-Go-Round,* however, the Trustee was attempting to reject a post-petition lease in the post-conversion period. Indeed, the one case that addressed the issue in this context held that § 365(d)(4) did in fact apply.[37]

Nonetheless, the Fourth Circuit's holding that the Trustee could not reject a post-petition lease after conversion of the case may not even have been

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[35] *Id*.

[36] *Merry-Go-Round*, 180 F.3d at 159-61, *citing* In re Cannonsburg Environmental Associates, Ltd., 72 F.3d 1260, 28 Bankr. Ct. Dec. (CRR) 465, Bankr. L. Rep. (CCH) ¶ 76754, 1996 FED App. 9P (6th Cir. 1996) (refusing to apply § 365 to post-petition contracts) and In re Dant & Russell, Inc., 853 F.2d 700, 706, 18 Bankr. Ct. Dec. (CRR) 301, 20 Collier Bankr. Cas. 2d (MB) 369, 28 Env't. Rep. Cas. (BNA) 1049, Bankr. L. Rep. (CCH) ¶ 72406, 18 Envtl. L. Rep. 21312 (9th Cir. 1988) (same).

[37] *See* Matter of Salzer, 52 F.3d 708, 713, 33 Collier Bankr. Cas. 2d (MB) 581, Bankr. L. Rep. (CCH) ¶ 76460 (7th Cir. 1995) (finding that post-petition lease was rejected because, af-

necessary to the Court's ultimate conclusion that the future rent claim was entitled to Chapter 11 priority. Even if the lease was deemed rejected post-conversion by the Chapter 7 trustee, the claim for future rent would not necessarily become a pre-petition claim. Arguably, the future rent claim would still be entitled to a Chapter 11 administrative priority.[38]

Section 365(g)(2) indicates that the post-conversion rejection of an assumed lease is considered a post-petition breach. It follows that the post-conversion rejection of a post-petition lease also should be considered a post-petition breach, given the Fourth Circuit's analogous treatment of assumed leases and post-petition leases. In other words, when a Chapter 11 trustee rejects a pre-petition lease, it becomes a pre-petition unsecured claim. However, if a Chapter 7 trustee rejects a post-petition lease after conversion, any claim for breach arguably would be entitled to Chapter 11 administrative priority. If so, then the Fourth Circuit's holding that the Chapter 7 Trustee could not reject the lease is superfluous to the ultimate outcome of the case.

3. Pre-Petition Claim Under § 365(g) and § 348(d)

The Trustee next argued that, based on § 365(g) and § 348(d), the landlord's claim should be treated as a pre-petition claim because it was filed before conversion. The Court rejected this contention, holding that neither section applies to administrative expenses. Specifically, the Court found that § 503(b) administrative expenses are exempt from § 365(g)(l)-(2) and that § 348(d) expressly excludes administrative claims.[39]

4. Rent Cap

Finally, the Trustee argued that, if the future rent is given administrative priority, it should be subject to the rent cap of § 502(b)(6). Section 502(b)(6) caps a landlord's claim for damages from the termination of a lease to the greater of one year's rent or 15 percent of the balance of the term of the lease not to exceed three years' rent. This cap is designed to prevent a landlord's single unsecured claim from a long-term lease from overwhelming the other unsecured creditors.[40] The Fourth Circuit noted that courts disagree as to whether the rent cap applies to a post-petition lease.[41] The Fourth Circuit agreed with *Klein Sleep*, finding that future rent administrative claims are

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ter bankruptcy court converted to Chapter 7, trustee took no action to accept or reject lease within 60 days).

[38] *Cf.* 11 U.S.C. § 365(g)(2)(B)(i).

[39] *Merry-Go-Round*, 180 F.3d at 161.

[40] *Klein Sleep*, 78 F.3d at 28.

[41] *Compare Klein Sleep*, 78 F.3d at 28-29 (rent cap does not apply to administrative expenses and therefore does not cap future rent under an assumed lease), with In re Highland Superstores, Inc., 154 F.3d 573, 33 Bankr. Ct. Dec. (CRR) 157, 40 Collier Bankr. Cas. 2d (MB)

not subject to the § 502(b)(6) cap. The Court stated that capping future rent would discourage landlords from leasing to debtors-in-possession. The Court further reasoned that landlords will not receive a windfall at the expense of other creditors because of their duty to mitigate by attempting to relet the premises.[42] This approach, the Court found, would strike the right balance between protecting the interests of landlords and preserving the discretion of Chapter 7 trustees.[43]

5. Chapter 7 or Chapter 11 Administrative Expense

Having decided that the landlord was entitled to an uncapped administrative claim, the Fourth Circuit then considered whether to characterize the claim as a Chapter 7 or Chapter 11 claim. A Chapter 7 administrative claim would have priority over the Chapter 11 administrative claimants, whereas a Chapter 11 claim would share pro rata with other Chapter 11 administrative claimants.[44] The Fourth Circuit held that granting a Chapter 11 administrative claim would correctly balance the priorities of preserving the Chapter 7 trustee's discretion with encouraging landlords to continue to lease to Chapter 11 tenants.[45]

C. Implications of *Merry-Go-Round*

At first glance, the Fourth Circuit's decision seems to unduly favor landlords. As explained in *Klein Sleep*, however, the holding may do no more than recognize the existence of a default rule for bankruptcy courts to consider when a lease is presented for the court's authorization.[46] Under this default rule, the court will consider the interests of the general creditors when deciding whether to approve a post-petition lease and will encourage negotiation of leases that do not make the debtor liable for long-term future rent.

In *Klein Sleep*, the Second Circuit predicted that bankruptcy courts will rarely find that assuming liability for 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. The Second Circuit believed that bankruptcy courts will refuse to approve such leases except in unusual

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1038, Bankr. L. Rep. (CCH) ¶ 77785, 1998 FED App. 265P (6th Cir. 1998) (Congress implicitly intended that all administrative claims must be capped to prevent lessors from receiving a windfall.).

[42] *Merry-Go-Round*, 180 F.3d at 161.

[43] *Id*. at 162.

[44] *Merry-Go-Round*, 208 B.R. at 643.

[45] *Merry-Go-Round*, 180 F.3d at 162.

[46] *Klein Sleep Products*, 78 F.3d at 21; *Lamparter*, 207 B.R. at 53-54.

cases.[47] As a result, the Second Circuit predicted that post-petition leases will limit the landlord's administrative claims for future rent.[48] However, if bankruptcy courts refuse to approve post-petition leases that require that the landlords will receive full payment for future rent, landlords may be discouraged from entering into such leases with debtors. Ironically, an unintended effect of *Merry-Go-Round* may be to discourage landlords from dealing with debtors-in-possession if they cannot be assured that the bankruptcy court will approve the full payment of future rent in long-term leases.

III. POST-PETITION, PRE-REJECTION OBLIGATIONS UNDER § 365(d)(3)

Section 365(d)(3) requires the trustee to timely perform all of the obligations of the debtor arising between the filing of a bankruptcy petition and the assumption or rejection of a lease of nonresidential real property.[49] One of the most litigated subjects in executory contracts during the past year was whether these obligations should be given § 365(d)(3) priority or whether they should be treated in part as pre-petition unsecured claims. Specifically, the issue is how to treat obligations that come due during the post-petition, pre-rejection period that can be allocated to other time periods. For example, leases of nonresidential real property frequently require the tenant to reimburse the landlord for real estate taxes incurred during the term of the lease. When the tax bill becomes due post-petition, the bill may represent taxes allocable to a period both before and after the filing of the bankruptcy petition. The question then becomes whether the tenant's debt to the landlord for the taxes is entirely a post-petition debt entitled to § 365(d)(3) priority or whether the debt must be prorated between the pre-petition and post-petition period of the tenant's occupancy. In addition to taxes, other obligations that frequently face this timing issue include rent and common area maintenance charges.

Courts have disagreed on how to treat these obligations. There are two basic judicial approaches: (1) the accrual or proration method, and (2) the billing date method. Under the accrual or proration method, § 365(d)(3) applies only to those obligations that accrue during the post-petition, pre-rejection period. The date on which the obligations become due is irrelevant. Under the billing date method, however, the debtor-in-possession must pay in full

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[47] *Klein Sleep*, 78 F.3d at 29; *Lamparter*, 207 B.R. at 54.

[48] *Klein Sleep*, 78 F.3d at 29; *Lamparter*, 207 B.R. at 53-54.

[49] Section 365(d)(3) provides in relevant part as follows:

> The trustee shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.

11 U.S.C. § 365(d)(3).

all amounts that come due during the post-petition, pre-rejection period regardless of whether some of those charges accrued pre-petition. Although the lower courts vary on how to treat these lease obligations, a majority of them follow the accrual or proration method.

A. *Handy Andy*

The Seventh Circuit is the only U.S. Court of Appeals to have considered the issue.[50] In *Handy Andy Home Improvement Centers Inc.*,[51] the lease in question required the tenant to pay all real estate taxes on the property. The lease also provided that, if the lease ended during rather than at the end of a tax period, the taxes would be prorated so that the tenant would be responsible only for those taxes that accrued before termination.[52] Under the terms of the lease, the landlord was to pay the taxes and bill the tenant for reimbursement. The lease called for the tenant to reimburse the landlord on the next rental due date.

In October 1995, Handy Andy was put into involuntary bankruptcy. An order for relief was issued on November 1, 1995. The following February, the landlord received the bill for the first installment of 1995 taxes, paid it, and billed Handy Andy. The landlord argued that the entire tax bill was required to be paid by the debtor pursuant to § 365(d)(3) because it became due after bankruptcy and before rejection. The Seventh Circuit held that the tax bill should be prorated for purposes of § 365(d)(3) priority between the pre-petition period and the post-petition period of the debtor's occupancy.

In reaching its conclusion, the Seventh Circuit considered whether Handy Andy's tax obligation ''arose'' before it was contractually obligated to reimburse the landlord. The Court found that the debtor's obligation ''could realistically be said to have arisen piecemeal every day'' during the lease.[53] The Court reasoned that, based on the terms of the lease requiring proration, had the lease been terminated for one reason or another on January 1, 1995, Handy Andy would have had a definite obligation to reimburse the landlord for the 1994 real estate taxes. Accordingly, the Court concluded that the obligation thus arose before the bankruptcy.

The Seventh Circuit conceded that the billing date approach is ''a possible reading of section 365(d)(3), but it is neither inevitable nor sensible.''[54] The

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[50] Matter of Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125, 32 Bankr. Ct. Dec. (CRR) 992, 40 Collier Bankr. Cas. 2d (MB) 295, Bankr. L. Rep. (CCH) ¶ 77722 (7th Cir. 1998).

[51] *Id*.

[52] *Id*. at 1126.

[53] *Id*. at 1127.

[54] *Id*.

Court found that the accrual method better tracked the purpose of granting priority to post-petition debt, namely, to enable the debtor to keep going for as long as its current revenues cover its current costs.[55] The Court believed that Congress did not intend to give landlords favored treatment for pre-petition debts.[56] The Court concluded that the billing date approach would make ''the rights of creditors turn on the happenstance of the dating of tax bills'' and would invite strategic behavior by landlords and tenants.[57]

B. The Judicial Landscape After *Handy Andy*

Lower court decisions since *Handy Andy* have been far from uniform. While some courts outside of the Seventh Circuit find *Handy Andy* persuasive others continue to follow the minority billing date approach. Still other courts distinguish *Handy Andy* based on the terms of the specific lease in question or on the nature of the obligation.[58]

1. Courts Following *Handy Andy* and the Accrual Method

In re Montgomery Ward Holding Corp.[59] presented a similar situation to *Handy Andy*. In *Montgomery Ward*, the lease in question required the tenant to reimburse the landlord for property taxes incurred during the term of the lease. The lease expressly provided that real estate taxes would be prorated between the landlord and the tenant for the first and last years of the lease. On July 7, 1997, the debtor filed for Chapter 11. Four days later, the landlord sent three invoices to the debtor. The first invoice was for the first installment of 1996 real estate taxes that were payable in 1997. The second invoice reflected the landlord's estimate for the second installment of 1996 taxes, and the third invoice related to a security deposit for 1996 and 1997 taxes contemplated by the lease. On August 12, 1998, the debtor paid the landlord a sum reflecting the prorated portion of the estimated 1997 real estate taxes attributable to the post-petition period. The landlord filed a motion to compel the debtor to pay the remainder of the 1996 and 1997 real estate taxes.

The Bankruptcy Court sided with the debtor, finding that the debtor was required to reimburse the landlord only for those taxes that accrued post-petition, regardless of the actual billing date. The District Court affirmed. The District Court found *Handy Andy* persuasive. The Court also cited Third Circuit precedent holding that a tax liability is generally incurred on the date

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[55] *Id*.

[56] *Id*. at 1128.

[57] *Id*.

[58] For example, when the obligation at issue is rent rather than taxes, a majority of courts refuse to prorate the debt.

[59] In re Montgomery Ward Holding Corp., 242 B.R. 142 (D. Del. 1999).

it accrues, not on the date of the assessment or the date on which it is payable.[60] In essence, the Court created a default rule, holding that it is ''reasonable to assume that the parties to a lease agree to the proration of real estate taxes, unless the lease contains a clear statement to the contrary.''[61] Given that the lease in question called for proration of real estate taxes for the first and last years of the lease, the Court concluded that the lease supported the proration approach. Accordingly, the Court held that the debtor satisfied its § 365(d)(3) obligation when it paid the prorated portion of the property taxes.

2. Courts Distinguishing *Handy Andy* Based on the Terms of the Lease

Both *Handy Andy* and *Montgomery Ward* relied in part on the specific terms of the lease in question in prorating the debtor's tax obligation. Other courts have followed the same approach but reached the opposite result based on the terms of the specific lease.

In *In re Consolidated Industries Corp.*,[62] the lease in question required the debtor to ''pay the real estate taxes due and payable during the term'' of the lease.[63] On May 28, 1998, the debtor filed for Chapter 11. The real estate tax bill became due on November 10, 1998, before the debtor decided whether to assume or reject the lease. The debtor refused to pay the taxes to the extent that they accrued pre-petition.

The Bankruptcy Court for the Northern District of Indiana, while recognizing that *Handy Andy* was controlling precedent, stated ''[t]hat does not mean, however, that the outcome in this case must be the same.''[64] According to the Court, the first step in determining whether a particular obligation arises ''from or after the order for relief''' under § 365(d)(3) is to consult the terms of the lease.

> A convenient way of conceptualizing the issue is to ask whether, as of the date of the petition, debtor's liability to pay a particular obligation had already attached so that, if the lease had ended on that date, the obligation in question would have been a claim against the debtor. If so, § 365(d)(3) does not require it to be performed. If, however, the obligation would not represent a claim had the lease terminated on the date of the petition, § 365(d)(3) requires performance until the lease is assumed or rejected.[65]

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[60] *Id*. at 146, *citing* In re Columbia Gas Transmission Corp., 37 F.3d 982, 984, Bankr. L. Rep. (CCH) ¶ 76318, 74 A.F.T.R.2d 94-6563 (3d Cir. 1994).

[61] *Id*.

[62] In re Consolidated Industries Corp., 234 B.R. 84, 34 Bankr. Ct. Dec. (CRR) 453 (Bankr. N.D. Ind. 1999).

[63] *Id*. at 85.

[64] *Id*. at 86.

[65] *Id*. at 87.

The Court concluded that, under the terms of the lease, the debtor's obligation to pay the taxes due on November 10, 1998, did not arise prior to that date. The Court observed that if the lease had terminated of its own accord on May 28, 1998, the debtor would not have been liable for any portion of those taxes and its landlord could not have asserted a claim for them. The Court interpreted the lease to mean that the tenant was liable to pay only those real estate taxes that actually became due and payable during the lease term regardless of the period to which such taxes related. Consequently, the Court held that the responsibility to pay the real estate taxes due on November 10, 1998, accrued post-petition and that § 365(d)(3) required the debtor to timely perform the entire obligation.

In ordering the debtor to pay the tax obligation, the *Consolidated Industries* court purported to follow *Handy Andy* and the proration approach, even though it refused to prorate the tax obligation.[66] The Court explained that it reached this result based on the terms of the lease.

The decision in *Consolidated Industries* appears to favor landlords by giving § 365(d)(3) priority to the entire tax obligation regardless of the period to which it is allocable. The Court's holding, however, invites just the type of strategic behavior that the Seventh Circuit warned against in *Handy Andy*. For example, under the *Consolidated Industries* rule, the tenant could have decided to reject the lease on November 9, 1998—the day before the tax bill became due—and avoided any post-petition liability for real estate taxes. Likewise, a landlord could time the filing of an involuntary petition against its tenant just before the tax bill became due in order to make the entire bill subject to § 365(d)(3). Thus, one should hesitate to negotiate lease terms that base the tenant's liability on the billing date because it may invite strategic behavior by the other side.

3. Courts Following Minority ''Billing Date'' Method

In re DeCicco of Montvale, Inc.[67] rejected the Seventh Circuit's approach in *Handy Andy*. In *DeCicco*, the debtor operated a supermarket. The lease required it to pay its share of the real estate taxes and common area maintenance charges (''CAM''). Under the terms of the lease, these obligations became due and payable within 30 days after the payment by the landlord.[68] On April 16, 1999, the landlord submitted a statement to DeCicco of various amounts due for taxes and CAM. On May 13, 1999, the debtor filed a Chapter 11 petition. On July 14, 1999, the landlord submitted another statement of additional amounts due.

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[66] *Id*. at 87 n.4.

[67] In re DeCicco of Montvale, Inc., 239 B.R. 475, 34 Bankr. Ct. Dec. (CRR) 1327, Bankr. L. Rep. (CCH) ¶ 78009 (Bankr. D.N.J. 1999).

[68] *Id*. at 477.

The debtor argued that the Bankruptcy Court should use the accrual method to determine its § 365(d)(3) obligations. The landlord urged the billing date approach. The Court adopted the billing date approach, requiring DeCicco to pay in full all obligations that came due during the post-petition, pre-rejection period regardless of whether some of those charges accrued pre-petition.

The Court disagreed with the majority approach articulated in *Handy Andy* that § 365(d)(3) is ambiguous. Rather, the Court found that the debtor did not become ''obligated'' to pay the taxes until the bill became due, regardless of when the charges accrued.[69]

Responding to the policy arguments raised by the Seventh Circuit in *Handy Andy,* the Court observed that § 365(d)(3) states that it applies ''notwithstanding section 503(b)(l).'' Accordingly, the Court ruled that the pre-rejection obligations should not be treated as administrative expenses whose purpose is to benefit the estate, but as obligations to be ''timely performed'' under the lease.[70] The Court found that § 503(b)(l)'s ''essential concepts'' of accrual and proration did not survive in § 365(d)(3).[71]

After adopting the billing date method, the *DeCicco* court examined the language of the lease to determine when the debtor's obligations arose. Based on the terms of the lease, the Court found that the charges submitted by the landlord on April 16, 1999 (which represented the lion's share of the debtor's obligation) ''arose'' before the bankruptcy petition was filed on May 13, 1999. The lease required DeCicco to pay the charges within 30 days of receiving the statement from the landlord but the Court found that the obligation ''arose'' on the first day of the 30-day period, not the last. Thus, the Court concluded that DeCicco's obligation to pay the amounts submitted on April 16, 1999, were pre-petition obligations, and the lesser amounts submitted on July 14, 1999, represented post-petition obligations.[72]

4. Reconciling *Montgomery Ward, Consolidated Industries, and DeCicco*

Montgomery Ward and *Consolidated Industries* followed the accrual

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[69] *Id*. at 479-81. *See also* In re R.H. Macy & Co., Inc., 152 B.R. 869, 873-84, 24 Bankr. Ct. Dec. (CRR) 262, 28 Collier Bankr. Cas. 2d (MB) 1271 (Bankr. S.D.N.Y. 1993), order aff'd, 1994 WL 482948 (S.D.N.Y. 1994) (distinguishing between the definition of an ''obligation'' and a ''claim,'' and noting that Congress chose to use the word ''obligation'').

[70] *DeCicco*, 239 B.R. at 481.

[71] *Id.* at 481. *See also* In re Krystal Co., 194 B.R. 161, 163, 28 Bankr. Ct. Dec. (CRR) 1071, 35 Collier Bankr. Cas. 2d (MB) 850 (Bankr. E.D. Tenn. 1996) (finding that Congress intended § 365(d)(3) to ''shift the burden of indecision to debtor,'' who must perform the lease obligations or decide to reject the lease before an obligation becomes due).

[72] *DeCicco*, 239 B.R. at 483.

method, and *DeCicco* adopted the billing date method. Yet, *Consolidated Industries* refused to prorate the debtor's obligation, and *DeCicco* found that most of the debtor's obligation arose pre-petition.

While each court went to great lengths to support its particular approach, the ultimate result appears to be based more on the language of the lease than on whether the court selected the accrual or billing date method. Thus, the particular approach articulated by the courts appears to serve more as a default rule that can be either supported or overridden by the particular terms of the lease. Accordingly, one should expect courts to closely examine the precise language of the lease regardless of whether the court adopts the majority accrual method or the minority billing date method.[73]

5. Treatment of Rent Obligations Under § 365(d)(3)

While a majority of courts use the accrual method to determine a debtor's real estate tax obligations, this is the minority approach when it comes to rent. When the post-petition obligation is rent, the majority of courts favor the billing date approach. For rent obligations, courts seem to prefer a literal interpretation of § 365(d)(3).

In *In re Koenig Sporting Goods, Inc.*,[74] the debtor operated sporting goods stores in leased spaces in shopping centers. The debtor filed for Chapter 11 in August of 1997. On December 2, 1997, it rejected a lease for a particular property and vacated the premises that day. The lease provided that monthly rent was payable in advance on the first day of each calendar month. The debtor argued, however, that it was in possession of the premises for only two days before it rejected the lease and that the post-petition, pre-rejection rent should be prorated accordingly.

After reviewing the relevant case law and reasoning behind the competing billing date and accrual methods, the Bankruptcy Appellate Panel for the

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[73] The factual context of the obligation also appears to play a role. For example, the 1997 case of In re McCrory Corp., 210 B.R. 934 (S.D.N.Y. 1997), involved a **prospective** tax obligation. Just a few days before the debtor-in-possession rejected the lease in early February 1996, real estate taxes for the entire calendar year became due. The court considered whether § 365(d)(3) obligated the debtor-in-possession to pay the entire bill or just the prorated amount to cover the first month of the year. The court followed the accrual approach, noting that it was particularly compelling based on the facts of the case. *Id*. at 940. Otherwise, the debtor would have been forced to pay taxes for an entire year in which it received only one month of benefit from the lease.

[74] In re Koenig Sporting Goods, Inc., 229 B.R. 388, 41 Collier Bankr. Cas. 2d (MB) 724, 1999 FED App. 4P (Bankr. 6th Cir. 1999), aff'd, 203 F.3d 986, 35 Bankr. Ct. Dec. (CRR) 187, 43 Collier Bankr. Cas. 2d (MB) 1229, Bankr. L. Rep. (CCH) ¶ 78114 (6th Cir. 2000).

Sixth Circuit adopted the billing date method.[75] The Sixth Circuit BAP held that the landlord was entitled to the payment of the full month's rent because that amount became due before Koenig rejected the lease.[76]

On appeal, the Sixth Circuit affirmed.[77] The Sixth Circuit noted that ''it is not really possible to reconcile section 365(d)(3) with according the Debtor the option not to pay its monthly rent when due, even though payment would impinge to some extent upon normal bankruptcy principles and priorities.''[78] Recognizing the split of authority within the district and bankruptcy courts on this subject,[79] the Sixth Circuit found § 365(d)(3) unambiguous as to the debtor's rent obligation and held that it requires payment of the full month's rent.[80] The Court found no inequity in requiring the debtor to pay an entire month's rent, despite having surrendered the premises on the second day of the month, observing that the debtor alone controlled the landlord's entitlement to rent.

> If the debtor had rejected the lease effective November 30, 1997, rather than December 2, it would not have been obligated to pay rent for December under 11 U.S.C. § 365(d)(3). Instead, an election was made to reject the lease effective December 2, one day after the debtor's monthly rent obligation would arise. In this case, involving a month-to-month, payment-in-advance lease, where the debtor had complete control over the obligation, we believe that equity as well as the statute favors full payment.[81]

The Sixth Circuit is the only U.S. Court of Appeals to address the application of § 365(d)(3) in the context of rent obligations.

Another recent case addressed the subject of percentage rent due under a lease, rejecting both the billing date and accrual methods in relation to a rent

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[75] The court found the billing date method to be consistent with the Sixth Circuit's decision in In re Vause, 886 F.2d 794, 19 Bankr. Ct. Dec. (CRR) 1400, 21 Collier Bankr. Cas. 2d (MB) 1346, Bankr. L. Rep. (CCH) ¶ 73074 (6th Cir. 1989).

[76] The Sixth Circuit BAP appeared to limit its decision to cases involving prospective rent payments, cautioning that ''this interpretation of § 365(d)(3) must be confined to these facts. Left for another day is the question whether ambiguities of interpretation arise under § 365(d)(3) when a nonresidential lease requires substantial payments in arrears or imposes obligations that are fundamentally inconsistent with other provisions of the Bankruptcy Code.'' *Id*. at 394. Thus, the Sixth Circuit BAP left open the question of tax obligations.

[77] 203 F.3d 986.

[78] *Id*. at 987.

[79] *See*, *e.g.*, In re McCrory Corp., 210 B.R. 934 (S.D.N.Y. 1997) (supporting proration approach); In re Krystal Co., 194 B.R. 161, 28 Bankr. Ct. Dec. (CRR) 1071, 35 Collier Bankr. Cas. 2d (MB) 850 (Bankr. E.D. Tenn. 1996) (supporting billing date approach).

[80] 203 F.3d at 989.

[81] *Id*.

obligation. In *In re Petrie Retail, Inc.*,[82] various leases entered into by the debtor required the debtor to pay a fixed annual rent in addition to a percentage of gross sales that exceeded a minimum threshold, designated as the sales ''breakpoint.'' The particular lease in question required the debtor to pay the landlord 12 percent of all gross sales made from the breakpoint date until the end of the first lease year on January 31, 1996. The debtor reached the breakpoint in December 1995, two months after the petition date.

The debtor argued that the ''percentage rent'' should be treated in part as a pre-petition claim, presumably because pre-petition sales contributed to reaching the breakpoint. On this basis, the debtor prorated the percentage rent over the entire year and paid the landlord only a fraction of the total percentage rent due.

The landlord filed a motion to compel the debtor to pay the unpaid balance of percentage rent. The landlord argued that the Court should use the billing date approach and focus on the date on which the percentage rent became due under the lease.[83] The lease stated that payment of percentage rent was not due until 45 days after the lease year. Since this occurred in the post-petition, pre-rejection period, the entire percentage rent would be a § 365(d)(3) payment under the billing date approach. The debtor argued that the Court should focus on the date when the debtor's sales exceeded the breakpoint, which occurred after the petition date. The parties called this approach the ''sales breakpoint'' method.

Rejecting the billing date approach, the Court found *Handy Andy* persuasive in this regard, holding that § 365(d)(3) does not compel the billing date approach and that this approach would work ''clear mischief'' to the Bankruptcy Code's purpose.[84]

The *Petrie* court also rejected the accrual method. In so doing, the Court distinguished *Handy Andy* by noting that a tenant's obligation under a lease to pay real property taxes is different from the obligation to pay percentage rent. The Court stated:

> Unlike percentage rent, the tenant's obligation to pay taxes ordinarily will not be contingent upon an uncertain future event, such as meeting a sales breakpoint. Rather, both the obligation to pay taxes and the amount of those taxes will usually be certain from the first day of the lease year, so that the tenant's obligation to pay these taxes can be said to have arisen incrementally over each

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[82] In re Petrie Retail, Inc., 233 B.R. 256 (S.D.N.Y. 1999).

[83] The billing date approach advocated by the landlord does not necessarily always serve the interests of landlords. If the debtor knew ahead of time that its obligation to pay percentage rent did not ''arise'' until the amount was due under the lease—in this case, 45 days after the end of the lease year—it could have rejected the lease 44 days after the end of the lease year and avoided paying any of its percentage rent obligations

[84] *Id*. at 260.

> day of the lease year. . . . There is, however, no such logical basis for proration of contingent obligations such as percentage rent, which can be said to arise only when the tenant exceeds the breakpoint and its obligation to pay percentage rent becomes certain.[85]

The Court concluded that the only construction of § 365(d)(3) consistent with the section's language and purpose is the ''sales breakpoint'' approach. This approach identifies the point at which the obligation to pay percentage rent arises. Once the sales breakpoint is reached, the Court reasoned that the tenant is obligated to pay percentage rent on all sales made in the remainder of the lease year. When the tenant reaches the sales breakpoint before the petition date, only the portion of percentage rent arising from post-petition sales is recoverable under § 365(d)(3). When the tenant reaches the breakpoint after the petition date, as was the case in *Petrie*, the entire percentage rent will be characterized as an obligation arising from the debtor's post-petition activities. Because Petrie reached the sales breakpoint after the petition date, the Court held that § 365(d)(3) required the payment of all percentage rent due.

6. Summary of § 365(d)(3) Cases After *Handy Andy*

After *Handy Andy*, the judicial landscape regarding § 365(d)(3) obligations can be summarized as follows: when the obligation in question is taxes, a majority of lower courts follow *Handy Andy's* accrual method, but a minority follow the billing date method. When the obligation is rent, most courts follow the billing date method. Regardless of the obligation, courts may adjust their particular approach depending on the facts and equities of the case.

Despite this apparent lack of uniformity, one rule seems to account for the outcome in all of the cases. In each case, the court ultimately focused on the particular language of the lease to determine the point at which the debtor's obligation ''arose.'' The method adopted by the court—the accrual, billing date, or sales breakpoint method—only served as a default rule. Accordingly, when confronted by these issues, parties should focus their arguments on the precise language of the lease and on when a particular obligation can be said to have arisen under the lease.

Given the courts' reliance on the contractual language, the parties may try to negotiate the terms of the lease in advance to reach the desired outcome in the event of bankruptcy. In bankruptcy, tenants appear to prefer the accrual method, and landlords appear to prefer the billing date method. But it should be recognized that once a method is negotiated, it may invite strategic bankruptcy behavior to avoid the consequences of the selection.

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[85] *Id*.

IV. PERFORMANCE PRIOR TO ASSUMPTION OR REJECTION

In re Pudgie's Development of NY, Inc.[86] raised another difficult § 365(d)(3) interpretation issue: Does § 365(d)(3) enable a landlord to recover post-petition, pre-rejection rent when the debtor is administratively insolvent?

Section 365(d)(3) of the Bankruptcy Code requires a debtor to pay rent due during the period between the filing of a bankruptcy petition and the assumption or rejection of a lease.[87] Courts disagree, however, as to whether § 365(d)(3) entitles a landlord to the payment of post-petition, pre-rejection rent when the estate is administratively insolvent. In *Pudgie's*, the Southern District of New York denied ''super-priority'' administrative status for such claims, joining the majority of courts that have considered the issue.

A. Facts of *Pudgie's*

After Pudgie's filed for Chapter 11, it failed to pay any post-petition rent. The Bankruptcy Court extended the period to assume or reject unexpired nonresidential leases through confirmation. More than 17 months after the petition date, the landlord filed a motion to compel Pudgie's to pay all post-petition rent due or to allow the landlord to commence eviction proceedings. In response, the Bankruptcy Court entered an order directing Pudgie's to pay two months' rent, failing which the lease would be deemed rejected. Pudgie's failed to pay the rent as ordered, and the lease was deemed rejected. By this time, Pudgie's owed almost $160,000 in post-petition rent.

After reorganization attempts failed, the Bankruptcy Court approved the sale of Pudgie's assets. Pudgie's administrative obligations greatly exceeded the sale proceeds, rendering the estate administratively insolvent. The landlord filed a claim for the unpaid post-petition, pre-rejection rent asserting § 365(d)(3) super-priority claim. The Bankruptcy Court held that, while the landlord is entitled to the timely payment of rent during the post-petition, pre-rejection period, it will not be granted super-priority status if the rent was not paid. The District Court affirmed.

B. Analysis

Section 365(d)(3) requires the timely performance of all obligations under unexpired nonresidential real property leases until such leases are assumed or rejected. Congress enacted this provision in 1984 to protect landlords in the post-petition, pre-rejection period because landlords are among the few

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[86] In re Pudgie's Development of NY, Inc., 239 B.R. 688, 42 Collier Bankr. Cas. 2d (MB) 2019 (S.D.N.Y. 1999).

[87] *Supra* note 49.

creditors forced to continue to do business with debtors after bankruptcy.[88] While § 365(d)(3) mandates ''timely performance,'' it does not specify a remedy in the event of default.

The *Pudgie's* court considered whether § 365(d)(3) entitled the landlord to a priority distribution from the sale of the debtor's assets. The Court adopted the widely held view that the § 503(b)(1) requirements do not apply to § 365(d)(3); that is, a landlord is entitled to post-petition, pre-rejection rent without having to show that either the amount is reasonable or benefits the estate.[89] The Court held that § 365(d)(3) entitles a landlord to timely payment of rent when the bankruptcy estate is solvent.[90] But what about when there is a risk of administrative insolvency? In such event, the *Pudgie's* court observed that the immediate payment of rent is tantamount to giving the landlord priority over other administrative claimants.[91]

1. Split of Authority

The *Pudgie's* court recognized the split of authority as to whether § 365(d)(3) grants a ''super-priority.'' A majority of courts reject super-priority status, finding that the Bankruptcy Code fails to expressly grant super-priority to § 365(d)(3) claims. As one court explained:

> All claims subject to super-priority administrative status are listed in Section 364 of the Bankruptcy Code. Post-petition rent payments are not included. Congress knew how to grant super-priority status and did not expressly do so under Section 365(d)(3). Accordingly, the better approach is to literally interpret the statute and to reject any super-priority status for the lessor's claim.[92]

In addition to this ''plain language'' argument, some courts within the majority also express concern that granting super-priority to § 365(d)(3) claims would place the court in the difficult position of determining who among the various super-priorities has the highest priority.[93] Based on these concerns, the majority hold that the landlord must share pro rata with other administrative claims.

A minority of courts, however, grant a special status to § 365(d)(3) claims.

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[88] *See Pudgie's*, 239 B.R. at 692.

[89] *Id*.

[90] *Id*. at 692-93.

[91] *Id*. at 693.

[92] In re Florida Lifestyle Apparel, Inc., 221 B.R. 897, 900, 40 Collier Bankr. Cas. 2d (MB) 275 (Bankr. M.D. Fla. 1997). *See also* In re Microvideo Learning Systems, 254 B.R. 90, 43 Collier Bankr. Cas. 2d (MB) 357 (S.D.N.Y. 1999), aff'd, 227 F.3d 474 (2d Cir. 2000); *Pudgie's*, 239 B.R. at 695 (noting that the court ''cannot reorder the priority scheme for administrative claims created by Congress'').

[93] *Microvideo*, 1999 WL 1084252 at *3.

Like the majority, these courts also purport to rely on the ''plain language'' of the statute. The minority position is that § 365(d)(3) requires timely performance of all of the debtor's obligations and does not include an exception for administrative insolvency.[94] Accordingly, these courts conclude that the trustee must pay post-petition, pre-rejection rent regardless of the solvency of the estate.

The minority also question the basic assumption underlying the majority's approach that payments made under § 365(d)(3) constitute § 503(b)(1) administrative expenses.[95] In *Telesphere*, the Court found that § 365(d)(3) rental payments should be treated according to the procedure for ''operational payments'' under § 363(c)(1) not as § 503(b)(l) administrative expenses.[96] Indeed, § 365(d)(3) states that it applies ''notwithstanding Section 503(b)(1),'' suggesting that it does not involve any of the procedures for court-supervised administrative payments. Unlike § 503(b)(1), § 363(c)(1) allows the debtor-in-possession to operate in the ordinary course of business without court supervision. Because § 365(d)(3) payments are to be made without court supervision and without the need to show a benefit to the bankruptcy estate, the court in *Telesphere* concluded that they are more akin to operational payments.[97] Accordingly, the minority courts argue that, ''contrary to the reasoning of the majority decisions, there would have been no reason for Congress to have provided any express grant of superpriority for Section 365(d)(3) rent payments.''[98] Similarly, the determination that § 365(d)(3) payments are not administrative claims alleviates the concern about deciphering the priority among the various administrative superpriorities. The court in *Telesphere* found that, unlike court-supervised administrative payments, operational payments do not share pro rata with other administrative expenses.[99]

The minority approach has support among some commentators.[100] One commentator has argued that, under the majority approach, ''there would be no incentive to adhere to the statute because, in the case of an anticipated

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[94] *See* In re Telesphere Communications, Inc., 148 B.R. 525, 528, 23 Bankr. Ct. Dec. (CRR) 1274 (Bankr. N.D. Ill. 1992).

[95] *Id*. at 519.

[96] *Id*. at 531.

[97] *Id*. at 530-31.

[98] *Id*. at 531.

[99] *Id*. at 530.

[100] *See* C. Alan Gauldin, *The Commercial Real Estate Landlord's Rights to Receive Post-Petition Rental Payments Under § 365(d)(3) of the Bankruptcy Code,* 14 U. ARK. LITTLE ROCK L.J. 498, 505-06 (1992). Gauldin argues that the majority approach conflicts with Congressional intent to give landlords special treatment protection for post-petition, pre-rejection obligations.

rejection, the trustee would have very good reasons to disregard it,'' withhold rent payments, and leave the landlord without payment when the estate became insolvent.[101] Indeed, this is not an uncommon strategy and practice in Chapter 11 cases.

2. The Holding in *Pudgie's*

After reviewing both sides of the debate, the *Pudgie's* court sided with the majority view and refused to grant super-priority to § 365(d)(3) claims. Interestingly, the Court agreed with *Telesphere* that § 365(d)(3) payments are more like operational payments because they are made without court supervision. Nonetheless, the Court concluded that ''timely performance'' is not equivalent to super-priority, implying that operational payments can be forced to share with administrative claims.[102] The *Pudgie's* court held that a landlord is entitled to the timely payment of post-petition rent but that § 365(d)(3) claims do not trump administrative claims when a risk of insolvency exists.

The *Pudgie's* court agreed with the majority's interpretation that § 365(d)(3) does not grant super-priority. But the landlord's failure to diligently pursue its rights was arguably the deciding factor. The Court found that the landlord had sat on its rights for 17 months, allowing Pudgie's rent obligation to accrue. According to the Court, ''a landlord cannot wait while unpaid rent accrues in hope that his later claim for lease payments will be given superpriority over secured creditors that have specific statutory authority.''[103]

This, however, seems similar to blaming the victim of a robbery for not running fast enough from the robber. The debtor has a statutory obligation under § 365(d)(3) to timely pay its post-petition rent. The Bankruptcy Code puts the burden of performance on the debtor not on the landlord. If the debtor deliberately fails to discharge its statutory burden, why should the landlord suffer? The answer, perhaps, is that, as among innocent administrative creditors, a landlord who neglects to enforce its rights is more culpable. The *Pudgie's* court noted that, instead of allowing the post-petition rent to accrue, a landlord can pursue the following remedies: (1) seek an order to compel the debtor to immediately perform its lease obligations; (2) move for

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[101] *Id*. *See also 2 NORTON BANKRUPTCY LAW AND PRACTICE 2D* § 39:42 at 39-121 (1998) (''The better view is that the 'shall timely perform' language in Code § 365(d)(3) means what it says.'').

[102] *Pudgie's*, 239 B.R. at 695.

[103] *Id*. at 695.

relief from the automatic stay to evict the debtor; or (3) move to convert the case to Chapter 7.[104]

C. Implications of *Pudgie's*

The lesson of *Pudgie's* is that a landlord must act promptly to collect post-petition, pre-rejection rent. The onus is on the landlord to act to obtain payment. Prompt action may allow the landlord to collect its rent before an estate becomes administratively insolvent and to factually distinguish *Pudgie's*.

In addition to seeking the remedies enumerated in *Pudgie's*,[105] a landlord with outstanding claims for post-petition rent should object to any extension of time for the debtor to assume or reject its lease.[106] One factor that courts consider in deciding whether to grant an extension is whether the post-petition rent has been paid. In view of the fact that most courts refuse to extend super-priority to post-petition rent, a landlord has a strong argument that it would be unfair to extend the 60-day period if the post-petition rent remains unpaid.

Finally, it should be noted that the proper interpretation of § 365(d)(3) remains an open issue in many jurisdictions because the circuit courts have yet to address the issue.

V. DEBTOR'S RIGHT TO EXERCISE OPTION TO EXTEND LEASE TERM PRIOR TO ASSUMPTION OR REJECTION

Can a debtor, prior to deciding whether to assume or reject a lease of nonresidential real property, exercise an option to extend the lease term even though post-petition defaults exist and the lease provides that it cannot be extended in the face of defaults? In *In re Leisure Corp.*[107] the Ninth Circuit Bankruptcy Appellate Panel addressed this issue. To better understand *Leisure Corp.*, however, one should be familiar with the earlier decision of the Ninth Circuit in *Circle K Corp.*[108]

In *Circle K,* the debtor filed for Chapter 11. The Bankruptcy Court extended the period in which the debtor has the right to elect to assume or

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[104] *See Pudgie's*, 239 B.R. at 696.

[105] *See* note 104 and accompanying text.

[106] Under § 365(d)(4) of the Bankruptcy Code, a lease of nonresidential real property is deemed rejected if the debtor does not assume or reject the lease within 60 days of the order for relief, unless the court extends the period for cause.

[107] In re Leisure Corp., 234 B.R. 916, 34 Bankr. Ct. Dec. (CRR) 662, 42 Collier Bankr. Cas. 2d (MB) 721 (Bankr. 9th Cir. 1999).

[108] In re Circle K Corp., 127 F.3d 904, 31 Bankr. Ct. Dec. (CRR) 808, 38 Collier Bankr. Cas. 2d (MB) 1445, Bankr. L. Rep. (CCH) ¶ 77562 (9th Cir. 1997), cert. denied, 522 U.S. 1148, 118 S. Ct. 1166, 140 L. Ed. 2d 176 (1998).

reject the lease. The term of the lease in question was scheduled to expire before the extended assumption/rejection period. The lease contained an option to extend the lease term for a five-year term if the tenant was not in default. Monetary and non-monetary defaults existed under the lease. The debtor exercised the option to extend the lease term. The landlord argued that the option could not be exercised in the face of pre-petition defaults under the lease.

The Ninth Circuit held that the bankruptcy court has the power to permit the debtor to extend the lease term without curing pre-petition defaults. The Ninth Circuit reasoned that, without the right to extend the lease term, the purpose of § 365 would be frustrated since the debtor would be denied the time to decide whether to assume or reject the lease.[109] According to the Ninth Circuit, if the debtor failed to cure the defaults, the lease would expire and the debtor would then be unable to exercise its choice to assume or reject; if the debtor cured the defaults in order to preserve this choice, it would have been forced into granting a de facto preference if it later decided to reject. Thus, the Ninth Circuit concluded that, if pre-petition defaults must be cured to exercise an option to renew, it would force the debtor into an early decision as to whether to assume or reject, and would render a court's extension of this period illusory.[110]

A. Facts of *Leisure Corp.*

Leisure Corp. had the same basic facts as *Circle K* except that the defaults were post-petition. Leisure Corp., the debtor, was a tenant under a pre-petition nonresidential real estate lease. The lease contained five successive one-year options to extend the lease term, which the tenant could exercise so long as it was not in material default. The first lease term ran from November 15, 1995, through November 14, 1996. On August 12, 1996, Leisure Corp. exercised its first option, extending the lease to November 14, 1997. Leisure Corp. filed for bankruptcy shortly after exercising this option to extend the lease term. While in Chapter 11, it sued the landlord for removing a display sign used by the debtor to attract customers. The Bankruptcy Court extended the debtor's time to assume or reject the lease until a decision was reached in the ''sign litigation.''

A few months before the expiration of the lease term, Leisure Corp. attempted to exercise its second lease option to extend the lease term by one year. The landlord refused, citing the existence of material pre- and post-petition defaults. The landlord filed a motion for relief from the stay. The landlord argued that the existence of material defaults under the lease

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[109] *Circle K*, 124 F.3d at 909.

[110] *Id*. at 910.

prevented the debtor from exercising the option to renew. The landlord sought an order terminating the stay and permitting it to pursue its non-bankruptcy options after the end of the current lease term. The debtor disputed the amount and materiality of the defaults, and argued that the resolution of the ''sign litigation'' would determine whether it had defaulted.

The Bankruptcy Court denied the landlord's motion. The Court held that it was bound by the Ninth Circuit's decision in *Circle K,* in which the Ninth Circuit held that the existence of pre-petition defaults did not preclude the debtor from exercising an option to renew a lease.

B. Analysis

On appeal to the Ninth Circuit Bankruptcy Appellate Panel, the landlord argued that the existence of material, uncured, post-petition defaults distinguished the case from *Circle K*, which primarily involved pre-petition defaults. The landlord argued that § 365(d)(3) requires timely performance of post-petition obligations, and that the debtor's failure to timely perform should preclude it from renewing the lease in contravention of the lease provisions prohibiting renewal upon default.

The Ninth Circuit BAP held that post-petition defaults and the failure to comply with § 365(d)(3) are not a bar to exercising an option to extend a lease term but they are a factor that the court will consider in deciding whether to allow a debtor to exercise such an option.[111]

The BAP noted that the Leisure Corp.'s situation was somewhat different from Circle K's in that the defaults in this case were post-petition not pre-petition. The BAP observed that § 365(d)(3) requires the debtor to timely perform its lease obligations pending a decision to assume or reject but that there is no specified remedy for violation of that requirement.[112] The BAP concluded that § 365(d)(3) does not absolutely prohibit renewal of the lease but instead is a factor to be considered in deciding whether a debtor may renew a lease.[113] The BAP remanded the case to the Bankruptcy Court, stating:

> If there were post-petition defaults at the time of renewal, the court must exercise its discretion in deciding whether the scope of the default, the cause of the default, any subsequent cure of the default, and the significance of the lease to the reorganization are sufficient to outweigh the policy of § 365(d)(3) that the landlord has a right to timely payment post-petition.[114]

It should be noted that *Leisure Corp.* presents a less compelling case for

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[111] *Id*. at 906.

[112] *Leisure Corp.*, 234 B.R. at 923.

[113] *Id*.

[114] *Id*. at 924.

the debtor than *Circle K* because the existence of post-petition defaults in *Leisure Corp.* created a conflict between the Bankruptcy Code's goal of ''suspending time'' for the debtor to decide whether to assume or reject a lease and § 365(d)(3)'s grant of special protection to landlords to receive timely payment during this period.

C. Implications of *Leisure Corp.*

The *Leisure Corp.* court decided that bankruptcy courts should decide on a case-by-case basis whether to allow a debtor to exercise a renewal option prior to the debtor making a decision on the assumption or rejection of the lease in question. It may seem nonsensical to allow a debtor to extend a lease term prior to deciding whether to assume the lease but, as the courts have discussed, this is simply an attempt by the courts to give meaning to the debtor's right to assume or reject a lease. In effect, the *Leisure Corp.* court refused to allow the landlord to draft its way around § 365. The lease in *Leisure Corp.* was a one-year lease with five successive one-year options to extend. The landlord, by granting a one-year lease with five one-year options instead of a six-year lease, may have attempted to prevent the debtor from extending the lease if the tenant subsequently filed for bankruptcy and was in default under the lease. The lease would have expired without the exercise of the option to extend, and the debtor would have had to surrender the premises. The *Leisure Corp.* court, however, looked through this device to preserve the debtor's right to assume the lease under § 365. *Leisure Corp.* is emblematic of the difficulty of bankruptcy proofing and a reminder that, when it comes to bankruptcy proofing, there is no silver bullet.[115]

It is uncertain how bankruptcy courts will apply *Leisure Corp*. This uncertainty may discourage landlords from negotiating leases that include an option to renew if the debtor faces a risk of insolvency.[116] To the extent bankruptcy courts allow debtors with post-petition defaults to renew their leases, it will favor the debtor's federal law right to reorganize over both the landlord's state law contractual rights and the § 365(d)(3) protections, placing the burden of the debtor's indecision on the landlord. However, the *Leisure* court made it plain that the exercise of a renewal option in the face of post-petition defaults will depend on a balancing of the landlord's right to

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[115] *See*, *generally*, Michael St. Patrick Baxter, *Bankruptcy Proofing: Bankruptcy Provisions in Restructuring Agreements,* 8 J. BANKR. L. & PRAC. 483 (1999) (''Regardless of the mechanism employed, once a bankruptcy case is commenced, the fate of the creditor, and likewise of the debtor, is in the hands of the bankruptcy court; and whether the bankruptcy court will grant relief to the creditor will depend not so much on the 'bankruptcy proofing' mechanism employed by the creditor as on the particular facts and circumstances of the case.'').

[116] Although there would seem to be no down-side to such leases in that the landlord is in no worse position.

timely post-petition payment and the significance of the lease to the debtor's reorganization. In other words, the court must weigh the nature and magnitude of the post-petition defaults against the effect on the reorganization of the forfeiture of the unassumed lease.

VI. SEVERANCE OF AN EXECUTORY CONTRACT INTO SEPARATE REJECTABLE EXECUTORY CONTRACTS

Can a debtor reject an unexpired lease that is part of a larger overall contract without rejecting the overall contract? In *In re Plitt Amusement Co. of Washington, Inc.*,[117] the Trustee moved to reject one of three leases signed by the debtor in connection with the purchase of a theater business from the lessor. The Court considered whether the lease in question could be considered a separate transaction from the other two leases and the overall purchase agreement, so that it could be separately rejected. The Court concluded that the lease was a separate transaction, and it granted the Trustee's motion to reject the lease.

A. Facts of *Plitt*

In 1990, the debtor purchased three motion picture theaters from the sellers. The theaters were located in separate towns in Washington state. Prior to the debtor's purchase of the business, the sellers owned the real estate where the theaters were located. Rather than sell the real estate, the sellers leased the property at each location to the debtor. The overall purchase transaction involved several documents: (1) a purchase agreement for the business of the three theaters; (2) one promissory note to pay the balance of the purchase price over ten years; (3) an unrecorded security agreement to secure the note with equipment in the theaters; and (4) three theater leases with 20-year terms (with options to renew for up to an additional 20 years).

The Chapter 7 Trustee sought to reject the Mount Vernon lease, one of the three leases. The sellers opposed the motion, arguing that the three leases, the purchase agreement, and the note constituted one indivisible transaction that the Trustee must assume or reject in its entirety.

B. Analysis

Section 365 permits a trustee (or debtor-in-possession) to pick and choose among the debtor's executory contracts and unexpired leases, and to assume those that benefit the estate and reject those that do not. It is generally recognized, however, that a debtor must assume or reject an executory

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[117] In re Plitt Amusement Co. of Washington, Inc., 233 B.R. 837, 34 Bankr. Ct. Dec. (CRR) 395 (Bankr. C.D. Cal. 1999).

contract or unexpired lease in its entirety. A debtor may not pick and choose among contractual provisions, rejecting some and accepting others.[118]

In *Plitt*, the Bankruptcy Court reviewed the relevant state law and federal bankruptcy law to determine whether the parties intended the Mount Vernon lease to be a separate transaction. Under the relevant state law, the Court concluded that it had to examine all of the instruments together to see whether they constitute a single integrated agreement. If it found that the instruments constituted a single integrated agreement, the Court must then determine whether the Mount Vernon lease could be severed from the remainder of the transaction.[119]

The Court found that the agreement had two principal features: (1) the sale of the business in return for a promissory note, and (2) the three leases. Moreover, the leases differed from the sale agreement in that the leases had a duration of 20 years while the promissory note for the sale was to be satisfied in ten years. Among the leases, each functioned independently as to the rent amount, rent date, commencement and termination dates of the lease, and location of the property.[120] On the other hand, the Court found it significant that all six documents were executed on the same day and that the leases included cross-default provisions, whereby the breach of one constituted breach of the others.

The Court found that the parties intended each lease to be an independent obligation.[121] The Court found, in the alternative, that, even if the instruments constituted a single integrated contract, the Mount Vernon lease was severable.[122] The Court also concluded that federal bankruptcy law favored treating the leases separately for purposes of § 365. Analogizing the case to a business consisting of hundreds of retail establishments purchased from a third party in a single transaction, the Court held that the debtor should be able to analyze each lease separately to determine whether to assume or reject. The Court held that the Trustee is entitled to assume or reject a lease independently as to each ''business establishment'' that is property of the

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[118] *See*, *e.g.*, In re Kopel, 232 B.R. 57, 63, 41 Collier Bankr. Cas. 2d (MB) 1013 (Bankr. E.D.N.Y. 1999) *citing* N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 531, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) ¶ 69580, 100 Lab. Cas. (CCH) ¶ 10771 (1984). ''It is axiomatic that an executory contract generally must be assumed cum onere. A debtor cannot simply retain the favorable and excise the burdensome provisions of an agreement.'' *In re Kopel*, 232 B.R. at 63-64 (citation omitted).

[119] *Plitt*, 233 B.R. at 841-44.

[120] *Id*. at 844.

[121] *Id*. at 845.

[122] *Id*.

estate.[123] The Court concluded that the Mount Vernon lease, as a separate business, constituted such a business establishment. Accordingly, it granted the Trustee's motion to reject the Mount Vernon lease.

C. Implications of *Plitt*

Plitt is indicative of the general bankruptcy court philosophy that ''[b]ankruptcy law is not subject to artful drafting.''[124] On the facts of *Plitt*, it was evident that the parties did not intend for the leases to integrate with the debtor's purchase of the sellers' theater business. The fact that each lease was supported by separate consideration and would continue to exist for decades after the completion of payment for the purchase of the theater business was pivotal to the disposition in the case. Compare this case with the decision in *In re Kopel*.[125]

In *Kopel*, the debtors purchased the veterinary practice of the sellers. In connection with the purchase of the veterinary practice, the parties executed an acquisition agreement, a lease, a promissory note, a consulting agreement and a pledge agreement.[126] Following the debtors' bankruptcy, the sellers sought a declaration that the lease could be assumed only if the debtors' defaults under the promissory note and the consulting agreement were cured because a cross-default provision in the lease deemed defaults under the note and the consulting agreement to be defaults under the lease.[127] The sellers also contended that the lease, the note and the consulting agreement formed a single, unified transaction such that the debtors could not retain their rights under the lease without performing their obligations under the other agreements.[128] The Court concluded that the lease and the non-lease agreements were entered into as part of a single, integrated transaction and that the defaults under the non-lease agreements must be cured as a condition of assuming the lease.

Stating that cross-default provisions are inherently suspect,[129] the *Kopel* court observed that courts will refuse to enforce cross-default provisions in situations where the cross-defaulted agreements are not interrelated: ''Federal bankruptcy policy is offended where the non-debtor party seeks

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[123] *Id*. at 848.

[124] *Id*. at 847.

[125] In re Kopel, 232 B.R. 57, 41 Collier Bankr. Cas. 2d (MB) 1013 (Bankr. E.D.N.Y. 1999).

[126] Of the $425,000 purchase price, the debtor paid $75,000 on closing and the $350,000 balance in the form of a 15-year note. Several years later, following defaults by the debtor, the note, the lease and the consulting agreement were amended. *Kopel*, 232 B.R. at 61.

[127] *Kopel*, 232 B.R. at 60.

[128] *Id*. at 61.

[129] *Id*. at 65.

enforcement of a cross-default provision in an effort to extract priority payments under an unrelated agreement.... Thus, where the non-debtor party would have been willing, absent the existence of the cross-defaulted agreement, to enter into a contract that the debtor wishes to assume, the cross-default provision should not be enforced.''[130]

The *Kopel* court stated, however, that the enforcement of a cross-default provision should not be refused where to do so would thwart the non-debtor party's bargain.[131] The Court found from the uncontroverted evidence that the parties intended the lease and the non-lease agreements to represent a single, unified transaction.[132] Accordingly, the Court held that the debtors must cure the defaults under the consulting agreement as a condition to the assumption of the lease.

The stated issue in *Plitt* was whether the Mount Vernon lease was a separate transaction from the other two leases and the related installment purchase of the theater businesses at the three locations so that the Mount Vernon lease may be separately rejected. The stated issue in *Kopel* was whether cross-default provisions are enforceable so that the assumption of the lease would require the cure of the defaults under the cross-defaulted agreements. This is how the *Plitt* and *Kopel* litigants framed their disputes to the Court.

Despite the different articulation of the issues, however, both *Plitt* and *Kopel* in fact dealt with the same fundamental issue: Whether the agreements in each case represented a single, unified transaction so that the debtor could retain its rights under one agreement without performing its obligations under the other agreements? The *Plitt* court found that the parties intended that the Mount Vernon lease to be a separate obligation of the parties independent from the other agreements.[133] The *Kopel* court found that the several agreements represented a single, integrated transaction so that default under the non-lease agreements must be cured as a condition to assuming the lease. The *Kopel* court also found that the cross-defaults were asserted to protect the very essence of the bargain made by the parties and that no federal bankruptcy policy was offended by enforcing the cross-default provision.[134]

Few courts have established a definitive test to determine whether a contract or lease should be treated as a separate document to be assumed or

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[130] *Id*. at 65-66.

[131] *Id*. at 66.

[132] *Id*. at 69. The debtors did not offer any extrinsic evidence to dispute the sellers' affidavit evidence that the agreements represented a single, unified transaction.

[133] *Plitt*, 233 B.R. at 845. In the alternative, the Court found that, even if the agreements constituted a single transaction, the Mount Vernon lease was severable. *Id*.

[134] *Kopel*, 232 B.R. at 67-68.

rejected.[135] The Eleventh Circuit is one of the few to develop such a test. In *In re Gardinier*, it identified three factors the court should consider: (1) whether the nature and purpose of the obligations differ; (2) whether the consideration for the obligations is separate and distinct; and (3) whether the obligations of the parties are interrelated.[136] The decisions of *Plitt* and *Kopel* are consistent with the approach outlined by the Eleventh Circuit in *Gardinier*.

VII. ASSUMPTION AND ASSIGNMENT OF SHOPPING CENTER LEASE

In *In re J. Peterman Co.*,[137] the Bankruptcy Court addressed the issue of whether a debtor could modify certain radius restrictions in a shopping center lease. In *J. Peterman*, the Chapter 11 debtor sought a court order to modify the radius restriction clause in a shopping center lease so it could assume and assign the lease. The Bankruptcy Court refused, finding that the radius restriction clause was reasonable and that the court lacked the authority to modify the provision.

A. Facts of *J. Peterman*

The debtor sold upscale clothing and household items through a mail order business and retail stores. In 1997, it leased a space in the Woodbury Common Shopping Center, an upscale, discount shopping center of approximately 200 stores located less than 60 miles from New York City. The lease contained a radius restriction clause that prevented the debtor from operating ''a similar or competing business'' under the same name ''within a radius of 60 air miles'' from the shopping center. The lease provided that the debtor would have to include the gross sales from any such business in its calculation of percentage rent if it violated this provision.

The debtor filed for a Chapter 11 liquidation on January 25, 1999. As part of its liquidation, the debtor sought to assume the Woodbury Common lease and assign it to a proposed assignee. The prospective assignee already operated one discount store within the 60-mile radius prohibited by the lease and had entered into leases for two more sites within the proscribed radius. The landlord indicated that it would waive the radius restriction for the proposed assignee's existing store but objected to the two new stores because they

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[135] *See* Jerald I. Ancel, Marlene Reich & Jennifer Ancel Reiter, *All for One and One For All? The Assumption and Rejection of Multiple Intertwined Executory Contracts and Unexpired Leases,* 18 AM. BANKR. INST. J. 16 (1999).

[136] In re Gardinier, Inc., 831 F.2d 974, 16 Bankr. Ct. Dec. (CRR) 1378, Bankr. L. Rep. (CCH) ¶ 72109 (11th Cir. 1987).

[137] In re J. Peterman Co., 232 B.R. 366, 34 Bankr. Ct. Dec. (CRR) 282, 41 Collier Bankr. Cas. 2d (MB) 1382 (Bankr. E.D. Ky. 1999).

were closer to New York City and would drain business from the Woodbury Common store.

The debtor moved to assume, assign, and modify the lease. It contended that the radius restriction was unreasonable and amounted to a non-assignability clause in violation of § 365(f)(1). The landlord argued, in response, that the radius restriction was reasonable given the nature of its shopping center and its proximity to New York City. The landlord also argued that § 365(b)(3)(C), which expressly recognizes radius provisions in shopping center leases, prevented the court from altering the radius restriction.

B. Analysis

It is well settled that a trustee or a debtor-in-possession ''takes the contracts of the debtor subject to their terms and conditions.''[138] A lease may not be rejected in part and assumed in part. As the bankruptcy court in *J. Peterman* explained, ''[w]hen the debtor assumes the lease or the contract under § 365, it must assume both the benefits and the burdens of the contract.''[139] The Court emphasized that the landlord is entitled to receive its ''bargained for exchange.''[140]

The *J. Peterman* court held that the radius provision was a ''bargained for exchange'' and that it would survive assignment of the lease unless it contravened the Bankruptcy Code's assignment provisions.[141] The proposed assignee argued that the radius restriction violated the Bankruptcy Code's assignment provisions because it limited the potential field of assignees. The proposed assignee apparently relied on § 365(f)(1), which provides that a debtor may assign an unexpired lease, notwithstanding a provision in the lease or in applicable law, that prohibits, restricts, or conditions the assignment of such lease.

The Bankruptcy Court rejected the argument that § 365(f)(1) somehow permitted it to allow assignment without the radius restriction clause. It held that the clause was reasonable based on the proximity of Woodbury Common to New York City, even though the 60-mile radius was larger than provisions upheld in other cases.[142] In addition, the Court stated that it was without authority to modify the radius restriction because it would change

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[138] *See*, *e.g.*, *Kopel*, 232 B.R. 57, 63.

[139] *J. Peterman*, 232 B.R. at 369 *quoting* City of Covington v. Covington Landing Ltd. Partnership, 71 F.3d 1221, 1226, 28 Bankr. Ct. Dec. (CRR) 377, 34 Collier Bankr. Cas. 2d (MB) 822, Bankr. L. Rep. (CCH) ¶ 76734, 1995 FED App. 376P (6th Cir. 1995).

[140] *Id*.

[141] *Id*. at 370.

[142] *Id*. at 370.

the bargain originally struck by the parties.[143] Finally, the Court recognized that the debtor's argument appeared to contravene the provisions of § 365(b)(3)(C).[144]

C. Implications of *J. Peterman*

In enacting § 365(b)(3)(C), Congress recognized that a shopping center is often a carefully planned enterprise.[145] Factors such as tenant mix and radius affect the patronage of stores at the center and are an important part of the landlord's bargained-for exchange. The *J. Peterman* court appears to recognize these policy considerations, and its decision is consistent with previous authority that refuse to permit assignment of a modified shopping center lease.[146]

VIII. CONCLUSION

The field of executory contracts is one of the most fascinating and complex areas of bankruptcy law. The recent developments in the case law in this area reflect the continuing struggle of the courts in their efforts to harmonize in a consistent and predictable way the disparate provisions of § 365 of the Bankruptcy Code.

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[143] *Id*.

[144] This subsection deals with assumption and assignment of shopping center leases. It provides that, if there has been a default in the lease, the debtor must adequately assure 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 provision.

[145] *See* In re TSW Stores of Nanuet, Inc., 34 B.R. 299, 307, 11 Bankr. Ct. Dec. (CRR) 201, 9 Collier Bankr. Cas. 2d (MB) 793, Bankr. L. Rep. (CCH) ¶ 69472 (Bankr. S.D.N.Y. 1983).

[146] *See Nanuet,* 34 B.R. at 305-08 (court refuses to modify restrictive use clause in shopping center lease pursuant to assumption and assignment).