NAVIGATING BANKRUPTCY TERRAIN: EXPLORING THE NEXUS OF BANKRUPTCY LAW IN MULTIFACETED LEGAL LANDSCAPES

INTRODUCTION

Bankruptcy is a cyclical practice area driven by economic cycles. During periods of economic growth, businesses thrive and often take on debt to fuel growth initiatives such as expansion, investment in new technology, or marketing campaigns. Likewise, personal spending increases and individuals may also take on debt for various reasons, like purchasing homes or cars. During this time, individuals and businesses tend to take on more risk. However, economic cycles are inevitable and, eventually, there comes a correction or downturn. This downturn can be triggered by a variety of factors such as interest rate changes, geopolitical events, or market saturation. During these downturns, businesses may experience declining revenues, while individuals may face job losses or reduced income. As the economy weakens, some businesses turn to bankruptcy to restructure or eliminate debt. The cyclical nature of bankruptcy therefore underscores the close relationship between bankruptcy and broader economic trends. During economic expansions, bankruptcy filings may decrease as businesses and individuals have the means to service their debts. Conversely, during economic downturns bankruptcy filings tend to increase as financial distress becomes more widespread.

Bankruptcy practitioners oftentimes must become experts in other practice areas to adjust to the economic cycles. This knowledge then translates well into bankruptcy law where, as practitioners, we are consistently faced with issues outside traditional bankruptcy.

PART ONE:

ESOPS IN BANKRUPTCY

I. What is an ESOP?

An employee stock ownership plan, or an "ESOP", is a type of employee benefit plan regulated by the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA"). An ESOP enables employees to own part or all of their employer-company. ESOPs are commonly used to facilitate succession planning and are started by the employer establishing an ESOP Trust. The ESOP typically holds the company's stock in trust for participating employees. Once an employee is fully vested, he or she is entitled to receive their allocated shares of stock after retirement, resignation, or termination. While there are numerous unique features of an ESOP, an important one is that the ESOP's trust funds must be primarily invested in one company, the employer-creator of the ESOP.

An ESOP operates under specific regulations and rules. For example, if a company's assets include its stock, the value of those assets depends on the employer's equity and the benefits that ESOP plan participants will ultimately receive are affected by the value of its stock. The ESOPs Trust Agreement, and related governing documents, outline how the ESOP will be managed, including, but not limited to (a) the appointment of an ESOP Trustee; and (b) the delegation of duties to the ESOP Trustee. The ESOP Trustee has The Trust Agreement and other governing documents are critical in terms of how an ESOP is treated under the Bankruptcy Code.

II. Treatment of ESOPs in Bankruptcy

A. ESOP Participants' Status as Equity Holders

Generally, the participants in the ESOP are treated as equity holders in bankruptcy. Under the Bankruptcy Code, this makes them effectively last for distribution and limits ESOP participants' rights.

B. Participants' Claims Against the Debtor

(i) *What is a Claim?*

The Bankruptcy Code defines a "claim" as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured[.]" 11 U.S.C. § 101(5)(A). However, it is not enough that a creditor has a right to payment; it must have a right to payment against the debtor-employer enforceable against its property. 11 U.S.C. § 502(b)(1). Therefore, if a third-party owes the claim rather than the debtor, it is not considered an allowed claim.

(ii) *Repurchase Obligations*

Whether an ESOP participant has a claim against the debtor-employer is dependent upon the employee's status as of the petition date. The Internal Revenue Code provides that an ESOP Participant "has the right to require than an employer repurchase employer securities under a fair value formula." 26 U.S.C. § 409(h)(1)(B). These "repurchase obligations" are typically triggered upon an employee's death, disability retirement, termination, or an employee's exercise of his/her/their diversification rights. Since companies often do not want to repurchase shares in one lump sum, they will oftentimes spread out repayment for as long as they are able to under ERISA. The Internal Revenue Code allows stock to be purchased from a participant and secured by a promissory note. If the debtor-company issues promissory notes prior to the petition date, the ESOP participant has direct rights against the company to enforce the promissory note. *See In re Indian Jewelers Supply Co.,* 604 B.R. 408 (Bankr. D.N.M 2019). In this scenario, the ESOP participant would have a claim against the debtor-employer.

(iii) *S Corporations and Repurchase Obligations*

Importantly, the repurchase obligations requirement under the Internal Revenue code is inapplicable to S corporations. 26 U.S.C. § 409(h)(2)(B)(ii)(II); *In re CPESAZ Liquidating Inc*., 2023 WL 3773642 at *4-5 (B.A.P. 9th Cir. June 2, 2023). S corporations are entitled to distribute cash in lieu of stock from the ESOP Trust. *Id*. at *5. In this scenario, the ESOP participants do not have a direct claim against the debtor-employer and, instead, only have claims against the ESOP Trust. As a result, ESOP participants who are not issued a promissory note from the debtor-company are not entitled to file claims in its bankruptcy proceeding. Instead, their claims are against the ESOP Trust and they are considered equity holders.

(iv) *Impact of ESOP Plan Documents and ESOP Trust Agreement*

It is not uncommon for an ESOP Plan and an ESOP Trust Agreement to vest the ESOP Trustee with the authority to sue, defend, compromise, arbitrate or settle any suit or legal proceeding or any claim due it or which it may be liable. In that instance, the ESOP Trustee is the individual with the sole authority to file proofs of claims against the debtor-company for any breaches of fiduciary duties or obligations the debtor-company owes the ESOP Trust. *See, e.g., In re CPESAZ Liquidating, Inc.*, supra, at *7-8.

C. Practitioner Tips

When faced with an ESOP in bankruptcy, it is important to have competent ERISA counsel involved from the beginning. ERISA counsel is oftentimes aggressive in bankruptcy courts due to their clients' reliance on the ESOP for retirement. It is important to understand the complex provisions of ERISA and the Internal Revenue Code and be able to explain the same properly to the Bankruptcy Court.

PART TWO:

HEALTHCARE BANKRUPTCY CONSIDERATIONS

Last year was the highest level of healthcare bankruptcy filings in the last five (5) years.[1] Whether driven by pandemic-related issues, low reimbursement rates, high labor costs and turnover, or high supply costs, health care provider bankruptcies comprise a significant portion of the total volume of filings.

By filing for chapter 11 bankruptcy protection, distressed hospitals and health systems receive short-term relief to determine next steps while continuing to operate. Depending on the debtor's financial situation at the time of filing, the debtor may file to restructure its debts, strengthen its balance sheet, sell to a third party, or pursue an orderly winddown. Oftentimes health care bankruptcies move quickly as the focus is on maintaining patient care. Therefore, it is important for practitioners to review all pleadings and be prepared for quick response deadlines.

I. Healthcare Bankruptcy Sales

When pursuing a sale under section 363 of the Bankruptcy Code, the heath care debtor must address numerous operational issues to preserve the continuity and quality of care for all existing patients, which requires the purchasing entity to receive and maintain all necessary permits and regulatory approvals to continue operations prior to closing on the sale.

The sale of a hospital or healthcare provider in bankruptcy is similar in some respects in that the sale is typically done through a competitive bidding process which includes a public auction to allow bidders to perform their own due diligence. The bankruptcy court will then approve the "highest and best" bid for the purchase. However, unlike traditional bankruptcy sales, both buyers and sellers must obtain critical regulatory approvals which vary depending on the type

[1] Record Bankruptcy Filings in Healthcare Sector in 2023, Gibbons Advisors (2023) https://gibbinsadvisors.com/record-bankruptcy-filings-in-the-healthcare-sector-in-2023/

of transaction, the entities involved, and the states where the debtor operates. Such approvals can be both at the federal and state levels and include the following: CMS, the Drug Enforcement Administration and the Nuclear Regulation Commission. The state Department of Health and state Department of Human Services will need to be notified and could object to the sale, if need be, as a party in interest. Similarly, the sale of a nonprofit healthcare entity also brings unique challenges, including approval from the state attorney general in circumstances where the protection of charitable assets becomes an issue.

II. Impact of Unions

In addition to being aware of required notifications to regulatory agencies, healthcare entities should attempt to negotiate with unions prepetition if possible. However, a recent example in the Northern District of California demonstrated the impact frustrated unions can have on a bankruptcy proceeding.

On May 23, 2023, San Benito Health Care District, operator of Hazel Hawkins Memorial Hospital in Hollister, California filed for bankruptcy protection under chapter 9 of the Bankruptcy Code in the United States Bankruptcy Court for the Northern District of California. The chapter 9 petition was challenged in July 2023 by two of its unions- the California Nurses Association ("CNA") and the National Union of Healthcare Workers ("NUHW"). The unions challenged the petition arguing that the district was solvent and filed in bad faith because its "primary if not sole real purpose in filing for chapter 9 bankruptcy is an improper one, which is to rid itself of the Collective Bargaining Agreements, and specifically, of its pension obligations, forever." The treatment of collective bargaining agreements was a contentious issue early on in the bankruptcy when the district moved to reject CBAs with four of its unions, including CNA and NUHW. After

the two unions objected to the Debtor's eligibility under chapter 9, the rejection motion was continued pending the court's eligibility determination.

In December 2023, the bankruptcy court held a four-day evidentiary hearing on the Debtor's chapter 9 eligibility. After that trial, additional disputes between the Debtor and the Unions continued when the debtor filed a motion to enforce the automatic stay against CAN and NUHW for filing unfair practice charges with California's Public Employment Relations Board challenging the Debtor's post-bankruptcy modification of certain leave, stand-by compensation, and pension plan benefits. The Court ruled that the union's actions violated that automatic stay and reasoned, in part, that the debtor had the power to unilaterally modify the contracts under § 365 of the Bankruptcy Code.

On March 21, 2024, the Court entered an order dismissing the debtor's chapter 9 petition, concluding that the district failed to meet its burden to provide it was insolvent within the meaning of §§ 109(c) and 101(32)(C) of the Bankruptcy Code, which the Court stated ensures that municipalities "are in bona fide financial distress before they are permitted to use federal law to impair existing contracts." On April 4, 2024, the District filed a notice of appeal to the United States District Court for the Northern District of California and the appeal is still pending as of the preparation of these materials.

III. Recent Trends and Interpretations

A. The "No Surprises Act"

The No Surprises Act ("NSA") protects people covered under group and individual health plans from receiving surprise medical bills when they receive most emergency services, non-emergency services from out-of-network providers at in-network facilities, and services from out-of-network air ambulance service providers. It also establishes an independent dispute resolution

process for payment disputes between plans and providers and provides new dispute resolution opportunities for uninsured and self-pay individuals when they receive a medical bill that is substantially greater than the good faith estimate from their provider. The NSA supplements state surprise billing laws already in place.

In 2023, two entities cited the NSA as one of their reasons for filing for chapter 11 protection. First, on May 15, 2023 Envision Healthcare Corporation ("Envision"), a national leading medical group, and 216 of its affiliated debtors, filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of Texas. The cases were jointly administered at Case No. 23-90342. Envision cited a "flawed" interpretation of the No Surprises Act as causing the company to lose hundreds of millions of dollars in delayed or reduced payments from insurers. *See*, *Declaration of Paul Keglevic, Chief Restructuring Officer of Envision Healthcare Corporation in Support of Debtors' Chapter 11 Petitions* [Doc. No. 2]. Envision ultimately emerged from bankruptcy having reduced its debt by 70%.

Similarly, on September 19, 2023, Tennessee-based hospital staffing firm, American Physicians Partners ("APP") filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. APP filed for chapter 11 protection seeking to complete the orderly winddown of its business affairs. argued that the regulatory implementation of the NSA favored insurers and allowed payors to "significantly delay and unilaterally reduce or deny payments." It is unclear what the impact of the No Surprises Act will be moving forward, but it may cause increased financial pressures for healthcare entities and, ultimately, lead to more filings.

B. Patient Ombudsman

Section 333 of the Bankruptcy Code requires that a bankruptcy court appoint a "patient care ombudsman" not later than 30 days after the commencement of any health care business's case "unless the court finds that the appointment is not necessary for the protection of patients under the specific facts of the case."[2] At least two bankruptcy courts addressed this provision in 2023. In *La Familia Primary Care, P.C.*, 2023 WL 5310817 (Bankr. D.N.M. Aug. 17, 2023), the United States Bankruptcy Court for the District of New Mexico determined that a small rural medical practice providing primary-care services did not qualify as a "health care business" and, even if it did, the appointment of a patient care ombudsman was not necessary to protect the practice's patients. Likewise, the United States Bankruptcy Court for the Southern District of New York concluded that a patient care ombudsman was not necessary for a dentistry and dental surgery facility absent allegations of patient care problems. *In re Parkchester Oral and Maxillofacial Surgery Associates PC*, 2023 WL 5761923 (Bankr. S.D.N.Y. Sept. 6, 2023). Moving forward, we may see reliance on these interpretations to limit the appointment of patient care ombudsman which creates a significant expense for the debtor's estates.

[2] Many courts have considered the following nine non-exclusive factors: (1) the cause of the bankruptcy; (2) the presence and role of licensing or supervising entities; (3) the debtor's past history of patient care; (4) the ability of the patients to protect their rights; (5) the level of dependency of the patients on the facility; (6) the likelihood of tension between the patients' interests and the debtor's interests; (7) the potential injury to the patients if the debtor drastically reduced its level of patient care; (8) the presence and sufficiency of internal safeguards to ensure appropriate level of care; and (9) the impact of the cost of an ombudsman on the likelihood of a successful reorganization. *In re Alternate Family Care*, 377 B.R. 754, 758 (Bankr. S.D. Fla. 2007)(internal citations omitted).

PART THREE:

LEASES AND FINANCING AGREEMENTS IN BANKRUPTCY

I. Bankruptcy Provisions Applicable to Discussion

A. Section 365 of the Bankruptcy Code

Section 365 of the Bankruptcy Code governs unexpired executory contracts and leases and is intended to "relief the estate of burdensome obligations while at the same time providing 'a means whereby a debtor can force others to continue to do business with it when debtor's bankruptcy filing might otherwise make them reluctant to do so.'" *In re Chateaugay Corp.*, 10 F.3d 944, 954-55 (2d Cir. 1993).

In chapter 9, 11, 12, or 13 cases, the debtor may assume or assign, or reject, an unexpired executory contract or lease any time prior to the confirmation of the plan. 11 U.S.C. § 365(d)(2). In a chapter 7 case, the trustee has sixty (60) days to assume or reject a lease unless otherwise extended by the bankruptcy court for cause. If an executory contract or lease is not assumed or rejected within that sixty (60) day timeframe, it is rejected as a matter of law.

In a chapter 11 case, the debtor must commence making lease payments and otherwise comply with the lease terms on the 61st day after the bankruptcy petition is filed. Specifically, §365(d)(5) requires the debtor in a chapter 11 case to "timely perform all of the obligations of the debtor…first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease…until such lease is assumed or rejected[.]" 11 U.S.C. §365(d)(5).

B. Assumption/Rejection of Leases

(i) Assumption

When the debtor assumes the lease, the debtor must (1) cure all defaults under the lease or provide assurance that it will do so; (2) compensate the landlord for any pecuniary loss resulting

from the breach of the lease; and (3) provide adequate assurance for future performance. 11 U.S.C. § 365(b). Sometimes, if the debtor is pursuing a sale, the debtor will assume and assign the lease. In that case, the debtor or the purchaser must cure all defaults under the lease and provide adequate assurance for future performance. In this case, the lessor oftentimes has the option to require additional security. Notably, a debtor is permitted to assign the lease regardless of any contractual prohibition of assignment in the subject lease.

Assumption of the lease can be done through a motion, included as party of a motion to approve sale under Section 363 of the Bankruptcy Code, or through the debtor's chapter 11 plan. The debtor is required to provide the contract counter-party with notice of the proposed cure amount to allow the counter-party time to object.

(ii) Rejection

When the debtor rejects the lease, the rejection is considered a breach of the lease as of the Petition Date and entitles the lessor to file a claim for rejection damages. Except for any post-petition amounts entitled to administrative expense priority, rejection damages are considered general unsecured claims.

II. Interplay of Commercial Real Estate and Bankruptcy

Per Epiq Data, in March 2023, commercial bankruptcy filings were seventy-nine percent (79%) higher compared to March 2022.[3] Commercial real estate has faced significant market pressures over the last few years due to post-pandemic work-from-home policies and rising inflation and interest rates. Specifically, as a response to inflation, the U.S. Federal Reserve significantly raised the benchmark interest rates to over five percent and hybrid work models has created downsizing or eliminating physical office spaces for some entities. A crash of the

[3] Bankruptcy Filings Increase Across All Chapters in March; Commercial Filings Up 79 Percent Year-over-year, EPIQ News, April 3, 2023 https://www.epiqglobal.com/en-us/resource-center/news/bk-filings-increase-across-all-chapters

commercial real estate market may be on the rise and will compound the existing distressed cycle as interest rates continue to rise. Less occupancy will result in defaults on leases and less renewals leading to a greater need to refinance.

Along these same lines, Real Estate Investment Trusts ("REITs") are companies that own and operate commercial real estate and generate income primarily through rental payments. When larger businesses file for bankruptcy protection, such as Bed, Bath & Beyond, REITs lose a significant portion of their rental income.

A. Bankruptcy Concerns Specific to Commercial Real Estate Landlords

(i) *Automatic Stay and Lease Security*

Once a commercial tenant files for bankruptcy, the landlord is prohibited from collecting debts from the tenant pursuant to the automatic stay. The automatic stay therefore prohibits the landlord from collecting on prepetition rent owed or the setoff of security deposits (other than most letters of credit and certain third-party guarantees).

Typically, commercial leases are secured by one or more of the following: (a) cash security deposit; (b) letter of credit; or (c) third-party guarantees. Each of these have certain implications when a tenant files for bankruptcy. With a cash security deposit, while this is the most liquid form of security to cure a defaulting defendant pre-bankruptcy, once the tenant files for bankruptcy, the deposit is considered part of the debtor-tenant's bankruptcy estate, and the landlord cannot take the security deposit absent court approval. While a letter of credit causes the landlord to take additional steps pre-bankruptcy filing after a tenant default, once the bankruptcy is filed letters of credit are typically not considered to be part of the debtor-tenant's estate, meaning that the landlord may have more flexibility to draw on the letter of credit while the debtor-tenant is in bankruptcy. Lastly, the Bankruptcy Code does not prohibit landlords from collecting against a non-bankrupt,

third-party guarantor, however collection may involve contentious litigation only to obtain a judgment against a judgment-proof guarantor.

(ii) *Cap on Rejection Damages*

The Bankruptcy Code sets a statutory limit on damages that a landlord may claim as a result of a debtor's lease rejection. 11 U.S.C. § 502(b)(6). Rejection damages are capped at the greater of either (1) the amount of rent due for one year following the effective date of the debtor's rejection of the lease; or (2) the rent due for fifteen percent (15%) of the remaining lease term, up to a maximum of three years. This cap applies to all claims resulting from the termination of the lease but is not reduced based on amounts received by the Landlord for re-letting the premises. *In re East Penn Children's Learning Academy, LLC*, 635 B.R. 243 (2021); *Solow v. PPI Enterprises (U.S.), Inc., et. al. (In re PPO Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d. Cir. 2003). The determination of the landlord's damages arising from a debtor's lease rejection is done in accordance with the terms of the lease and applicable state law and then limited by the Bankruptcy Code's cap.

The cap on damages is designed to strike a balance in giving a fair remedy to both the debtor and the landlord. While it compensates the landlord for their loss, it also ensures that the landlord does not receive a lion's share of the bankruptcy estate to the detriment of other creditors. *In re Titus & McConomy, LLP*, 375 B.R. 165 (Bankr. W.D. Pa. 2013). The legislative history behind the statutory cap suggests that it acts like a liquidated damage provision and takes into account that the landlord retains the property at the end of the lease.

(iii) *Landlord's Remedies in Bankruptcy*

Post-petition amounts owed are entitled to administrative authority under the Bankruptcy Code until the lease is assumed or rejected. If a debtor-lessee is failing to make the required post-

petition rent payments, a landlord may file a motion to compel administrative expense payment and compel assumption or rejection of the lease. Alternatively, a landlord may also seek relief from the automatic stay to exercise its rights under the lease. In either case, the landlord must seek court approval or risk a violation of the automatic stay and potential sanctions.

B. Practical Considerations for Commercial Landlords

(i) *Review Tenant's Financials and Consider Prebankruptcy Workout Alternatives*

Most commercial leases allow for the landlord to review the tenant's financials. If a tenant defaults under the lease or is consistently making delayed payments, the landlord may preemptively request and review the tenant's financials to prepare for a potential tenant bankruptcy filing. In the wake of the COVID-19 pandemic, commercial tenants relied on force majeure clauses or the defenses of impossibility and frustration of purpose to negotiate concessions from the commercial landlords. Given the market, landlords may consider forbearance agreements or other forms of an out-of-court workout to limit litigation and legal costs. This could also allow the landlord the opportunity to require additional collateral, such as guarantees or letters of credit.

(ii) *Monitoring Tenant's Bankruptcy Case and Service on UCC*

It is incredibly important for commercial landlords to have counsel review all filings to determine any impact on the landlord's rights. Additionally, a landlord may be asked and should consider serving on any official committee of unsecured creditors (the "UCC"). If the debtor-tenant contemplates rejecting the lease or has defaulted on the lease prepetition, Landlords are typically eligible to serve on the UCC, which is formed in some chapter 11 cases by the United States Trustee's Office. Depending on the size of the case, the UCC can play a central role in advocating for the general unsecured creditors and may allow the landlord to have a strong voice in the proceeding.

III. Interplay of Equipment Financing, Insurance Premium Financing and Bankruptcy

A. Insurance Premium Financing

Insurance premium financing is a popular tool by companies seeking to preserve cash by amortizing the expense over the policy period. Typically, the insured makes a down payment which, alongside a secured loan funded by the insurance company, is used to pay down the premium. These transactions are traditionally documented through a financing agreement with the collateral being an assignment of all rights, title and interest the Insured has in the financed policy including the "unearned" premium of the insurance policy to the financing company.

Debtors, Trustees, and other creditors have challenged a finance company's secured interest on unearned premiums. However, bankruptcy courts have overwhelmingly held that all that is required to vest a finance company with a security interest in unearned premium is the effective assignment and notice to the insurer.

B. Equipment Financing Concerns in Bankruptcy

(i) *Protections for Equipment Lessors*

Section 365(d) requires a debtor in a chapter 11 case to timely perform all of the debtor's obligations (including making lease payments) starting sixty (60) days after the lessee's bankruptcy filing. These payments must continue until the lease is assumed or rejected unless the court, based upon the equities of the case, orders otherwise. Section provides that the post-petiton entitled to administrative expenses. Section 503(b) allows lessors to still seek administrative expense claims for amounts due in the first sixty (60) days to the extent the equipment conferred a benefit on the debtor.

As set forth above, treatment of unexpired leases and executory contracts, which would include equipment leases, is codified in Section 365 of the Bankruptcy Code. Section 365 requires

a chapter 11 debtor-lessee to perform under the equipment lease after sixty (60) days from entry of the order of relief until the lease is assumed or rejected. A chapter 11 debtor is entitled to assume or reject an equipment lease at any time prior to confirmation of the chapter 11 plan. During this timeframe, the debtor-lessee is required to make all payments when due, however, this is also when the equipment lessors are most vulnerable and may experience non-payment or depreciation in the equipment's value. Therefore, it is critical for lessors to closely monitor payments and the debtor-lessee's use of equipment during this timeframe.

(ii) *Remedies if the Equipment is Used Post-Petition*

When the debtor-lessee fails to make payments as required under § 365, a lessor should consider filing a motion to compel payment or request the bankruptcy court require the debtor-lessee assume or reject the lease. In this motion, the equipment lessor will request payment for the post-petition amounts owed and also request the bankruptcy court require the debtor to assume or reject the lease within a certain timeframe to define the relationship between the parties going forward.

Bankruptcy courts will consider the equipment lessor's timeframe for the lessee-debtor to assume or reject a particular executory contract. The termination of "reasonableness" is within the bankruptcy court's pure discretion and is conducted on a case-by-case basis considering the cases circumstances. Bankruptcy courts has considered the following as to what constitutes "reasonable time" under section 365(d)(2): (a) the nature of the interests at stake; (b) the balance of harm to the parties; (c) the safeguards afforded to the parties; (d) the damage third parties may suffer; (e) the debtor's failure or ability to satisfy post-petition obligations; (f) the purposes of chapter 11; (g) the importance of the contract to the debtor's reorganization; and (h) whether the action taken is in so derogation of Congress' scheme as to be said to be arbitrary.

(iii) *Remedies if the Equipment is Not Used Post-Petition*

If the debtor-lessor is not using the equipment *and* not making its post-petition payments, the lessor may consider seeking relief from the automatic stay to obtain possession of the equipment or, alternatively, compel the debtor-lessee to assume or reject the lease. Due to the debtor-lessor not using the subject equipment, it may be more difficult for the equipment lessor to compel payment of post-petition rent as an administrative expense because it requires that the equipment lessor conveyed a benefit on the debtor-lessee. *See, e.g., In re Furley's Transp., Inc.*, 263 B.R. 733, 740–41 (Bankr. D. Md. 2001); *In re D.M. Kaye & Sons Transp., Inc.*, 259 B.R. 114, 119 (Bankr. D.S.C. 2001). The automatic stay can be terminated, modified, or conditioned under § 362(d) of the Bankruptcy Code (1) for cause, including lack of adequate protection of an interest in the property; or (2) if the debtor does not have equity in such property and the property is not necessary for the debtor's effective reorganization.

C. Practical Tips for Practitioners

It is important to pay close attention to the contents of § 363 sale motions and sale/bidding procedures motions in bankruptcy proceedings as these filings oftentimes provide for critical leases, such as equipment leases, to be assigned to the purchaser. The cure amount will be identified in these pleadings and sometimes debtors will identify the cure amount as $0.00. If the lessor fails to object, the lessor will be unable to assert claims going forward for amounts owed under the lease.

PART ONE
MATERIALS

KeyCite Yellow Flag - Negative Treatment
Distinguished by In re CPESAZ Liquidating, Inc., 9th Cir.BAP (Cal.), June 2, 2023

604 B.R. 408
United States Bankruptcy Court, D. New Mexico.

IN RE: INDIAN JEWELERS SUPPLY CO., INC., Debtor.

No. 17-11874 t11
|
Signed June 6, 2019

Synopsis
Background: Corporate Chapter 11 debtor objected to proofs of claim filed by its former employees.

Holdings: The Bankruptcy Court, David T. Thuma, J., held that:

[1] retired employee who had "put" her shares in employee stock ownership plan (ESOP) and received a promissory note from debtor had to be treated as "creditor," rather than as equity security holder, and

[2] terminated employees were likewise "creditors" for the value of their vested balances in ESOP plan, whose proofs of claim could not be disallowed because they were interest holders.

Objections overruled.

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

West Headnotes (8)

[1] **Bankruptcy** Evidence

In contested matter arising out of Chapter 11 debtor's objections to its former employees' proofs of claim, bankruptcy court could take judicial notice of its docket. Fed. R. Evid. 201.

[2] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Employees of a debtor that files for bankruptcy may be equity security holders, rather than creditors, to extent that they participate in debtor's employee stock ownership plan (ESOP).

[3] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Retired employee of corporate Chapter 11 debtor who, after participating in debtor's employee stock ownership plan (ESOP) and receiving distribution of stock upon her retirement, had "put" her shares to debtor and been issued a promissory note based upon value of those shares, was no longer an "equity security holder," but a "creditor" for amount owing on promissory note, whose proof of claim could not be disallowed because she was an interest holder. 11 U.S.C.A. § 502(b).

1 Case that cites this headnote

[4] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Laid off employee of corporate Chapter 11 debtor who, despite requesting a distribution of his vested interest in employee stock ownership plan (ESOP) upon termination of his employment, a distribution that would have allowed him to "put" the stock to debtor and receive the value of his shares, still had not received such a distribution nearly five years post-termination, had to be treated as "creditor" of debtor for value of his shares, rather than as equity security holder, whose proof of claim could not be disallowed on theory that he had no "claim"; it would be unfair to treat laid off employee as equity holder based solely on debtor's breach of its obligation, under ESOP plan documents that were in effect at time, to make prompt distribution to retired or terminated employees. 11 U.S.C.A. § 502(b).

[5] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Labor and Employment Retroactive change of eligibility or coverage rules or reduction in benefits

Corporate Chapter 11 debtor, by unilaterally modifying the documents governing its employee stock ownership plan (ESOP) less than two months before it fired employee, could not affect his right, as a vested participant in ESOP plan, to receive prompt distribution of his vested balance following his discharge, so that this discharged employee had to be treated as "creditor" of debtor for value of his vested account balance, whose proof of claim could not be disallowed because he was equity security holder; allowing debtor to unilaterally modify employee's rights once they had vest would violate implied covenant of good faith and fair dealing. 11 U.S.C.A. § 502(b).

[6] **Contracts** Terms implied as part of contract

Under New Mexico law, contracts contain an implied covenant of good faith and fair dealing.

More cases on this issue

[7] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Labor and Employment Amount of Benefit and Form of Distribution

Change in documents governing Chapter 11 debtor's employee stock ownership plan (ESOP), under which retired and terminated employees had previously been entitled to "prompt" distribution of their vested balances in ESOP plan, so that such employees were now entitled to distribution "no later than" five years after they retired or were terminated, was ambiguous as to whether it allowed debtor to wait five years before making a distribution, or whether it instead required debtor to make distribution within a reasonable time, but in no event any later than five years after cessation of plan participant's employment, and would be interpreted against debtor, as drafter, to give discharged employee a right to payment within reasonable time and thus to confer "creditor" status on employee. 11 U.S.C.A. § 101(10).

1 Case that cites this headnote

[8] **Bankruptcy** Claims by insiders and by attorneys in excess of value

Even if it were not breach of contract, given changes that corporate Chapter 11 debtor had unilaterally made to documents governing its employee stock ownership plan (ESOP) less than two months before firing employee, for debtor to refuse to promptly distribute to employee his vested balance in ESOP plan following termination of his employment, it would be unfair, given debtor's conduct, to treat employee as equity holder and thus to disallow his proof of claim for value of his vested interest in ESOP plan. 11 U.S.C.A. § 502(b).

1 Case that cites this headnote

Attorneys and Law Firms

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OPINION

Hon. David T. Thuma, United States Bankruptcy Court

Three former employees filed claims based on the debtor's defunct employee stock ownership plan ("ESOP"). Debtor objected to the claims, arguing that the claimants were stockholders, not creditors, because the ESOP held debtor's stock in trust for them. As a general matter, the Court agrees with the proposition that employees of a corporation with an ESOP are equity security holders to the extent of their vested ESOP interests. On the other hand, the Court finds and concludes that *former* employees of the corporation, who were or should have been "cashed out" of their ESOP interest years before, are creditors rather than stockholders. As the three claims at issue fall in the latter ***410** category, the Court will overrule the objections.

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I. FACTS

[1] The Court finds: [1]

Debtor Indian Jewelers Supply Co., Inc. a New Mexico corporation founded in 1943, was a wholesale and catalog distributor of precious metal, semi-precious gem-stones, tools, equipment, and supplies used to make Indian and southwestern jewelry. Debtor was founded in 1943 and operated until July, 2017.

Pierce Notah, Riley Valentino, and Carolyn Bowen are former employees of the Debtor. Messrs. Notah and Valentino were laid off pre-petition, while Ms. Bowen retired pre-petition.

In 1976 the Debtor established an ESOP. As stated in the plan documents, the ESOP was to:

> (i) provide for [employee's] future financial security by deferring a portion of their compensation and having those funds accumulate under the Plan; (ii) share in the growth and prosperity of the Company; and (iii) accumulate capital for their future economic security; and (iv) acquire beneficial stock ownership interests in the Company.

Pursuant to a related trust agreement, all of Debtor's stock in the ESOP was held in trust for participating employees. There was a vesting schedule. Once an employee was fully vested, she was entitled to receive her allocated shares of Debtor's stock after she retired, quit, or was laid off. The ESOP was governed by the federal Employee Retirement Income Security Act, 29 U.S.C. § 1001 et seq. ("ERISA").

The ESOP documents went through a number of revisions over the years. The Court does not have all the iterations of the plan documents. The record includes the following:

- Indian Jewelers Supply Co. Employees Stock Ownership Plan Benefit Distribution Policy, dated January 1, 2009;
- First Amendment to the Indian Jewelers Supply Co. Employees Stock Ownership Plan, signed December 20, 2011;
- Indian Jewelers Supply Company Employees Stock Ownership Plan Distribution Policy (Effective as of September 1, 2012);
- Summary of Material Modifications to the Summary Plan Description of Indian Jewelers Supply Co. Employees Stock Ownership Plan (effective September 1, 2012);
- Second Amendment to the Indian Jewelers Supply Co. Employees Stock Ownership Plan (dated October 18, 2012);
- Fourth Amendment to the Indian Jewelers Supply Co. Employees Stock Ownership Plan (undated, but apparently intended to become effective September 30, 2013);
- Employee Stock Ownership and 401(k) Plan (As amended and Restated Generally Effective as of April 1, 2014);
- ESOP Component-Distribution Election Information; and
- Summary of Material Modifications to the Summary Plan Description of Indian Jewelers Supply Company Employee Stock Ownership Plan;

***411** The ESOP also allowed for some diversification of an employee's account. Although most of the claimants' accounts held Debtor's stock, they each had relatively small amounts of cash or other investments.

The ESOP's rules about distributing shares to laid-off employees changed in 2014. The rule on January 1, 2009, was:

> 2. Termination of Service for a Reason Other than Retirement, Death or Disability: If a Participant terminates Service because of designation by the Company as a laid-off employee distribution of his Company Stock Account will be offered to him

> *beginning as soon as practicable following his termination.* [2]

(emphasis added). This rule was re-written as of September 1, 2012:

> Timing of Distributions. Effective as of September 1, 2012, when you terminate employment on or after age 65 or due to Total and Permanent Disability or death, distribution of your Account will begin as soon as practicable in the Plan Year (which ends on March 31) following the Plan Year in which your termination occurs. If, however, you are laid off, distribution of your Account will begin *as soon as practicable following your termination.* [3]

(emphasis added). Debtor changed the rule again as of April 1, 2014:

> Termination of Employment for a Reason Other than Death, Disability or Retirement. In the case of a Participant who terminates employment with all of the Employers for a reason other than retirement on or after attaining his Normal Retirement Age, Total and Permanent Disability or death, the Committee will direct the Trustee to commence distribution of the Participant's vest Account as follows:
>
> ....
>
> (ii) Participant's Vested Account Exceeds $ 5,000. Subject to subsections 8.5(c) and 8.5(d), if the Participant's vested Account exceeds $ 5,000 on the date payment is to be made or commence, his vested 401(k) Account will be distributed as soon as administratively practicable following the Participant's termination of employment and his vested ESOP Account will be distributed *no later than the end of the Plan Year following the earlier of: (A) the end of the fifth Plan Year following the Plan Year in which the Participant terminates employment*; or (B) the end of the Plan Year in which the Participant attains Normal Retirement Age. [4]

(emphasis added).

Debtor's stock was not publicly traded. Because there was no ready market for the stock, the ESOP included a "put" option, which if exercised obligated the Debtor to buy the distributed shares from the former employee at their fair market value. Fair market value was determined by an independent appraiser. If the value of the "put" shares was more than $ 25,000, the Debtor had the right to pay for the shares over five years in equal annual payments.

The appraised value of the Debtor's stock declined dramatically between 2010 ***412** and 2016: [5]

Valuation Date	Appraised debtor value	Total Shares Outstanding	Value Per Share	Valuation company
3/31/2010	$3,405,000	1,034	$3,292	Prairie Capital
3/31/2011	$3,918,000	1,034	$3,788	Prairie Capital
3/31/2012	$3,867,000	1,034	$3,739	Prairie Capital
3/31/2013	$1,624,000	1,034	$1,570	Prairie Capital
3/31/2014	$1,381,000	1,034	$1,335	Prairie Capital
12/31/2014	$406,000	1,034	$392	Prairie Capital
12/31/2015	$472,000	1,034	$456	Valuation Advis. Services
12/31/2016	$23,000	759	$30	Valuation Advis. Services

Carolyn Bowen was employed from 1993 until 2013. She participated and was fully vested in the ESOP. When Ms. Bowen retired in December 2013 at age 74, she asked for distributions of all Debtor shares and diversified investments. Ms. Bowen received some cash for her diversified accounts. In May 2015 the ESOP distributed her Debtor shares to her. Ms. Bowen exercised her right to "put" the shares to the Debtor and receive cash. The Debtor gave her a promissory note dated May 19, 2015 for $ 25,923.11, payable in five equal annual payment of $ 5,184.62, with the first payment due May 19, 2015. [6] Because of the tax laws governing ESOP distributions, Ms. Bowen had to pay income tax on the entire $ 25,923.11 in 2015.

On October 24, 2017, Ms. Bowen filed a claim for $ 21,554.87. Her claim is based entirely on the unpaid balance of the promissory note she received in May 2015.

Pierce Notah worked for Debtor from 1981 until 2012. According to a letter Mr. Notah filed with the Court on July 27, 2018:

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> I worked 36 years for this company and put my best effort to travel 80 miles a day to work. The last year I got an eye injury during working there.

Mr. Notah was laid off in October 2012. He was 59 at the time. The last statement sent to Mr. Notah from the ESOP, for the period 4/1/2011 through 3/31/2013, showed:

***413**

	Beginning balance	Contributions	Earnings	Shares released due to contribution	Shares reallocated	Ending balance
Money market account	$1,881.81	$2,475.59	($48.40)		($238.54)	$4,070.47
Company stock account	37.656			1.072	0.052	38.780
Total value of company stock (price per share: $3,739.01)	$144,999.23					
Total Money Market Account	$4,070.47					
Total Account Balance as of March 31, 2012	$149,069.69					
Total Vested Account Balance as of March 31, 2012	$149,069.69					
Vesting Percentage	$100.00%					

The ESOP did not comply with the plan requirement to distribute Mr. Notah's Debtor shares "as soon as practicable" after he was laid off. In fact, no stock distributions were made to Mr. Notah in the nearly five years that elapsed between his termination and Debtor's bankruptcy filing.

Mr. Notah attempted from time to time to receive payment on his ESOP account. He stated in his July 27, 2018, filing:

> I and other employees were told this ESOP plan was to be distributed to us when we leave the company after one year to the anniversary of the following year. Since I was let go on October 12, 2012, I should've already been paid on October 12, 2013 on my ESOP plan. David Vining was CEO at the time and Chris Caldes was the General Manger [sic], and trustee of this plan, also Joe Ward was too, at time I was let go. Linda Zachary was a new Trustee to the plan, after contacting her about being paid on my ESOP, she told me I will be paid out on later date, which never happened to this date. She also gave me a hard time with it, not answering question, or accepting phone calls, and refusing to meet me.

On October 2, 2017, Mr. Notah filed a claim for $ 149,069.69. The stated basis of the claim is "retirement claim." Attached are annual ESOP statements from 3/31/2008 through 3/31/2012.

Riley Valentino, a former employee, was laid off on May 29, 2014. He never received a distribution of his vested Debtor shares. Mr. Valentino filed a proof of claim for $ 23,133.92 on October 5, 2017.

In the years leading up to the bankruptcy filing, the Debtor began delaying the purchase of shares "put" to it by retiring or laid off employees. On December 20, 2011, the Debtor suspended making distributions entirely until it could re-value its stock. Distributions were resumed on September 1, 2012. On February 7, 2014, the Debtor notified Ms. Bowen that it would buy her "put" shares over time rather than in a lump sum.[7] In a January 8, 2015, letter to ESOP participants, the Debtor said that it "is currently exploring options for funding distributions and diversifications to eligible participants." In a February ***414** 27, 2015 letter to participants, the Debtor notified them that stock payouts would be by promissory note. The Debtor began issuing promissory notes to buy stock rather than pay cash.[8] In March 2017, Debtor defaulted on its promissory note obligations to former employees.[9]

Debtor filed this case on July 21, 2017, immediately after terminating its employees ceasing all business operations.

On July 11, 2018, Debtor objected to all ESOP-related claims (the "Equity Security Objection"), including the Bowen, Notah, and Valentino claims, arguing that the claimants hold equity securities, not debt. Bowen, Notah, and Malentino responded to the claim objection. On the same date, Debtor objected to the claims of Ms. Bowen and two other former employees who were given promissory notes by the Debtor (the "Noteholder Objection"). In the Noteholder Objection the Debtor asks the Court to "correctly classify" Ms. Bowen's interest as an equity security interest rather than a debt claim.

Mr. Valentino did not attend the preliminary hearing on the claim objection and the Court entered a default order

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disallowing his claim (the "Default Order"). Mr. Valentino filed a motion to set aside the Default Order, saying he was ill on the preliminary hearing date and could not attend. Mr. Valentino appeared at the final hearing on the claim objection. The Court took under advisement his request to set aside the Default Order and allowed Mr. Valentino to participate in the final hearing.

II. DISCUSSION

A. Debtor's Claim Objection.

The claim objection states:

> 2. Although most of the claims were inaccurate, the Debtor is not challenging the amount of the claim at this time only the categorization and general unsecured claims. There will not be enough funds to pay all general unsecured claims in full so the ESOP claimants, unfortunately, are expected to receive no dividend for their ESOP interest.
>
> 3. The ESOP participants are equity security holders under the Bankruptcy Code, Code section 101(16), and under both under the Bankruptcy Code and New Mexico Law, cannot receive payment if creditors will not be paid.
>
> ....
>
> WHEREFORE, [the claims] should be Disallowed as unsecured claims and treated as equity for the purposes of the Chapter 11 Plan.

Thus, Debtor is not asking the Court to equitably subordinate the claims, *see, e.g., In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977) (oft-cited case on equitable subordination), nor to recharacterize the debt claims as equity, *see generally In re S.M. Acquisition Co.*, 2006 WL 2290990, at *8 (N.D. Ill. June 7, 2006) (discussing the elements needed to recharacterize debt as equity), but simply to rule that the claimants hold equity securities. Debtor cites 11 U.S.C. § 101(16) and (17), which provide:

> (16) The term "equity security" means--
>
> (A) share in a corporation, whether or not transferable or denominated "stock", or similar security;
>
> (B) interest of a limited partner in a limited partnership; or
>
> (C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest ***415** of a kind specified in subparagraph (A) or (B) of this paragraph.
>
> (17) The term "equity security holder" means holder of an equity security of the debtor.

B. Treatment of ESOP Claims in Bankruptcy.

[2] Employees of a debtor who files bankruptcy may be equity security holders to the extent they participate in the debtor's ESOP. *See, e.g., In re Mansfield Ferrous Castings, Inc.*, 96 B.R. 779, 781 (Bankr. N.D. Ohio 1988) (as participants in and beneficiaries of the ESOP Trust which holds the debtor's stock, employees are equity security holders); *In re Merrimac Paper Co.*, 420 F.3d 53, 64 (1st Cir. 2005) (during period of employment, an ESOP participant is functionally a stockholder); *see generally Matter of Envirodyne Indus., Inc.*, 79 F.3d 579 (7th Cir.1996) (stock redemption claims are in essence equity security claims).

The claims of terminated or retired employees are different. The leading case on this point is *Merrimac Paper*. In *Merrimac Paper* the debtor brought an adversary proceeding to equitably subordinate the claim of a retired employee. The former employee's claim was based on a stock redemption note he received from the debtor when he "put" his ESOP shares to the debtor for purchase. The bankruptcy court and the district court ruled that his note claim should be equitably subordinated. The First Circuit reversed, holding:

> [T]he stock redemption transaction in this case occurred within the ERISA framework. That matters because a participant in an ERISA plan does not assume the same levels of risk as a typical equity investor. Indeed, one of ERISA's principal purposes is to minimize risks to a participant's retirement benefits. *See* 29 U.S.C. § 1001(b); *see also Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 375, 100 S. Ct. 1723, 64 L.Ed.2d 354 (1980) (stating that ERISA seeks to ensure that "if a worker has been promised a defined pension benefit upon retirement—and if he has fulfilled whatever conditions are required to obtain a vested benefit—he will actually receive it"). Thus, although the employee's position entails market risk during the period of employment (the ESOP holds the stock in trust for its participants, and so the employee is, functionally, a stockholder), ERISA seeks to eliminate that risk once retirement occurs. The ordinary repurchase by a company of its stock carries with it the implied condition that payment is contingent on the fulfillment of obligations to other creditors. *Cf Robinson v.*

> *Wangemann,* 75 F.2d 756, 757–58 (5th Cir.1935) (implying the existence of such a condition). The mandates of ERISA, however—particularly its requirement that the holders of ESOP-spawned stock redemption notes be given adequate security—argue persuasively against the implication of any such condition where an ERISA-qualified ESOP is involved.

420 F.3d at 64. The Court finds *Merrimac Paper's* analysis persuasive. Employees are not typical investors. Retired and terminated employees, in particular, view their ESOP accounts as retirement accounts whose value is fixed on the date of termination, especially when their former employer is obligated to buy the ESOP shares at fair market value.

C. Whether the Objections Should be Sustained as to Bowen, Notah, and Valentino.

[3] 1. Ms. Bowen. In Ms. Bowen's case, Debtor's objection must be overruled. Ms. Bowen does not hold an equity security; she holds a promissory note. While it would be possible for the Debtor to file an ***416** adversary proceeding to recharacterize or equitably subordinate Ms. Bowen's note, it has not done so. [10] Whether such a proceeding would be successful is questionable, given the *Merrimac Paper* analysis. [11] The relief Debtor has sought, i.e., disallowance of the claim because Ms. Bowen holds an equity security, cannot be granted. Ms. Bowen holds a debt instrument.

[4] 2. Mr. Notah. Mr. Notah's situation is different, but the Court concludes that the result should be the same. There is no question that Mr. Notah would have "put" his shares to the Debtor had he been given the chance to do so. Through no fault of his own, the Debtor refused to distribute Mr. Notah's vested shares to him, even though the Debtor was obligated to do so "as soon as practicable." It would be unfair to treat Mr. Notah's situation differently than Ms. Bowen's simply because the Debtor complied with the ESOP distribution rules in her case but not in his. [12] The Court finds and concludes that Mr. Notah's claim against the Debtor is a debt claim, not an equity claim.

3. Mr. Valentino. The Court rules that Mr. Valentino's motion to set aside the Default Order is well taken and should be granted, based on Mr. Valentino's excusable neglect. *See* Bankruptcy Rules 9014 and 7054 and Fed. Rules of Civ. Pro. 54 and 60(b)(1). The Court finds credible Mr. Valentino's testimony that he was ill on the day of the preliminary hearing and could not attend. The Court makes some allowance for the fact that Mr. Valentino is pro se, is not sophisticated in legal matters, responded to the claim objection timely, promptly filed the motion to set aside the Default Order, and attended the final hearing on the claim objection.

[5] **[6]** The Court finds that, on the merits, the Debtor's objection to Mr. Valentino's claim should be overruled. Mr. Valentino was laid off more than three years before Debtor filed this case. Debtor changed the ESOP language about distributions to laid off employees less than two months before firing Mr. Valentino. The language went from "as soon as practicable but not later than" to "not later than ...." The Court questions whether the Debtor can unilaterally reduce an employee's vested retirement rights *ex post facto* and without consent. Under New Mexico law (see § 10.4 of the Plan), there is an implied covenant of good faith and fair dealing. *See, e.g.,* ***417** *Bogle v. Summit Investment Co., LLC*, 137 N.M. 80, 87-88, 107 P.3d 520 (Ct. App. 2005). The Court finds and concludes that it would violate the implied covenant of good faith and fair dealing to take a long-term employee's vested ESOP right to be paid "as soon as practicable" and change it to "five years after being laid off" right before firing him.

[7] Third, the Court finds that the plan language is ambiguous. "No later than" could mean "probably not until," or it could mean "within a reasonable time but no later than." The Court will construe the ambiguity against the drafter. *See, e.g., Heye v. American Golf Corp., Inc.*, 134 N.M. 558, 563, 80 P.3d 495 (Ct. App. 2003) Long before Debtor filed this case, it should have purchased Mr. Valentino's distributed ESOP shares and paid him cash and/or a note.

[8] Finally, even if was not a breach of contract for the ESOP to refuse to distribute Mr. Valentino's shares, upon termination Mr. Valentino's interest in the ESOP changed from a plan participant to a frustrated creditor, trying to collect his retirement benefits from the Debtor. Given all of the circumstances of this case, it would not be fair to treat Mr. Valentino as an equity security holder.

III. CONCLUSION

Former employees with claims that arise under a debtor's ESOP should not necessarily be viewed as equity security holders. In Ms. Bowen's case, it is clear she holds a note, not stock. Equitably subordinating or recharacterizing the note would be an uphill battle, given *Merrimac Paper*, but Debtor has not sought those remedies. Mr. Notah's and Mr.

Valentino's claims should have been the same as Ms. Bowen's, but for the ESOP's inexcusable refusal to distribute their vested shares after Debtor laid them off. Separate orders will be entered overruling Debtor's claim objections and granting Mr. Valentino's motion to set aside the Default Order.

All Citations

604 B.R. 408, 67 Bankr.Ct.Dec. 87

Footnotes

1 The Court took judicial notice of its docket. *See St. Louis Baptist Temple, Inc. v. Fed. Deposit Ins. Corp.*, 605 F.2d 1169, 1172 (10th Cir. 1979) (holding that a court may sua sponte take judicial notice of its docket); *LeBlanc v. Salem (In re Mailman Steam Carpet Cleaning Corp.)*, 196 F.3d 1, 8 (1st Cir. 1999) (same).

2 Indian Jewelers Supply Co. Employees Stock Ownership Plan Benefit Distribution Policy, dated January 1, 2009.

3 From the Summary of Material Modifications to the Summary Plan Description of Indian Jewelers Supply Co. Employees Stock Ownership Plan (effective September 1, 2012).

4 Employee Stock Ownership and 401(k) Plan (As amended and Restated Generally Effective as of April 1, 2014)

5 According to a February 7, 2014, letter from the ESOP's counsel to Ms. Bowen's counsel, Debtor retained a new stock appraisal firm to value the shares held by the ESOP. The new firm, Prairie Capital, reappraised the stock value for the years ended March 31, 2010, 2011, and 2012.

6 The stock value was substantially less than Ms. Bowen had been led to believe she would receive on retirement. While her account statement for the plan year ending March 2012 showed a balance of $ 99,854.24, revised figures for March 31, 2013 reflected a balance of $ 45,320.16. The reduction was entirely the result of the decrease in the value of the Debtor's stock.

7 Ms. Bowen had asked for ESOP distributions several years before she retired. Although the plan documents allow for such "in service" distributions, the plan administrator did not tell Ms. Bowen about that option, so she never followed up on it.

8 May 19, 2015 letter to Ms. Bowen.

9 March 27, 2017 letter to note holders.

10 The Court does not view the either objection as asserting a cause of action for equitable subordination or recharacterization. The Noteholder Objection comes closer to seeking recharacterization, perhaps, but falls short. Such equitable causes of action must be brought by adversary proceeding, *See* Fed. R. Bankr. P. 7001 (7) and (8), and should allege the elements of a recharacterization claim. In the Noteholder Objection the Debtor again cites 11 U.S.C. § 101(16), so it is difficult to say that it is fundamentally different than the Equity Security Objection. The Court's ruling is without prejudice to the Debtor's right to bring an equitable subordination/recharacterization adversary proceeding.

11 Like in *Merrimac*, "by structuring the transaction to play out over time, the debtor placed the appellant in his present predicament as a noteholder." 420 F.3d at 64. The Court, like the court in *Merrimac*, concludes that

under such circumstances "there is a strong policy argument that the Note should be viewed for what it is: a note received in partial payment of retirement plan benefits." *Id.* at 64-65.

12 One difference between the two is that Ms. Bowen retained able counsel to represent her in her demand for a payout, while Mr. Notah did not. It does not reflect well on the Debtor that it responded promptly to Ms. Bowen's demands but brushed Mr. Notah aside for nearly five years, and then objected to his claim.

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2023 WL 3773642
NOT FOR PUBLICATION
United States Bankruptcy Appellate Panel of the Ninth Circuit.

IN RE: CPESAZ LIQUIDATING, INC., fka Community Provider of Enrichment Services, Inc.; NDS Liquidating, Inc., fka Novelles Developmental Services, Inc.; CPESCA Liquidating, Inc., fka CPES California, Inc., Debtors.
Robert Bennetti; Linda Mariano; Linki Peddy; Charles Foust, Jr.; CPES, Inc., Employee Stock Ownership Plan and Trust Participants, Appellants,
v.
Oxford Restructuring Advisors LLC, Appellee.

BAP Nos. CC-22-1156-FSG, CC-22-1157-FSG (Related Appeals)
|
Bk. No. 9:20-bk-10554-DS
|
FILED JUNE 2, 2023

Appeal from the United States Bankruptcy Court for the Central District of California, Deborah J. Saltzman, Bankruptcy Judge, Presiding

Attorneys and Law Firms

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Russell Clementson, Los Angeles, CA, Brian David Fittipaldi, US Department of Justice, Santa Barbara, CA, Kenneth Misken, Office of the United States Trustee, Los Angeles, CA, for U.S. Trustee.

Before: FARIS, SPRAKER, and GAN, Bankruptcy Judges.

MEMORANDUM [*]

INTRODUCTION

***1** The chapter 11 [1] debtors created an employee stock ownership plan, or ESOP, under which the debtors contributed cash and shares of their stock to a trust for the benefit of their employees. Former employees of the debtors asserted claims against the debtors based on their rights in the ESOP. The bankruptcy court disallowed their claims, holding that the employees had rights against the ESOP trust but that those rights did not give them any claim against the debtors.

The employees fail to establish an entitlement to payment from the debtors: the debtors were not obligated to the employees under the ESOP, and the employees' claims were duplicative of claims asserted by the ESOP trustee. We therefore AFFIRM.

FACTS

A. Prepetition events

Community Providers of Enrichment Services, Inc. ("CPES") and its subsidiaries, Novelles Developmental Services, Inc. and CPES California, Inc. (collectively, the "Debtors"), [2] provided behavioral health services in California and Arizona. The latter two entities were wholly-owned subsidiaries of CPES. CPES was an S corporation; in order to maintain that status, CPES could not have more than 100 shareholders. 26 U.S.C. § 1361.

CPES created an ESOP for the benefit of all three companies' employees. Appellants Robert Bennetti, Linda Mariano, Linki Peddy, and Charles Foust, Jr. (the "ESOP Participants") [3] are participants in the ESOP.

The ESOP was governed by the CPES Employee Stock Ownership Plan ("ESOP Plan") and CPES Employee Ownership Trust Agreement ("ESOP Agreement"). Under these documents, CPES created a trust that held all of CPES's stock. The ESOP trust is operated by a trustee and a committee, both of which are selected by CPES's board of directors.

Section 13 of the ESOP Plan provided for distributions to plan participants as directed by the ESOP committee. The distributions may be made in CPES stock, cash, or both. However, because CPES was an S corporation, distributions could be restricted to cash payments:

> (b) ... **[W]hile CPES is an S Corporation, the distribution of a**

> **Participant's Capital Accumulation may be made entirely in cash without granting him the right to demand distribution in shares of CPES Stock**. Alternatively, CPES Stock may be distributed subject to the requirement that it be immediately resold to CPES under payment terms that comply with Section 14.(b).

***2** (Emphasis added.)

Section 19 of the ESOP Plan provided that, upon termination of the plan, "the Accounts of the affected Participants ... will become fully vested as of that date.... A complete discontinuance of Employer Contributions shall be deemed to be a termination of the Plan for this purpose." Plan termination could trigger distribution of participants' benefits.

CPES appointed Miguel Paredes of Prudent Fiduciary Services, LLC as trustee of the ESOP ("ESOP Trustee").

B. The chapter 11 case

In 2020, the three Debtors filed chapter 11 petitions. The bankruptcy court later approved the sale of the Debtors' assets. [4]

The bankruptcy court approved an amended joint plan of reorganization ("Liquidation Plan") in May 2021. [5] The Liquidation Plan called for liquidating the Debtors, which would result in a 100% payout to unsecured creditors and a surplus for the ESOP, as stockholder of CPES. [6] Appellee Oxford Restructuring Advisors, LLC was appointed liquidating trustee of the CPES Liquidating Trust (the "Liquidating Trustee").

C. The proofs of claim

In the meantime, on September 29, 2020, dozens of ESOP participants filed proofs of claim for various dollar amounts. The proofs of claim were filed with a claims agent and later filed under seal. [7]

The following day, the ESOP Trustee, on behalf of the ESOP, filed two proofs of claim. The first claim asserted an unsecured claim for $255,150, for "all amounts due to the ESOP related to participant distributions that were made based on the prior 2018 stock value." He stated that, based on his review, CPES had inflated the valuation of its stock in 2018, that distributions to ESOP participants based on that valuation had been too large, and that as a result, the ESOP had less assets for the other participants than it should have had.

In the second claim, the ESOP Trustee asserted that the ESOP held 100% of CPES's shares and that "the ESOP, on behalf of the participants, asserts a proof of interest for its equity interests in the Debtor. The ESOP, on behalf of the participants, also asserts a proof of claim for all amounts due to the ESOP related to its equity interests in the Debtor."

D. The omnibus objections

***3** The Liquidating Trustee filed a pair of omnibus objections [8] to the ESOP Participants' proofs of claim. It argued that the ESOP Participants' proofs of claim did not support claims against the Debtors, because the ESOP Participants had rights against only the ESOP trust. It also argued that the ESOP Participants' claims were duplicative of the ESOP Trustee's claims and lacked sufficient information.

The ESOP Participants opposed the omnibus objections. They argued that the Debtors had an obligation to repurchase company stock distributed to plan participants and beneficiaries under 26 U.S.C. § 409(h)(1)(B), and that the ESOP participants are entitled to exercise a "put" option and force the Debtors to repurchase the company stock under 26 U.S.C. § 409(h)(4). They acknowledged that this requirement does not apply to S corporations such as CPES "if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash...." 26 U.S.C. § 409(h)(2).

The ESOP Participants argued that the termination of the ESOP triggered the Debtors' repurchase obligations. They concluded that their rights under the Debtors' repurchase obligations are "at parity" with unsecured creditors under Arizona state law.

They also argued that their proofs of claim provided sufficient information and were not duplicative of the ESOP Trustee's claims.

The bankruptcy court sustained the objections, holding that the ESOP Participants held no claims against the Debtors. It

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noted that "(1) the Debtors are S corporations, which exempts them from the requirements of 26 U.S.C. § 409(h)(1), and (2) the ESOP Participants were never given debt instruments of any kind...." It explained that, because "CPES Stock is held in the CPES ESOP and is never distributed directly to ESOP Participants, it does not appear that the Debtor owes any direct obligation to the Participants...."

The bankruptcy court summarized:

> There is not a "put" option in the CPES ESOP. The Debtors are not required to repurchase stock held by ESOP Participants because ESOP Participants do not hold stock under the CPES ESOP. The Debtor contributes cash to the ESOP or repurchases stock held *in the ESOP Trust*, which allows the ESOP to fund distributions. The ESOP Participants simply have not shown that this is a direct obligation of the Debtors. Accordingly, the claim must be disallowed.

The court also held that the ESOP Participants' claims were duplicative of the ESOP Trustee's claims. It agreed with the Liquidating Trustee "that the ESOP Trustee is the only party with the authority to sue, defend, compromise, arbitrate, or settle any suit or legal proceeding or any claim due it or on which it may be liable...." However, it disagreed with the Liquidating Trustee's position that the claims lacked sufficient information.

The bankruptcy court entered orders sustaining the Liquidating Trustee's two omnibus objections. The ESOP Participants timely appealed.

JURISDICTION

***4** The bankruptcy court had jurisdiction under 28 U.S.C. §§ 1334 and 157(b)(2)(B). We have jurisdiction under 28 U.S.C. § 158.

ISSUE

Whether the bankruptcy court erred in disallowing the ESOP Participants' claims.

STANDARDS OF REVIEW

In the claim objection context, we review the bankruptcy court's legal conclusions de novo and its findings of fact for clear error. *Lundell v. Anchor Constr. Specialists, Inc. (In re Lundell)*, 223 F.3d 1035, 1039 (9th Cir. 2000).

"De novo review requires that we consider a matter anew, as if no decision had been made previously." *Francis v. Wallace (In re Francis)*, 505 B.R. 914, 917 (9th Cir. BAP 2014).

Factual findings are clearly erroneous if they are "illogical, implausible, or without support in the record." *Retz v. Samson (In re Retz)*, 606 F.3d 1189, 1196 (9th Cir. 2010). If two views of the evidence are possible, the court's choice between them cannot be clearly erroneous. *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985).

DISCUSSION

A. The ESOP Participants do not have any enforceable claim against the Debtors.

The bankruptcy court held that the ESOP Participants do not have any rights against the Debtors and so do not have any enforceable claims against the Debtors. We agree; the ESOP Participants' rights under the ESOP do not make them unsecured creditors of the Debtors.

The Bankruptcy Code defines a "claim" as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured[.]" § 101(5)(A).

It is not enough that a creditor have a right to payment. The creditor must also have a right to payment that is enforceable against the debtor or the debtor's property. § 502(b)(1). In other words, an obligation that a third party owes, and the debtor does not owe, is not an allowed claim.

The ESOP Participants assert that they have rights against the Debtors pursuant to the Tax Code, the ESOP Plan, Arizona law, and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). They are wrong.

First, the ESOP Participants contend that the Tax Code mandates that CPES owes them a "repurchase" or "put" obligation, whereby CPES must repurchase the ESOP Participants' stock following termination of the plan.

The Tax Code requires that, in certain situations, an ESOP must provide that a participant "has a right to require that the employer repurchase employer securities under a fair valuation formula." 26 U.S.C. § 409(h)(1)(B). However, this requirement is inapplicable if the employer is an S corporation,[9] 26 U.S.C. § 409(h)(2)(B)(ii)(II), and if "such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash," subject to an exception not relevant here, 26 U.S.C. § 409(h)(2)(B)(i). This limitation is important because an S corporation may not have more than 100 shareholders. If more than 100 parties become owners of the corporation's stock, the corporation loses substantial tax benefits. *See* 26 U.S.C. § 1362(d)(2)(A) (termination of S corporation status); *Taproot Admin. Servs., Inc.*, 679 F.3d at 1110-11 & n.1 (noting that, "[t]o receive such favorable tax treatment under the statute, a small business corporation must first meet all of the eligibility requirements before electing S corporation status[,]" and that "any subsequent violation of one or more of the eligibility rules automatically terminates a corporation's S status").

***5** The parties agree that CPES is an S corporation. As such, the ESOP need only provide the ESOP Participants a right to receive the distributions in cash. Here, the ESOP Plan provides for this situation: "Distribution ... will be made in shares of CPES Stock, cash or a combination of both.... [W]hile CPES is an S Corporation, the distribution of a Participant's Capital Accumulation may be made entirely in cash without granting him the right to demand distribution in shares of CPES Stock." In other words, consistent with the Tax Code, the ESOP Plan provides that the Debtors' employees have no right to receive distribution in the form of stock.[10]

The ESOP Participants acknowledge that S corporations may distribute cash in lieu of stock.[11] Rather, they seem to argue that the ESOP's distribution of cash is the legal equivalent of the employer's repurchase of shares from the ESOP Participants. They cite no authority for this novel proposition, and we reject it. The employees had the right to receive cash distributions from the ESOP trust; they had no right to receive any cash payment from CPES.

Similarly, the ESOP Participants point out that the ESOP Plan provides that they are to receive their vested benefits following the termination of the plan.[12] They conclude that, "whether in the form of shares of [CPES] or cash [funded by CPES], the Participants are entitled to payment from [CPES] under the ESOP."

The ESOP Participants misconstrue the ESOP Plan. Termination of the ESOP triggers certain distribution rights, but section 19 of the ESOP Plan does not require that those distributions be made in the form of CPES stock. The ESOP Participants are entitled to a cash distribution, but that distribution comes from the ESOP, not the Debtors.

Therefore, the ESOP Participants did not have a right to any payment from the Debtors (as opposed to the ESOP). As such, they could not properly assert a proof of claim against the Debtors. The cases they rely on do not convince us otherwise and, in any event, are not binding.

In re Indian Jewelers Supply Co., 604 B.R. 408 (Bankr. D.N.M. 2019), is readily distinguishable. That case similarly concerned the treatment of the claims of three ESOP participants against their employer, a chapter 11 debtor, whose shares were held in an ESOP trust for the employees. *Id.* at 410. However, unlike this case, the employees did have the right to receive stock, and they had a "put" option which, if exercised, would require the employer to buy the stock directly from the employees. *Id.* at 411. The first claimant was allowed to assert a claim because she held a promissory note issued to the claimant when she exercised her "put" option, *id.* at 415-16; the second claimant's distributions were improperly refused by the debtor, who did not allow the claimant to exercise his "put" option, *id.* at 416; and the third claimant was "trying to collect his retirement benefits from the Debtor," *id.* at 417. None of these situations are applicable to this appeal: in this case, it is the ESOP, not the Debtors, that distributes retirement benefits to the ESOP Participants.

***6** *Merrimac Paper Co. v. Harrison (In re Merrimac Paper Co.)*, 420 F.3d 53 (1st Cir. 2005), is similarly unavailing. As in *Indian Jewelers*, the relevant ESOP plan provided that the vested portion of an employee's individual account would be distributed to him in the form of stock, and he could enforce a "put" option. The claimant held a promissory note issued

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by the debtor for the value of the redeemed shares; this gave the claimant a right to payment against the debtor and entitled him to assert an unsecured claim. The ESOP Participants here do not have similar rights against the Debtors.

The ESOP Participants next argue that Arizona law provides that they are on parity with unsecured creditors. They cite Arizona Revised Statutes § 10-640(F), which provides that "[a] **corporation's indebtedness to a shareholder incurred by reason of a distribution** made in accordance with this section is at parity with the corporation's indebtedness to its general, unsecured creditors...." (Emphasis added.) This statute is of no moment. As discussed above, the Debtors were not indebted to the ESOP Participants due to stock distributions or otherwise; rather, CPES funds the ESOP with company stock and cash, and only the ESOP has obligations to make distributions to the employees.

Finally, the ESOP Participants assert that they were entitled to bring their claims under 29 U.S.C. § 1132(a). That section creates certain private rights of action in favor of plan participants, beneficiaries, and fiduciaries. But none of those private rights of action allows the ESOP Participants to assert rights to payment against the Debtors.

For example, section 1132(a)(1)(B) allows a participant or beneficiary to bring a civil action "to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan." But as we have explained, under the terms of this ESOP plan, the ESOP trust owes benefits to the participants; the Debtors do not.

Similarly, section 1132(a)(2) permits a participant or beneficiary to sue "for appropriate relief under section 1109 of this title." Section 1109 in turn makes plan fiduciaries "personally liable to make good **to such plan** any losses to the plan" caused by a breach of duties under ERISA, "and to restore **to such plan** any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary...." 29 U.S.C. § 1109(a) (emphases added). By its terms, the statute obligates the fiduciary to make the plan (i.e., the ESOP trust) whole and does not create a payment obligation to plan participants.

Finally, 29 U.S.C. § 1132(a)(4) authorizes a participant or beneficiary to sue "for appropriate relief in the case of a violation of section 1025(c) or 1032(a) of this title[.]" Those sections require the "administrator" or "plan administrator" of the plan to provide certain notices and statements to participants and beneficiaries. CPES was the plan administrator of the ESOP Plan, so it owed a duty directly to the ESOP Participants to provide the required reports and statements. The ESOP Participants say in their briefs that they did not receive all required statements and reports, but as far as we can tell from the record, their proofs of claim did not assert claims based on that failure. [13]

***7** In short, ERISA does not give the ESOP Participants a right to payment from the Debtors and does not transform them into unsecured creditors of the Debtors.

The ESOP Participants rely on *LaRue v. DeWolff, Boberg & Associates, Inc.*, 552 U.S. 248 (2008), to support their position that they are entitled to allege claims for breach of fiduciary duty directly against the Debtors under ERISA. In that case, the U.S. Supreme Court held that individual plan participants could assert claims on behalf of a benefits plan. *Id.* at 256. But *LaRue* is inapplicable. In that case, the employer had allegedly breached fiduciary duties to the plan. The Court stated that, because the appeal arose out of a motion to dismiss, "we must assume that respondents breached fiduciary obligations defined in § 409(a) ...." *Id.* at 252. In this case, however, the Debtors do not owe the ESOP or the ESOP Participants any fiduciary duty. Rather, the ESOP Plan provides that "[t]he members of the Committee [14] shall be the named fiduciaries with authority to control and manage the operation and administration of the Plan." The ESOP Participants do not point to any law or agreement imposing fiduciary duties on the Debtors. [15]

B. The ESOP Participants' claims were duplicative of the ESOP Trustee's claims.

The ESOP Participants argue that the bankruptcy court erred in holding that their claims were duplicative of the ESOP Trustee's claims. We discern no error.

The ESOP Participants have not included the proofs of claim in their excerpts of record or directed us to where we can find them in the record. Because we do not have the proofs of claim before us, we cannot review them. *See Brown v. State Bar of Ariz. (In re Bankr. Petition Preparers Who Are Not Certified Pursuant to Requirements of Ariz. Sup. Ct.)*, 307 B.R. 134, 144 (9th Cir. BAP 2004) ("We need not examine the record beyond that provided in the excerpts."); *Kritt v. Kritt (In re Kritt)*, 190 B.R. 382, 387 (9th Cir. BAP 1995) ("The appellants bear the responsibility to file an adequate record,

and the burden of showing that the bankruptcy court's findings of fact are clearly erroneous. Appellants should know that an attempt to reverse the trial court's findings of fact will require the entire record relied upon by the trial court be supplied for review." (cleaned up)). Therefore, the record on appeal does not permit us to compare their claims with the ESOP Trustee's claims.

***8** Even if we were to rely on the ESOP Participants' unverified representation of what they asserted in the proofs of claim, we would discern no error. The ESOP Participants allegedly asserted unsecured claims against the Debtors for the dollar amount of their ESOP account balances as of the end of 2018. They also apparently asserted "claims for the failure of the members of the [CPES's] Board of Directors, and the ESOP Board of Trustees or Committee and/or the ESOP Trustee, to ensure a proper valuation of the shares of [CPES's] capital stock."

As we have explained, we reject the proposition that the ESOP Participants had a right to payment from the Debtors based on the dollar amounts in the individual accounts as of 2018 as unsecured debt.

The claims against the Debtors for breach of fiduciary duty relating to the stock valuation is duplicative of the ESOP Trustee's first claim. He asserted a claim for $255,150 based on allegations that the 2018 valuation overstated the value of the stock held by the ESOP. This appears to be the same claim as that asserted by the ESOP Participants, even if the dollar amounts differ.

Furthermore, the ESOP Trustee was solely empowered to bring these claims under the ESOP Agreement and Liquidation Plan. Section C of the ESOP Agreement provides that the ESOP Trustee has the power to:

> (8) sue, defend, compromise, arbitrate or settle any suit or legal proceeding or any claim due it or on which it may be liable;
>
> (9) exercise any of the powers of any owner with respect to the Trust Assets; and
>
> (10) perform all acts which the Trustee shall deem necessary or appropriate and exercise any and all powers and authority of the Trustee under this Trust Agreement.

Similarly, the Liquidation Plan provided that "the ESOP Trustee shall retain responsibility, standing, and authority to commence, prosecute and settle lawsuits or actions on behalf of the holders of beneficial interests to the Equity Interest in the ESOP." The ESOP Participants cannot usurp the ESOP Trustee's powers to exercise the rights of the ESOP. [16]

The ESOP Participants complain, in summary, that the ESOP Trustee's claims do not protect their rights. However, any claim recovered by the ESOP Trustee benefits the ESOP trust, which in turn benefits the ESOP Participants. Conversely, the ESOP Participants' strategy of sustained litigation diminishes the assets available for distribution. As counsel conceded at oral argument, the ESOP Participants are only entitled to receive the fair market value of the CPES stock; needless litigation that wastes estate assets is contrary to the ESOP Participants' interests. [17]

CONCLUSION

The bankruptcy court did not err in sustaining the Liquidating Trustee's omnibus objections. We AFFIRM.

All Citations

Slip Copy, 2023 WL 3773642, 131 A.F.T.R.2d 2023-1909

Footnotes

* This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have, *see* Fed. R. App. P. 32.1, it has no precedential value, *see* 9th Cir. BAP Rule 8024-1.88.

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1 Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references are to the Federal Rules of Bankruptcy Procedure.

2 During the course of the bankruptcy case, the Debtors changed their names: CPES became CPESAZ Liquidating, Inc.; Novelles Developmental Services, Inc., became NDS Liquidating, Inc.; and CPES California, Inc. became CPESCA Liquidating, Inc. To minimize confusion, we will largely disregard the name change.

3 The ESOP Participants purport to include the named parties as well as ninety-two other individuals. Neither the notice of appeal nor the ESOP Participants' briefs identifies these ninety-two individuals. We express no opinion on the question whether one may prosecute an appeal on behalf of unnamed appellants.

4 No party appealed the sale order, and the sale has been consummated.

5 We affirmed the confirmation order. *Bennetti v. CPESAZ Liquidating, Inc. (In re CPESAZ Liquidating, Inc.)*, BAP No. CC-21-1123-LGT, 2022 WL 2719642 (9th Cir. BAP Sept. 2, 2022). The ESOP Participants appealed the ruling to the Ninth Circuit, where it is pending.

6 The Liquidation Plan placed the equity interest in CPES held by the ESOP in Class 6. It provided that equity interests would be paid a pro rata dividend once unsecured claims were paid in full. It also stated that "the ESOP Trustee shall retain responsibility, standing, and authority to commence, prosecute and settle lawsuits or actions on behalf of the holders of beneficial interests to the Equity Interest in the ESOP."

7 Counsel for the ESOP Participants acknowledge that they did not provide us with copies of their proofs of claim in their excerpts of record. We have also been unable to locate the proofs of claim on the bankruptcy court's claims register or docket.

8 In bankruptcy parlance, an objection to multiple claims is called an "omnibus objection." *See* Rule 3007(d) ("[O]bjections to more than one claim may be joined in an omnibus objection if all the claims were filed by the same entity, or the objections are based solely on the grounds that the claims should be disallowed, in whole or in part, because: ... (1) they duplicate other claims; ... (7) they are interests, rather than claims[.]").

9 Most corporations are treated as separate taxable entities that pay income tax on their own income. An "S corporation" under 26 U.S.C. § 1361 is not a separately taxable entity; rather, the corporation's income is "passed through" to its shareholders. *See Taproot Admin. Servs., Inc. v. Comm'r*, 679 F.3d 1109, 1110 (9th Cir. 2012) ("[A]n S corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. In this way, an S corporation serves as a conduit through which income flows to its shareholders." (cleaned up)).

10 Section 14(b) of the ESOP Plan discusses a "put option." However, this section explicitly does not apply to distribution of capital accumulation as discussed in section 13(b), which allows the ESOP to forego a distribution in stock because it is an S corporation.

11 As the bankruptcy court pointed out, the ESOP Participants conceded that CPES was not permitted to make any distribution directly to the ESOP Participants.

12 The ESOP Participants argue that the ESOP terminated at the latest on the petition date, thus triggering the stock repurchase obligation. We need not decide if or when the ESOP terminated, because the Debtors had no obligation to buy stock from, or distribute cash to, the ESOP Participants upon plan termination.

13 As we explain in the following section, we cannot review the proofs of claim themselves because the ESOP Participants did not include them in their excerpt of record and we have been unable to locate them on the

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bankruptcy court's docket. The lengthy excerpt from the proofs of claim in the ESOP Participants' reply brief does not assert a claim based on the failure to provide reports and statements.

14 According to the ESOP Plan, the Administrative Committee "is appointed by the Board of Directors."

15 The definition of a "fiduciary" under ERISA provides:

> [A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation ..., or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21)(A); *see also* *Johnson v. Couturier*, 572 F.3d 1067, 1076 (9th Cir. 2009) (The Ninth Circuit has "recognized that where members of an employer's board of directors have responsibility for the appointment and removal of ERISA trustees, those directors are themselves subject to ERISA fiduciary duties, albeit only with respect to trustee selection and retention."). The ESOP Participants have not demonstrated that the Debtors fall within this definition. The ESOP Participants believe that the ESOP Trustee, the Debtors' officers and directors, and possibly others breached fiduciary duties to them, but they do not show that the Debtors owed them any such duty.

16 The ESOP Participants argue that the plan confirmation order preserved their right to sue the Debtors. But the order only protected the ESOP Participants' rights to assert claims "to the extent any such claims or causes of action exist." In other words, the confirmation order only permitted them to retain existing causes of action; the bankruptcy court held (and we agree) that they had no causes of action against the Debtors. The confirmation order did not create any new claim.

17 The ESOP Participants maintain that their proofs of claim provided sufficient information to support their claims. We do not understand why the ESOP Participants are arguing this point because the bankruptcy court agreed with them.

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PART TWO
MATERIALS

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Record Bankruptcy Filings in the Healthcare Sector in 2023

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January 25, 2024

Gibbins Advisors, a leading healthcare restructuring advisory firm, has issued its **latest report** analyzing healthcare sector Chapter 11 bankruptcy cases filed from 2019 to 2023 for companies with more than $10 million in liabilities ("Healthcare Bankruptcy Filings").

According to the report, there were 79 Healthcare Bankruptcy Filings in 2023 which made it the highest of the last five years, with the next closest being 2019 which saw 51 cases. Case volumes in 2023 were over ***3 times*** the level seen in 2021 and over ***1.7 times*** the level in 2022.

Large Healthcare Bankruptcy Filings with liabilities over $100 million surged in 2023, reaching 28 filings compared to only 7 in 2022 and 8 in 2021.

While the number of Healthcare Bankruptcy Filings increased across ***six consecutive quarters*** through Q3 2023, there was a decline from Q3 to Q4 2023. While the number of cases in the second half of 2023 approximate those in the first half of 2023, it is yet unclear if lower volumes in Q4 2023 indicate an emerging trend.

Senior care and pharmaceutical subsectors comprised almost half the total healthcare bankruptcy filings in 2023, consistent with previous trends.

Of particular note, hospital bankruptcy filings spiked in 2023 with 12 filings compared to a total of 11 filings from the prior 3 years ***combined***.

What's driving the increase in financial distress of healthcare organizations?

There are challenges ahead driven by sector-wide headwinds, but optimism may be on the horizon for some healthcare providers:

1) Capital market constraints:

- September 2023
- August 2023
- July 2023
- June 2023
- May 2023
- March 2023
- February 2023
- January 2023
- December 2022
- September 2022
- August 2022
- April 2021
- March 2020
- January 2020
- December 2019
- November 2019
- October 2019
- December 2018

- Softening of interest rates expected in 2024 but refinancings, access to capital, valuations and transactions are still impacted by relatively high rates.
- New requirements of FTC and state anti-trust protections may limit strategic options.

2) Labor and Supply Cost Pressures

- Large cost increases over the past 2 years have set a new baseline, creating a margin squeeze.
- Agency labor settling down in some markets, but workforce headwinds continue and possible federal mandates for minimum staffing ratios would compound the challenges.

3) Revenue Pressure

- Payment rate increases often not in line with cost inflation.
- Material increase in denials from payors, especially Medicare Advantage.
- Unwinding of Medicaid Continuous Enrollment during 2023 may materially increase the number of uninsured patients.

4) Possible Optimism

- Mixture of rate and volume increases may be expected in 2024, but costs will likely remain a challenge, and smaller organizations with revenue under $500 million may fare worse than larger health systems.
- COVID-19-related Federal Emergency Management Agency (FEMA) funds may be available as one-time grants.

5) Continuing shift to out-of-hospital care delivery

- Care is moving from hospitals and skilled nursing facilities to outpatient, community and home-based settings, creating both opportunities and headwinds.

"We saw a dramatic increase in healthcare bankruptcy filings in 2023, continuing the trend which began in mid-2022" said Clare Moylan, Principal at Gibbins Advisors. *"Key observations from 2023 are the return of large bankruptcy cases with over $100 million in liabilities, and a spike in hospital filings, both of which appear to primarily be a result COVID-19 pandemic-related protections ending."*

- March 2018
- February 2018
- November 2017
- October 2017
- February 2017
- December 2016

"Some of the recent data was surprising" said Tyler Brasher, Director at Gibbins Advisors. *"Total healthcare filings spiked in Q3 and then receded in Q4 2023, and there were no senior care bankruptcies filed in Q4 2023 when we expect to see about 5 per quarter. We will closely monitor in 2024 to see if the market is changing".*

What does Gibbins Advisors predict for 2024?

"Despite the absence of senior care bankruptcy filings in Q4 2023, based on our knowledge of the market we expect to see senior care bankruptcies return in 2024" said Brasher. *"As for total case volume, we are seeing a lot of distress in healthcare as the market remains very challenging for providers, so we expect to see continued levels of healthcare bankruptcies in 2024 that we saw last year."*

"*As we anticipated, restructuring activity in the hospital sector increased markedly in 2023 and we expect to see a continuation of that level of distress this year as hospitals, particularly rural and standalone hospitals, work through challenging profitability, liquidity and leverage dynamics,*" said Moylan.

—

For questions, comments or more information, contact Clare Moylan: cmoylan@gibbinsadvisors.com

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2023 WL 5310817
United States Bankruptcy Court, D. New Mexico.

IN RE: LA FAMILIA PRIMARY CARE, P.C., Debtor.

Case No. 23-10566-t11
|
Signed August 17, 2023

Attorneys and Law Firms

Shay Elizabeth Meagle, Slingshot, LLC, Albuquerque, NM, for Debtor.

OPINION

David T. Thuma, United States Bankruptcy Judge

***1** Before the Court is Debtor's motion for a ruling that no patient care ombudsman need be appointed in this bankruptcy case. The United States Trustee ("UST") objects and contends that an ombudsman is necessary. The Court took evidence and heard arguments of counsel at a final hearing. It now rules that appointment of an ombudsman is not necessary for the protection of patients.

A. Facts. [1]
The Court finds: [2]

La Familia Primary Care, P.C. ("La Familia" or "Debtor") is a professional corporation formed in 2006. It provides primary medical care to patients in and around Raton, New Mexico. Dr. Misbah Zmily owns Debtor and is its only medical doctor. Dr. Zmily graduated from the University of Jordan in 1991. He did a residency in internal medicine at the University of Illinois and was awarded a medical license in 1996. He began his medical practice in Raton, a town of about 6,000 residents in northern New Mexico. Dr. Zmily has practiced in and around Raton ever since.

Dr. Zmily testified that five years ago there were eight doctors in the Raton area, but that now he is the only one left.

Dr. Zmily is board certified in internal medicine and, through Debtor, provides office-based primary medical care for adults. In addition to Dr. Zmily, Debtor employs a physician's assistant and a registered nurse practitioner. Debtor also provides medical care to a nursing home in Springer, New Mexico (population 1,300) and a Raton nursing home. Finally, Debtor has a contract with a local high school to visit once a week and provide medical care to the students. A large percentage of Debtor's patients are on Medicare [3] or Medicaid.

In 2020, pharmaceutical company BioLab Sciences approached Dr. Zmily about its amniotic fluid-based injections for the treatment of osteoarthritis. BioLab provided Dr. Zmily with literature detailing FDA approval of the fluid and Medicare's conditional approval of the treatment for certain patients. Dr. Zmily was persuaded that the injections might help some of his patients, especially those who were not good candidates for surgery. He began offering the procedure to these patients. If Dr. Zmily determined that a patient might benefit from the amniotic fluid-based injections and the patient was interested, Dr. Zmily would submit his patient notes to BioLab for pre-approval. If BioLab approved, it would ship the medication to Debtor. BioLab charged Debtor about $4,000 for each treatment. Dr. Zmily would administer the treatment and bill Medicare for the approved cost, about $4,400. Medicare paid the bills as submitted. La Familia made about $300-500 per injection.

***2** Some of Dr. Zmily's patients showed marked improvement from the BioLab treatments. Dr. Zmily believed and still believes that the injections provided a substantial benefit to his elderly osteoarthritic patients. Dr. Zmily also testified that the patients suffered few or no side effects.

Medicare, however, came to the opposite conclusion. In January 2022, Medicare notified Debtor that it would no longer pay for BioLab's amniotic-fluid treatment. Debtor promptly stopped administering it. That was not the end of the story, however. Under Medicare's reimbursement policies and procedures, Medicare asserted the right to "claw back" all the payments it had ever made to Debtor for the BioLab treatments, including the money Debtor had paid to BioLab. The claimed clawback totaled about $3.6 Million, plus interest. To collect the money, Medicare began setting off what it owed Debtor for treating Medicare patients. The setoff caused Debtor to lose most of its cash flow, prompting the filing of this bankruptcy case on July 19, 2023.

To date, there have been no patient complaints about the BioLab injection treatments, nor any reason to think that any of Debtor's patients might have claims against Debtor because of the injections.

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Debtor enjoys a good reputation in the community. Neither Dr. Zmily, its other practitioners, nor Debtor have had any malpractice complaints against them since Debtor's inception. There is no evidence of substandard patient care, improper record-keeping, or privacy violations. There is no evidence that the bankruptcy filing has interrupted or adversely affected Debtor's patient care.

Based on the budget submitted with its cash collateral motion, Debtor operates on a very thin margin and does not have regular excess cash with which to pay for additional professional services. Additional administrative expense could jeopardize Debtor's reorganization and could cause it to shut down. Loss of "the last doctor in town" would be a severe blow to Raton's residents, as well as the nursing home residents in Springer and Raton who depend on Dr. Zmily and Debtor's services.

B. Patient Care Ombudsman.

Section 333(a)(1) [4] provides:

> If the debtor in a case under chapter 7, 9, or 11 is a health care business, the court shall order, not later than 30 days after the commencement of the case, the appointment of an ombudsman to monitor the quality of patient care and to represent the interests of the patients of the health care business unless the court finds that the appointment of such ombudsman is not necessary for the protection of patients under the specific facts of the case.

The Court must determine whether Debtor is a health care business and, if so, whether it is necessary to appoint a patient care ombudsman to protect Debtor's patients.

C. Debtor is not a "health care business."

"[H]ealth care business" is defined in § 101(27A):

The term "health care business"--

(A) means any public or private entity (without regard to whether that entity is organized for profit or not for profit) that is primarily engaged in offering to the general public facilities and services for--

(i) the diagnosis or treatment of injury, deformity, or disease; and

(ii) surgical, drug treatment, psychiatric, or obstetric care; and

(B) includes--

***3** (i) any--

(I) general or specialized hospital;

(II) ancillary ambulatory, emergency, or surgical treatment facility;

(III) hospice;

(IV) home health agency; and

(V) other health care institution that is similar to an entity referred to in subclause (I), (II), (III), or (IV); and

(ii) any long-term care facility, including any--

(I) skilled nursing facility;

(II) intermediate care facility;

(III) assisted living facility;

(IV) home for the aged;

(V) domiciliary care facility; and

(VI) health care institution that is related to a facility referred to in subclause (I), (II), (III), (IV), or (V), if that institution is primarily engaged in offering room, board, laundry, or personal assistance with activities of daily living and incidentals to activities of daily living.

The definition of health care business was added as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Section 101(27A) is not easy to parse. In particular, courts applying the definition have particularly with two questions: first, must a debtor come within both subsections (A) *and* (B) to be a health care business, or is

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it enough to come within either subsection; and second, if it is enough to come within either subsection (A) *or* (B) and a debtor seems to qualify under subsection (A), must the debtor's business be similar to the businesses listed in subsection (B)?

As a preliminary matter, it is useful to know that the Bankruptcy Code's drafters, when listing nonexclusive examples of a defined term, sometimes write "includes A, B, C, *and* D" rather than "includes A, B, C, *or* D." For example, § 1112(b)(4) contains a nonexclusive list of "causes" for dismissal or conversion of a chapter 11 case. After the penultimate example, the drafters used "and" rather than "or." For other examples of this drafting style, see §§ 101(31)(E), 101(49), 330(a)(3), 362(c)(3)(C), 503(b)(1), 557(d), 707(a), 741(4)(A), 761(10)(A), 783(b), 1208(c), 1521(a), and 1527. While this usage has been criticized, *see, e.g., In re TCR of Denver, LLC*, 338 B.R. 494, 498 (Bankr. D. Colo. 2006), it makes as much sense to end a nonexclusive list of examples with "and" as with "or." In this context, "and" means "and also includes," while "or" means "or, as another example." Both are intelligible.

1. A debtor coming within subsection (A) *or* (B) is a health care business. Case law is split on whether a debtor must satisfy both subsections (A) and (B) to qualify as a health care business. In *In re Banes, D.D.S.*, 355 B.R. 532, 534 (Bankr. N.D.N.C. 2006), the court found that ["[b]ecause every section of this statute is connected by the conjunctive, a health care business must meet the requirements of every subsection to require the appointment of an ombudsman." Similarly, the court in *In re William L. Saber, M.D., P.C.*, 369 B.R. 631, 636 (Bankr. D. Colo. 2007) held that "it is important to note the subsection of § 101(27)(A) and of subsubsection (B) are connected by the conjunctive. Thus, a debtor who is a "health care business" must meet every requirement under both subsections for a patient care ombudsman to be appointed."

***4** In contrast, in court in *In re Aknouk*, 648 B.R. 755 760 (Bankr. S.D.N.Y. 2023) held that "there is nothing in the text to indicate that the statute should be read conjunctively." Likewise, in *In re Smiley Dental Arlington, PLLC*, 503 B.R. 680, 685 (Bankr. N.D. Tex. 2013), the court held that "[t]he language in section 101(27A) (B) is inclusive of the specific entities listed and other similar entities, but not exclusive of other business entities meeting the test under section 101(27A)(A)."

The Court agrees with *Aknouk* and *Smiley Dental* that an entity is a health care business if it comes within either subsection (A) *or* (B). If all the "ands" in § 101(27A) are construed as conjunctions, very few entities would qualify as health care businesses. For example, homes for the aged, hospices, and home health agencies do not provide facilities and services for the treatment of injury, deformity, or disease. They would not be health care businesses under this construction. More to the point, the strictly "conjunctive" reading would require that hospitals also be long-term care facilities, and vice versa, as well as qualifying under subsection (A). The number of health care businesses under the conjunctive interpretation approaches zero.

Because, as noted above, the Code drafters sometimes used "and" to mean "and also includes" when listing examples of things that are "included" in a defined term, the better construction of § 101(27A) is:

> The term "health care business"--
>
> (A) means any public or private entity (without regard to whether that entity is organized for profit or not for profit) that is primarily engaged in offering to the general public facilities and services for--
>
> > (i) the diagnosis or treatment of injury, deformity, or disease; and [5]
> >
> > (ii) surgical, drug treatment, psychiatric, or obstetric care; and
>
> (B) ***also*** includes--
>
> > (i) any--
> >
> > > (I) general or specialized hospital;
> > >
> > > (II) ancillary ambulatory, emergency, or surgical treatment facility;
> > >
> > > (III) hospice;
> > >
> > > (IV) home health agency; and ***also includes***
> > >
> > > (V) other health care institution that is similar to an entity referred to in subclause (I), (II), (III), or (IV); and ***also includes***
> >
> > (ii) any long-term care facility, including any--
> >
> > > (I) skilled nursing facility;

> (II) intermediate care facility;
>
> (III) assisted living facility;
>
> (IV) home for the aged;
>
> (V) domiciliary care facility; and ***also includes***
>
> (VI) health care institution that is related to a facility referred to in subclause (I), (II), (III), (IV), or (V), if that institution is primarily engaged in offering room, board, laundry, or personal assistance with activities of daily living and incidentals to activities of daily living.

Under this construction, the word "includes" at the beginning of subsection (B) applies to "health care business," rather than to subsection (A). Thus, the section should be read: "health care business" means [the definition in subsection (A)] and also includes [the examples of hospitals and long-term care facilities in subsection (B)]. That is the construction that makes the most sense. The drafters apparently wanted § 331 to apply to hospitals, long-term care facilities, and also to debtors coming within the subsection (A) definition.

***5** 2. Debtors coming within subsection (A) need not be similar to hospitals or long-term care facilities. The case law also is split on whether debtors that come within subsection (A) must be similar to the businesses listed in subsection (B). In *Banes*, for example, the court held that "the types of businesses listed [in subsection B] are all of such a similar nature in that they provide both housing and treatment ... that it is difficult to imagine that the legislature would have intended a business that is so fundamentally different, such as an outpatient dental practice, to be read into the statute." 355 B.R. at 535. Similarly, in *In re 7-Hills Radiology, LLC*, 350 B.R. 902, 905 (Bankr. D. Nev. 2006), the court held that "subparagraph (B) of Section 101(27A) would seem to indicate a restrictive range for health care businesses." Finally, the court in *In re Medical Associates of Pinellas, L.L.C.*, 360 B.R. 356, 361 (Bankr. M.D. Fla. 2007), held that "the examples included in subparagraph (B) appear to contemplate something more than a doctor's office ...." for an entity that qualifies under subsection (A).

Disagreeing with this interpretation, the *Smiley Dental* court held:

> At the Hearing, Debtors and the U.S. Trustee advocated that the court should follow the second line of cases applying section 101(27A) and read into the statute an element of direct and ongoing contact with patients while providing shelter and sustenance. By comparing the similarities of the entities listed in subparagraph (B) of section 101(27A), this second line of cases has created an inpatient treatment requirement for health care businesses.
>
> ....
>
> Requiring this judicially created element, which does not appear in section 101(27A), misconstrues the statute. The language in section 101(27A)(B) is *inclusive* of the specific entities listed and other similar entities, but not *exclusive* of other business entities meeting the test under section 101(27A)(A). *See* 11 U.S.C. § 102(3) ("In this title ... 'includes' and 'including' are not limiting.") ....

503 B.R. at 687-88. *See also Aknouk*, 648 B.R. at 763 ("the court declines to read an inpatient services requirement into the definition of a health care business in section 101(27A)").

Again agreeing with *Aknouk* and *Smiley Dental*, the Court does not construe subsection (A)'s application to be limited to businesses "like" those enumerated in subsection (B). For one thing, it is hard to know what the subsection (B) business are "like." Some are in-patient care facilities (hospitals and homes for the aged), but others, e.g., [home] hospice, home health agencies, and ambulatory surgical treatment facilities, are not. Furthermore, if Congress intended to limit the definition of health care business to entities like the ones in subsection (B) (whatever that might be), it could have omitted subsection (A) entirely; the "catch-all" subclauses (B)(i)(V) and (B)(ii)(VI) would have been sufficient. The *noscitur a sociis*[6] interpretation of *7-Hills Radiology* is interesting but ultimately unpersuasive because the businesses listed in subsection (B) are not all similar to each other.

3. Applying subsection (A) to Debtor. The UST does not contend that Debtor comes within subsection (B), and the Court agrees. The UST does argue, however, that Debtor comes within subsection (A).

As stated in *Pinellas*:

> subsection (A) of the definition of health care business in section 101(27A) requires the existence of the following four elements in order for a debtor to qualify as a "health care business":
>
> 1. The debtor must be a public or private entity;

2. The debtor must be primarily engaged in offering to the general public facilities and services;

***6** 3. The facilities and services must be offered to the public for the diagnosis or treatment of injury, deformity or disease; and

4. The facilities and services must be offered to the public for surgical care, drug treatment, psychiatric care or obstetric care.

360 B.R. at 359; *see also* *Saber*, 369 B.R. at 636-37 (citing and following *Pinellas*); *In re Alternate Family Care*, 377 B.R. 754,757 (Bankr. S.D. Fla. 2007) (same); *Smiley Dental*, 503 B.R. at 687 (same); *Aknouk*, 648 B.R. at 763 (same).

Debtor clearly satisfies the first three elements. The question is whether Debtor provides facilities and services to the general public for surgical care, drug treatment, psychiatric care, or obstetric care. That is more doubtful. Debtor does not provide surgical care, drug treatment, [7] or obstetric care, which leaves only psychiatric care. Dr. Zmily testified that he sometimes prescribes antidepressants to patients. While the UST argued that prescribing antidepressants is providing psychiatric care, that seems a slender reed. Dr. Zmily is not a psychiatrist or psychologist. Debtor does not provide counseling services. Most people do not view primary care physicians as providing psychiatric care. It is a close question, but the Court rules that prescribing antidepressants, without more, is not tantamount to providing psychiatric care. Debtor, therefore, is not a health care business.

D. Appointing a Patient Care Ombudsman is Not Necessary to Protect Patients.

Even if Debtor were a health care business, the Court would have the discretion not to appoint a patient care ombudsman if the appointment was "not necessary for the protection of patients under the specific facts of the case." § 333(a)(1).

To determine the necessity of an ombudsman, courts weigh the following factors:

1. The cause of the bankruptcy;

2. The presence and role of licensing or supervising entities;

3. Debtor's past history of patient care;

4. The ability of the patients to protect their rights;

5. The level of dependency of the patients on the facility;

6. The likelihood of tension between the interests of the patients and the debtor;

7. The potential injury to the patients if the debtor drastically reduced its level of patient care;

8. The presence and sufficiency of internal safeguards to ensure appropriate level of care; and

9. The impact of the cost of an ombudsman on the likelihood of a successful reorganization.

Alternate Family Care, 377 B.R. at 758; *see also* *In re Valley Health Sys.*, 381 B.R. 756, 761 (Bankr. C.D. Cal. 2008) (citing and following *Alternate Family Care*); *Aknouk*, 648 B.R. at 761 (citing *Alternate Family Care* and *Valley Health*). "The weight to be accorded to each of the *Alternate Family Care* factors in making a determination whether to appoint a patient care ombudsman is left to the sound discretion of the court." *Valley Health*, 381 B.R. at 761.

***7** Courts also considers these additional factors:

1. The high quality of debtor's existing patient care;

2. The debtor's financial ability to maintain high quality patient care;

3. The existence of an internal ombudsman program to protect the rights of patients, and/or

4. The level of monitoring and oversight by federal, state, local, or professional association programs which renders the services of an ombudsman redundant.

Valley Health at 761, citing 3 Collier on Bankruptcy ¶ 333.02, at 333–4 (15th ed. 2007).

"Debtors found to be health care businesses bear the burden of establishing that the appointment of a Patient Care Ombudsman is not necessary." *Aknouk*, 648 B.R. at 761, citing *In re Starmark Clinics, LP*, 388 B.R. 729, 734 (Bankr. S.D. Tex. 2008).

Assuming for the sake of argument that Debtor is a health care business, the Court will weigh each of the 13 factors to determine whether the appointment of a patient care ombudsman is necessary:

Factor	Discussion
The cause of the bankruptcy.	Debtor filed this case because Medicare changed its position on amniotic fluid-based injections and now claims that Debtor owes it $3.6 Million, an amount Debtor clearly cannot pay. There is no evidence of a patient care-related cause for the filing.
The presence and role of licensing or supervising entities.	Debtor is supervised by the New Mexico Medical Board, Medicare, the U.S. Department of Health and Human Services, and other state and federal agencies. There is no evidence that Debtor's patient care has been questioned by any board or regulatory agency.
Debtor's history of patient care.	Debtor's patient care history is good; no malpractice claims have ever been asserted against Debtor or its professions since Debtor began business in 2006.
The ability of the patients to protect their rights.	Patients in New Mexico can and do protect their rights by bringing medical malpractice claims; there is no evidence that Debtors' patients are particularly vulnerable or unable to so hold Debtor accountable.
The level of dependency of the patients on the facility.	Patients depend on Debtor remaining open because Dr. Zmily is the only practicing non-hospital physician in Raton; care of patients in and around the Raton area would suffer if the Debtor shut its doors.
The likelihood of tension between the interests of the patients and the debtor.	There is no evidence of any tension between Debtor's patients and Debtor. Rather, Debtor needs its patients, and its patients need Debtor.
The potential injury to the patients if the debtor drastically reduced its level of patient care.	Patients would be harmed if Debtor reduced its level of patient care because they would have to travel long distances to find other providers.

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The presence and sufficiency of internal safeguards to ensure appropriate level of care.	Dr. Zmily testified that internal safeguards are in place to ensure an appropriate level of patient care. Debtor uses FDA approved software.
The impact of the cost of an ombudsman on the likelihood of a successful reorganization.	The Court has no evidence about what an ombudsman would charge or do. In the Court's only other experience with a patient care ombudsman, the charge was substantial. *See In re Santa Fe Medical Group, LLC*, 557 B.R. 223, 225 (Bankr. D.N.M. 2016).
The high quality of debtor's existing patient care.	The current level of patient care seems to be at an acceptably high level. The UST argues that Debtor's decision to treat patients with BioLab's amniotic fluid-based injections casts doubt on Debtor's patient care. The Court disagrees. It is beyond the scope of this contested matter to determine whether the injection provided a medical benefit, but the uncontradicted evidence is that Dr. Zmily observed a substantial benefit to his patients. Because of that, and because there have been no claims of harm or adverse side effects, administering the injections does not reflect adversely on Debtor's patient care.
The debtor's financial ability to maintain high quality patient care.	If the Debtor is not undone by excessive administrative expenses, it should have enough money to reorganize and maintain high quality patient care.
The existence of an internal ombudsman program to protect the rights of patients.	There is no such program. Debtor's size does not warrant it.
The level of monitoring and oversight by federal, state, local, or professional association programs which renders the services of an ombudsman redundant.	Medical practice in the United States is heavily regulated at the state and federal level.

***8** The factors weigh heavily against appointing a patient care ombudsman. Debtor provides no inpatient treatment, like a hospital or long-term care facility. Unlike hospital patients or nursing home residents, Debtor's patients do not face the prospect of being turned out on the street if Debtor fails to reorganize. Patient care is good. Debtor will be squeezed for cash until Medicare starts paying post-petition bills. Even

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then, the practice will not be particularly profitable. The cost of a patient care ombudsman is unknown but could be substantial. Debtor can ill afford any additional administrative expenses.

While bankruptcy courts have no hesitation appointing patient care ombudsmen in hospital and nursing home cases, they are reluctant to do so with small businesses like Debtor. *See, e.g., Smiley Dental*, 503 B.R. at 688 (dentist); *Saber*, 369 B.R. at 638 (plastic surgeon); *Aknouk*, 648 B.R. at 764 (dentist); *Pinellas*, 360 B.R. at 361-62 (administrative support for doctors); *Banes*, 355 B.R. at 535 (dentist). It is not an issue of statutory construction, but rather the conclusion that, with a typical small doctor's or dentist's office, the benefit of an ombudsman (if any), is substantially outweighed by the attendant expense and disruption.

CONCLUSION

The Court finds and concludes that Debtor is not a health care business. Alternatively, the Court finds and concludes that the appointment of a patient care ombudsman is not necessary for the protection of Debtor's patients. By a separate order, the Court will grant Debtor's motion to dispense with the appointment of a patient care ombudsman.

All Citations

Slip Copy, 2023 WL 5310817, 72 Bankr.Ct.Dec. 202

Footnotes

1 The Court takes judicial notice of its docket *See* *St. Louis Baptist Temple, Inc. v. Fed. Deposit Ins. Corp.*, 605 F.2d 1169, 1172 (10th Cir. 1979) (a court may sua sponte take judicial notice of its docket and of facts that are part of public records).

2 Some of the Court's findings are in the discussion section of the opinion. They are incorporated by this reference.

3 Medicare is a governmental national health insurance program administered by the Centers for Medicare and Medicaid Services, an agency of the Department of Health and Human Services. For ease of reference, it and the administering agency will be called “Medicare.”

4 Unless otherwise indicated, statutory references are to 11 U.S.C.

5 The Court considered whether Congress intended this particular “and” to be an “or.” Because it is not at the end of a nonexclusive list, however, and because it restricts the scope of health care businesses subject to the appointment of a patient care ombudsman, the Court concludes that Congress intended the conjunctive here, not the disjunctive. The case law, discussed below, uniformly agrees.

6 “Roughly,” [*noscitur a sociis* means] ‘it is known from its associates.’ .... Under this canon, courts look to the language surrounding—or associated with—the language in question to determine the meaning of a disputed word or phrase.” 350 B.R. at 904.

7 “The Court views Congress’ reference to “drug treatment” as applying to facilities that treat drug addiction or abuse. The interpretation suggested by the U.S. Trustee [the writing or dispensing of prescriptions] would render meaningless the balance of section 101(27A)(A)(ii) because virtually all areas of medical treatment involve the prescription of drugs ....” *Pinellas*, 360 B.R. at 360 n.3; *Smiley Dental*, 503 B.R. at 686 (quoting *Pinellas* with approval).

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KeyCite Yellow Flag - Negative Treatment
Declined to Follow by In re Flagship Franchises of Minnesota, LLC, Bankr.D.Minn., January 4, 2013

377 B.R. 754
United States Bankruptcy Court,
S.D. Florida,
Broward Division.

In re ALTERNATE FAMILY CARE, Debtor.

No. 07–18203–BKC–RBR.
|
Oct. 30, 2007.

Synopsis
Background: United States Trustee (UST) filed motion for appointment of patient care ombudsman.

Holdings: The Bankruptcy Court, Raymond B. Ray, J., held that:

[1] debtor, a state-licensed child placing and caring agency, was a "health care business" within the meaning of the Bankruptcy Code, but

[2] an ombudsman was not necessary under the specific facts of this case.

Motion denied.

West Headnotes (7)

[1] **Bankruptcy** Employment of Professional Persons or Debtor's Officers

If a debtor is a health care business, the bankruptcy court must appoint a patient care ombudsman within 30 days of the commencement of the case unless the court determines an ombudsman is not required. 11 U.S.C.A. § 333(a)(1).

6 Cases that cite this headnote

[2] **Bankruptcy** Construction and Operation

Under the *Pinellas* test, for a debtor to be a "health care business" within the meaning of the Bankruptcy Code (1) the debtor must be a private or public entity; (2) the debtor must be primarily engaged in offering to the general public facilities and services; (3) the facilities and services must be for the diagnosis or treatment of injury, deformity, or disease; and (4) the facilities must be for surgical care, drug treatment, psychiatric care, or obstetric care. 11 U.S.C.A. §§ 101(27A), 333(a)(1).

3 Cases that cite this headnote

[3] **Bankruptcy** Construction and Operation

Debtor, a state-licensed child placing and caring agency that provided psychiatric residential treatment services to emotionally disturbed children, afforded temporary care for foster children, and facilitated placement of children in foster care relationships throughout the State of Florida, was a "health care business" within the meaning of the Bankruptcy Code; debtor was a public or private entity, debtor had a website and it was possible for members of the general public to access debtor's services, even though most of its business came through referrals from other agencies, the psychological and emotional issues that afflicted the children under debtor's care rose to the level of disease, and debtor's services or facilities were used for drug treatment and/ or psychiatric care. 11 U.S.C.A. §§ 101(27A), 333(a)(1).

[4] **Bankruptcy** Employment of Professional Persons or Debtor's Officers

For purposes of determining whether to appoint a patient care ombudsman, if a condition is severe enough to warrant a course of medically supervised treatment, whether or not it involves pharmacological treatment, such a condition is sufficient to meet the requirements of the Bankruptcy Code's definition of "health care business," namely, that the debtor's services or facilities be used for the "treatment of injury,

deformity or disease." 11 U.S.C.A. §§ 101(27A), 333(a)(1).

[5] **Bankruptcy** Employment of Professional Persons or Debtor's Officers

In evaluating whether the appointment of a patient care ombudsman is necessary for the protection of patients under the specific facts of a case, the bankruptcy court will examine the totality of the circumstances surrounding the bankruptcy filing and the operations of the debtor. 11 U.S.C.A. § 333(a)(1).

4 Cases that cite this headnote

[6] **Bankruptcy** Employment of Professional Persons or Debtor's Officers

In evaluating whether appointment of a patient care ombudsman is necessary for the protection of patients under the specific facts of a case, the bankruptcy court analyzes the following non-exclusive list of nine salient factors: (1) cause of the bankruptcy, (2) presence and role of licensing or supervising entities, (3) debtor's past history of patient care, (4) ability of patients to protect their rights, (5) level of dependency of patients on the facility, (6) likelihood of tension between interests of patients and debtor, (7) potential injury to patients if debtor drastically reduced its level of patient care, (8) presence and sufficiency of internal safeguards to ensure appropriate level of care, and (9) impact of the cost of an ombudsman on likelihood of a successful reorganization. 11 U.S.C.A. § 333(a)(1).

15 Cases that cite this headnote

[7] **Bankruptcy** Employment of Professional Persons or Debtor's Officers

Appointment of patient care ombudsman was not necessary under specific facts of case of debtor, a state-licensed child placing and caring agency that provided psychiatric residential treatment services to emotionally disturbed children, afforded temporary care for foster children, and facilitated placement of children in foster care; although children under debtor's care were highly dependent and were unable to adequately protect themselves without help and would suffer if debtor reduced its level of patient care, there was a tremendous amount of supervision and oversight of debtor from other state and private entities, as well as other in-house procedural safeguards, cause of debtor's bankruptcy, a fire at its primary facility, was not in any way related to patient care, debtor had history of few patient care complaints, both debtor and patients had substantial interest in seeing debtor successfully reorganize, and cost of ombudsman would be waste of scarce financial resources. 11 U.S.C.A. § 333(a)(1).

13 Cases that cite this headnote

Attorneys and Law Firms

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Denyse Heffner, Office of the U.S. Trustee, Miami, FL, for U.S. Trustee.

MEMORANDUM OPINION DENYING MOTION TO APPOINT HEALTHCARE OMBUDSMAN

RAYMOND B. RAY, Bankruptcy Judge.

THIS MATTER came before the Court for hearing on October 26, 2007 upon the *Motion to Appoint Patient Care Ombudsman* [D.E. 20] filed by the United States Trustee and the Debtor's response thereto [D.E. 21]. At the hearing Alternate Family Care, the debtor, (hereafter "AFC") was represented by Counsel and Dr. Ronald Simon the secretary and treasurer of AFC. Also present at the hearing was the United States Trustee, through Counsel and the Guardian ad Litem for a minor child who is under the supervision of AFC. At the hearing the Court received into evidence proffered testimony of Dr. Simon. The Court has also thoroughly reviewed the file and the AFC's website. Based on the following analysis the Court declines to appoint a patient care ombudsman.

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The facts of this case can be described as ugly, but relatively simple. AFC is a state licensed child placing and caring agency that provides psychiatric residential treatment services to emotionally disturbed children, affords temporary care for foster children and facilitates placement of children in foster care relationships throughout the State of Florida. AFC has been in business for over 20 years. Dr. Simon founded AFC on the premise that "specially selected, trained, and supported foster parents could successfully care for seriously emotionally disturbed children in a private residential home setting." *Affidavit of Dr. Simon* [D.E. 36].

At the timing of the filing AFC ran three group homes and two residential facilities. The children in these locations are under constant supervision of AFC. AFC also oversees the placement of children with foster parents. In total there are approximately 109 children under AFC's care or supervision. A slight majority of the children are in foster care placements, with the rest in one of the five facilities.

[1] Pursuant to 11 U.S.C. § 333(a)(1) [1], if a debtor is a healthcare business the Court must appoint an ombudsman within 30 days of the commencement of a case unless the Court determines an ombudsman is not required.

The appointment of an ombudsman is determined by the results of a two part test. First the Court must decide if AFC is a healthcare business as defined in § 101(27A). Second, if the Court finds AFC to be a healthcare business it must appoint an ombudsman unless it finds "such ombudsman is not necessary for the protection of patients under the specific facts of the case." § 333(a)(1).

***757** *Is the Debtor a Healthcare Business?*

At the same time that Congress added § 333 it also amended § 101 by adding § 101(27A) which defines the term "health care business". The definition section is divided into two parts. The first part § 101(27A)(A) proposes a general definition. The second part, § 101(27A)(B) is a rather large list of types of entities that are healthcare businesses. AFC does not fit into any of the businesses listed in § 101(27A)(B). Therefore, for AFC to be considered a healthcare business it must meet the § 101(27A)(A) definition.

[2] The leading case on § 101(27A)(A) is *In re Medical Assc. of Pinellas, LLC,* 360 B.R. 356 (Bankr.M.D.Fla.2007). In *Pinellas* the court distilled § 101(27A)(A) into a four part test: (1) the debtor must be a private or public entity; (2) the debtor must be primarily engaged in offering to the general public facilities and services; (3) the facilities and services must be for the diagnosis or treatment of injury, deformity or disease; and (4) the facilities must be for surgical care, drug treatment, psychiatric care or obstetric care. *In re Medical Assc. of Pinellas, LLC,* 360 B.R. at 359.

[3] The first element is undisputed. AFC is indeed either a private or public entity. This Court agrees with the observation made by Judge Williamson that the first prong of the test "includes almost every conceivable entity." *In re Medical Assc. of Pinellas, LLC,* 360 B.R. at 359.

The second prong requires that AFC be "primarily engaged in offering to the general public facilities and services". *See* § 101(27A)(A). In *Pinellas,* the court determined that the debtor was not a health care business. This determination was based primarily on the fact that the debtor was engaged in providing support services to doctors. *Pinellas* 360 B.R. at 357. The court noted that the debtor "did not advertise or procure patients on behalf of the member doctors nor were the doctors doing business under the name of [the debtor] but instead conducted business in their individual names or the names of their individual professional associations." *Pinellas* 360 B.R. at 360. According to the court this limitation on its services meant that the debtor failed the second prong of the test; namely, that the services were not offered to the public. *Id.* The court further noted that services provided were administrative in nature and not for the purposes of diagnosis or surgery. *Id* at 360.

The same result was reached in *In re 7–Hills Radiology LLC,* 350 B.R. 902 (Bankr.D.Nev.2006)(J. Markell). In that case the debtor was a radiology clinic that only tested patients who were there by referral. *Id* at 904. Further "after the tests are given, [the debtor] does not advise the patients of the test results. Instead it simply sends the reports to the treating physician, who reviews them with the patient." *Id.* The court held that because only referred patients could receive an x-ray, the business was not held out to the public and as such did not meet the definition of a health care business. *Id.*

AFC presents a more complicated situation. First, AFC has on its website a link titled "placement availability". This link includes a number to contact. Second, the very presence of the website suggests that AFC has a public presence and with the link mentioned it is plausible to suggest that it is offering its services to the general public. Third, Dr. Simon stated that it is

possible for parents to approach AFC for help in dealing with their child's emotional or psychological problems. Dr. Simon also noted that such cases are exceedingly rare and represent a very small ***758** minority of the children that are under the care of AFC. The vast majority of the children under AFC's care are referred to AFC from another agency.

The striking similarity between AFC and the *7–Hills Radiology* case is that referrals were the vital method which the debtor procured business. However, there are two key differences. In *7–Hills Radiology* referrals were the only way for a member of the public to access the debtor's services. Whereas, in AFC's case it is possible, though rare, for a member of the public to access AFC's services. Secondly, in *7–Hills Radiology* the debtor only administered the x-ray, it was otherwise uninvolved in the day to day care of the patients or their treatment. AFC on the other hand has extensive and continuing responsibilities for the well-being of the children in its custody or over which it has supervision. Accordingly, based on its website and the cases where members of the general public have contacted the debtor directly for services the Court finds that AFC is indeed offering services to the general public.

[4] The third prong requires the services or facilities be used for the "treatment of injury, deformity or disease." § 101(27A)(A). This prong is clearly met. In the opinion of the Court if a condition is severe enough to warrant a course of medically supervised treatment, whether or not it involves pharmacological treatment, such a condition is sufficient to meet the requirements of § 101(27A). The psychological and emotional issues that afflict the children under AFC's care rise to the level of disease.

The final prong requires that the services or facilities be used for surgical care, drug treatment, psychiatric care or obstetric care. This prong is also easily met. AFC's mandate is to provide psychiatric treatment services to emotionally disturbed children. Further, according to Dr. Simon as many as 90% of the children under AFC's supervision receive medications of some sort. This is sufficient to find that the fourth prong is met.

Accordingly, the Court finds that AFC does meet the definition of the a healthcare business. The Court now turns to examine the second step of the test and determine whether under the facts of this case a healthcare ombudsman is necessary.

Is an Ombudsman Necessary Under The Specific Facts of The Case?

[5] **[6]** Pursuant to § 333(a)(1) the Court must appoint an ombudsman "unless the court finds that the appointment of such ombudsman is not necessary for the protection of patients under the specific facts of the case." § 333(a)(1). In making this evaluation the Court will examine the totality of the circumstances surrounding the bankruptcy filing and the operations of the debtor. This determination will be made by analyzing the following non-exclusive list of nine salient factors:

(1) the cause of the bankruptcy;

(2) the presence and role of licensing or supervising entities;

(3) debtor's past history of patient care;

(4) the ability of the patients to protect their rights;

(5) the level of dependency of the patients on the facility;

(6) the likelihood of tension between the interests of the patients and the debtor;

(7) the potential injury to the patients if the debtor drastically reduced its level of patient care;

(8) the presence and sufficiency of internal safeguards to ensure appropriate level of care;

(9) the impact of the cost of an ombudsman on the likelihood of a successful reorganization.

***759** **[7]** The first factor is the cause of the bankruptcy. In *In re: Saber* the debtor was a medical professional corporation that provided plastic surgery to patients. *In re William L. Saber, M.D., P.C.,* 369 B.R 631, 633 (Bankr.D.Colo.2007). The company was owned by the sole physician Dr. Saber. *Id.* His only other employees were a secretary, a medical assistant and a patient coordinator. *Id.* The court determined that the debtor did meet the *Pinellas* test and as such was a health care business. *Id* at 637. However, the court determined that under the facts of the case it was not necessary to appoint an ombudsman. *Id.* at 638. In reaching this conclusion the court noted the bankruptcy was not "precipitated by concerns relating to the quality of patient care or patient privacy matters." *Id.* at 637. Rather it was a contractual dispute

between the debtor and former employee that caused the bankruptcy filing. *Id.*

This same factor was considered by the court in *In re The Total Woman Healthcare Center P.C.,* 2006 WL 3708164, 2006 Bankr.LEXIS 3411 (Bankr.M.D.Ga.2006). In that case the court noted that "[m]ost of [the debtor's] obligations appear to be for taxes. The obligations do not appear to arise from deficient patient care." *In re The Total Woman Healthcare Center P.C.,* 2006 WL 3708164 at *2, 2006 Bankr.LEXIS 3411 at *5 (Bankr.M.D.Ga.2006).

Similarly, the cause of the bankruptcy in this case was a fire at AFC's primary facility in Hollywood, Florida. AFC generates revenues by a per diem per child payment from either insurance companies or appropriate government entities. The Hollywood facility was the most profitable facility. AFC did not have adequate insurance to cover the costs of repair and rebuilding the facility. The loss of its most profitable revenue stream coupled with the costs of rebuilding are the direct cause of the bankruptcy. The fire was a result of an electrical failure. Thus the cause of the bankruptcy filing was not related to patient care in anyway. This finding militates against the appointment of an ombudsman.

The second factor looks to see if there are licensing or supervisory entities that are already supervising the level of patient care. In AFC's case they are licensed by several government agencies, including the Florida Department of Child Services. AFC is also subject to supervision by Childnet [2] . Most importantly the vast majority of the children under the supervision of AFC are also under the supervision of a State of Florida Circuit Court by virtue of them being in the foster care system. The child safety net in Florida is already a vast and diffuse bureaucracy. Adding an ombudsman for the pendency of this bankruptcy would be a total duplication of the efforts of the various public and private entities already overseeing the welfare of the children. Accordingly, this factor heavily weighs against the appointment of an ombudsman.

The third factor is the debtor's past history of patient care. The *Saber* court also examined this factor. In that case the court noted "Dr. Saber has practiced more than twenty years and remains in good standing in his profession." *Saber* 369 B.R. at 638. Dr. Simon testified that in the past 20 years there have been many hundreds, if not thousands, of children that have been under the supervision of AFC. In total there have been three complaints ***760** against AFC that related to patient care. The presence of a mere three complaints over the course of 20 years shows that AFC has a remarkable track record of excellence. The Court is convinced that the past history of AFC does not require the appointment of an ombudsman.

The fourth factor is the ability of the patients to protect their rights. If a patient has the faculties to preserve their interests as opposed to a patient that is incapable of articulating and protecting their interests, then the appointment of an ombudsman would be extraneous. In this case the patients are all minor children. By presumption children are generally unable to protect and preserve their interests. In this case it is highly unlikely that children with severe emotional and psychological issues would be able to protect their own interests. The Court is cognizant that many of the children do have guardians ad litem. This factor does seem to weigh somewhat in favor of the appointment of an ombudsman. However, the children's inability to advocate or protect their own interests is not something that is heightened by virtue of the bankruptcy. Accordingly, the Court finds that this factor marginally weighs in favor of the appointment of an ombudsman.

The fifth factor is the level of dependency of the patients on the facility. There is no doubt that all of the children under AFC's care or supervision are highly dependant on AFC for their safety and well being. Accordingly, this factor militates towards the appointment of an ombudsman.

The sixth factor is the likelihood of tension between the interests of the patients and the debtor. In AFC's case there is little tension. AFC is looking to recover from the disastrous effects of the fire at its Hollywood facility. The reduction of patient care would not help AFC's reorganization. This is because a decline in patient care, whether real or perceived, would severely impact AFC's ability to receive placements from referring agencies. These referrals constitute the bulk of the placements AFC receives and make up a large part of its revenue. Further, the largest cost currently facing AFC is the cost of rebuilding the damaged facility, making reductions to patient care absent shuttering the business would not materially affect the solvency of the company. The Court is convinced that there is a low likelihood that patient care will be sacrificed or compromised in order to effectuate the reorganization of AFC. Accordingly, this factor weighs against the appointment of an ombudsman.

The seventh factor is the potential injury to the patients if the debtor drastically reduced its level of patient care. In this case

if AFC was to drastically reduce its level of care or cease operations the children could suffer severe trauma. Much of this trauma would be a result of having to move to another facility and possibly having to develop new relationships with new care givers. Furthermore, any substantial interruption in patient care would be negative for the children, if one or more of them did not receive their prescribed medications. Accordingly, the potential risk to the patients if AFC reduced its level of care is quite high, the Court finds that this factor weighs in favor of an ombudsman.

The eighth factor is the presence and sufficiency of internal safeguards to ensure appropriate level of care. Dr. Simon testified that there many internal safeguards to ensure that the children are well cared for. Overall, AFC is licensed and supervised by various state and private agencies. Within AFC the care of the children is handled by professionals. With respect to any medication, it is only given according to a prescription. The staff of AFC are responsible ***761** to make sure the children take the medication at the appropriate times. However, AFC does not prescribe or medicate the children, all prescriptions are made by a licensed doctor. At any given time the children are only handed a single dose of the medication. Finally, any changes to prescription medication, according to Dr. Simon, are made by the child's doctor and are explained to the State Court in charge of the child's well being. These procedures and safeguards are adequate. Accordingly, this factor weighs against the appointment of an ombudsman.

The ninth factor is the impact of the cost of an ombudsman on the likelihood of a successful reorganization. At the time of the filing AFC had assets of $996,825.00 and liabilities of $1,837,130.59. This case is, as the Court stated at the hearing, “dead on arrival.” The only thing keeping AFC alive and functioning is the financial commitment of Dr. Simon. Dr. Simon lent AFC $75,000 in emergency post petition financing. He has also agreed to extend $500,000 in debtor-in-possession financing. The lack of cash and the inability to obtain financing from conventional sources are clear indicators that this case cannot afford an ombudsman. As such, this factor weighs against the appointment of an ombudsman.

Based on the foregoing it is evident that the patients are highly dependant on AFC and are unable to adequately protect themselves without help and would suffer if AFC reduced its level of patient care. However, there is a tremendous amount of supervision and oversight on AFC from other state and private entities. This supervision is coupled with extensive in house procedural safeguards. Furthermore, the cause of the bankruptcy was not in anyway related to patient care. In fact, the past history of AFC shows that it has been relatively free of patient care complaints. Finally, the lack of tension between the interests of the patients and AFC is readily apparent, both the patients and AFC have a substantial interest in seeing AFC successfully reorganize. To this end the cost of an ombudsman would be a waste of scarce financial resources and would merely add another layer of bureaucracy to an already heavily regulated and supervised company. Accordingly, the Court finds that under specific facts of the case the appointment of an ombudsman is not warranted.

Based on the foregoing it is,

ORDERED and ADJUDGED pursuant to 11 U.S.C. § 333(a)(1) that a patient care ombudsman is not necessary according to the specific facts of the case.

All Citations

377 B.R. 754, 58 Collier Bankr.Cas.2d 1531, Bankr. L. Rep. P 81,057

Footnotes

1 11 U.S.C. § 333 was added, effective for all cases filed on or after October 17, 2005, by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). Unless otherwise noted, all code references are to Title 11 of the United States Code, also known as the Bankruptcy Code.

2 ChildNet is a private, not for profit organization created specifically to manage the child protection system in Broward County as part of a statewide program to transfer the responsibility for child protection, foster care, adoptions and related services to community based organizations.

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PART THREE
MATERIALS

10 F.3d 944
United States Court of Appeals,
Second Circuit.

In re CHATEAUGAY CORPORATION, Reomar, Inc., LTV Corporation, LTV Steel Company, Inc., LTV Steel Tubular Products Company, Debtors.
FRITO-LAY, INC., FL Holding, Inc., Ainwick Corporation, and Aetna Casualty and Surety Company, Plaintiffs-Appellants,
v.
LTV STEEL CO., INC., Chateaugay Corporation, Reomar, Inc., LTV Corporation, Kentron Saudi Arabia, Inc., LSC Leasing, Inc., The LTV Corporation (Wyoming), LTV International, N.V., LTV Sales Finance Company, LTVUS Corp., Repsteel Overseas Finance N.V., LTV Educational Systems, Inc., BCNR Mining Corporation, Bardale Coal Company, Barrel Corporation of West Virginia, Crystalane, Inc., Crystalee Coal Co., Dearborn Leasing Co., Erie B. Corporation, Erie Development Co., Erie I Corporation, LTV Steel Mining Co., (formerly Erie Mining Company), Georgia Tubing Corporation, Gulf States Steel Corporation, J.W. Storage Company of Ohio, Jalcite I, Inc., Jalcite II, Inc., Jarole Mining Company, Ltd., Jones & Laughlin Environmental Properties, Inc., Jones & Laughlin Mining Company, Ltd., Jones & Laughlin Ore Mining Company, LTV Electro-Galvanizing, Inc., LTV Holdings, Inc., LTV Leasing, Inc., LTV Steel Tubular Products Company, Lorain Pellet Terminal Co., Lykes Equipment Corporation, Lykes Leasing Corporation, Nemacolin Mines Corporation, Republic Buildings Corporation, Republic Drainage Products Company, Republic Technology Corporation, Republic-Reserve, Inc., Tuscaloosa Energy Corporation, YST Erie Corporation, Youngstown Erie Corporation, LTV Aerospace and Defense Company, National Telephone Systems, Inc., Sierra Information Systems Corporation, Sierra Research International Corporation, Universal Time/Frequency, Inc., LTV Industries, Inc., LTV Multinational, Inc., Vought Overseas, Ltd., LTV Vehicle Corp., Amland Corporation, Vought Properties, Inc., LTV Energy Products Company, Continental EMSCO Company, FC Divestiture Corporation, Halcorp, Inc., J.K. Industries, Inc., Juddcorp, Inc., LTV Properties, Inc., Oil States Offshore Marine, Inc., Oil States Rubber Co., Technical Plastics, Inc., et al., Debtors-Appellees, The Official Committee of Unsecured Creditors of the LTV Corporation ‘LTV’ and The Official Committee of Unsecured Creditors of the LTV Steel Company, Inc., Appellees.

Nos. 2058, 2059, 2061 to 2064, Docket 93-5048L, 93-5050CON, 93-5056CON, 93-5058CON, 93-5060CON and 93-5062CON.
|
Argued July 15, 1993.
|
Decided Nov. 29, 1993.

Synopsis
Tax lessors filed claims against Chapter 11 debtors for indemnification under sale-and-lease-back agreements, and also asserted claims sounding in tort and quasi-contract for improper appropriation of tax benefits. The United States Bankruptcy Court for the Southern District of New York, Burton R. Lifland, Chief Judge, entered orders determining amount of tax lessors' liquidated claims, estimating lessors' contingent and unliquidated claims, and holding that lessors' tort and quasi-contract claims were defective as matter of law. Both parties appealed. The District Court, John E. Sprizzo, J., 156 B.R. 391, affirmed. On further review, the Court of Appeals, Jacobs, Circuit Judge, held that: (1) tax lessors' claims were not rendered moot by substantial consummation of debtors' confirmed plan; (2) lessor was not entitled to administrative expense priority claim for adverse tax consequences that it incurred as result of debtors' postpetition retirement of assets that were subject of sale-and-lease-back agreements; and (3) lessor failed to establish that it had any possessory interest in tax benefits such as would support conversion claim under New York law.

Affirmed.

West Headnotes (21)

[1] **Bankruptcy** Moot questions

Appeal from decision of bankruptcy court must be dismissed as moot, pursuant to Article III's “case or controversy” requirement, if event occurs while appeal is pending that makes it

impossible for appellate court to grant any effective relief to prevailing party. U.S.C.A. Const. Art. 3, § 2, cl. 1.

18 Cases that cite this headnote

[2] **Bankruptcy** Moot questions

Bankruptcy appeal should be dismissed as moot, even though effective relief could conceivably be fashioned, where implementation of that relief would be inequitable.

30 Cases that cite this headnote

[3] **Bankruptcy** Moot questions

In bankruptcy context, mootness doctrine involves equitable considerations as well as the constitutional requirement that there must be a case or controversy. U.S.C.A. Const. Art. 3, § 2, cl. 1.

11 Cases that cite this headnote

[4] **Bankruptcy** Moot questions

Substantial consummation of plan of reorganization while bankruptcy appeal is pending will not moot appeal, if court can still order some effective relief, if such relief will not affect the re-emergence of debtor as revitalized corporate entity, if such relief will not unravel intricate transactions so as to create an unmanageable, uncontrollable situation for bankruptcy court, if parties who would be adversely affected by modification have notice of appeal and opportunity to participate in proceedings, and if appellant pursued with diligence all available remedies to obtain stay of execution of objectionable order where a failure to do so creates a situation rendering it inequitable to reverse orders from which appeal is taken.

113 Cases that cite this headnote

[5] **Bankruptcy** Moot questions

Substantial consummation of debtor's Chapter 11 plan did not moot creditor's appeal from bankruptcy court order denying its priority administrative expense claim, to the extent that relief could be granted so as not to unravel debtor's reorganization or to adversely affect parties not before court by allowing creditor to seek recoupment of funds that had revested in debtor or that were distributed to parties represented on appeal.

57 Cases that cite this headnote

[6] **Bankruptcy** Moot questions

Appellant should not be out of court on grounds of mootness solely because Chapter 11 plan has been substantially consummated, and because its injury is too great for debtor to satisfy in full without impairing feasibility of plan or affecting parties not before court, if appellant would be willing to accept some fractional recovery that does not impair plan or affect absent parties.

10 Cases that cite this headnote

[7] **Bankruptcy** Assumption, Rejection, or Assignment

Main purpose of bankruptcy statute authorizing debtor to assume or reject its executory contracts is to relieve estate of burdensome obligations, while at the same time providing a means whereby debtor can force others to continue to do business with it when debtor's bankruptcy filing might otherwise make them reluctant to do so. Bankr.Code, 11 U.S.C.A. § 365.

17 Cases that cite this headnote

[8] **Bankruptcy** Leases

Court could not compel debtors to assume nunc pro tunc an unexpired lease which had never been expressly rejected, where debtors' plan had since been confirmed and was now substantially consummated. Bankr.Code, 11 U.S.C.A. § 365.

[9] **Bankruptcy** Administrative expenses in general

Bankruptcy Use and occupancy claims; administrative rent

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Debtor may sometimes incur priority expenses under executory contract or unexpired lease, even without an express election to assume lease, if bankruptcy estate derives benefits under contract. Bankr.Code, 11 U.S.C.A. § 365.

10 Cases that cite this headnote

[10] **Bankruptcy** Reorganization cases
Bankruptcy Use and occupancy claims; administrative rent

Any tax benefits that debtors derived under the Internal Revenue Code upon their postpetition retirement of assets subject to sale-and-lease-back agreements, when assets were deemed to have been transferred back to debtors, did not arise under agreements themselves; accordingly, company which had nominally “purchased” the assets was not entitled to administrative priority expense claim, under bankruptcy statute dealing with executory contracts and unexpired leases, based on adverse tax consequences that it sustained as a result of debtor's exercise of their reserved contractual right to sell or retire assets. Bankr.Code, 11 U.S.C.A. § 365.

6 Cases that cite this headnote

[11] **Bankruptcy** Reorganization cases

Claim will be afforded administrative expense priority as necessary cost of preserving the state only to the extent that consideration supporting claimant's right to payment was both supplied to and beneficial to debtor-in-possession in the operation of its business. Bankr.Code, 11 U.S.C.A. §§ 503, 507.

4 Cases that cite this headnote

[12] **Bankruptcy** Classification of claims

Chapter 11 plan could separately classify indemnity claim secured by letters of credit or surety bonds issued by third-party financial institutions from unsecured indemnity claim arising out of debtors' postpetition retirement of assets subject to sale-and-lease-back agreements. Bankr.Code, 11 U.S.C.A. § 1122(a).

2 Cases that cite this headnote

[13] **Bankruptcy** Moot questions

Any argument that secured claims should have been estimated was rendered moot by substantial consummation of debtors' Chapter 11 plan.

4 Cases that cite this headnote

[14] **Conversion and Civil Theft** In general; nature and elements

Under New York law, the basis of action for “conversion” is denial or violation of plaintiff's dominion, rights or possession of property.

22 Cases that cite this headnote

[15] **Conversion and Civil Theft** In general; nature and elements

Under New York law, “conversion” implies a wrongful act, a misdelivery, a wrongful disposition, or a withholding of property.

5 Cases that cite this headnote

[16] **Implied and Constructive Contracts** Unjust enrichment

Under New York law, quasi-contract claim for “unjust enrichment” is based on obligation which the law creates, in absence of any agreement, when and because acts of parties or others have placed in possession of one person money, or its equivalent, under such circumstances that in equity and good conscience he ought not to retain it, and which ex æquo et bono belongs to another.

25 Cases that cite this headnote

[17] **Conversion and Civil Theft** Title and Right to Possession of Plaintiff

Under New York law, company which had nominally “purchased” the debtors' assets pursuant to sale-and-lease-back agreements solely for the purpose of securing tax benefits associated with property failed to demonstrate that it had any possessory interest in such

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tax benefits, such as would support conversion claim against debtors when they retired assets that were subject to the sale-and-lease-back agreements with the result that, under the Internal Revenue Code, assets were deemed to have been transferred back to debtors.

11 Cases that cite this headnote

[18] **Implied and Constructive Contracts** Effect of Express Contract

Under New York law, contractual indemnification claim asserted by company which had nominally "purchased" the debtors' assets pursuant to sale-and-lease-back agreements, when debtors retired assets and deprived company of the tax benefits for which it had bargained, precluded company from also recovering on quasi-contractual claim for debtors' alleged unjust enrichment.

13 Cases that cite this headnote

[19] **Action** Nature of Action

Under New York law, tort claim will not arise when plaintiff is essentially seeking enforcement of contractual bargain.

41 Cases that cite this headnote

[20] **Bankruptcy** Moot questions

Any objection to sufficiency of bankruptcy court's consideration of feasibility of confirmed Chapter 11 plan was rendered moot upon plan's substantial consummation.

18 Cases that cite this headnote

[21] **Bankruptcy** Bond

Constitutional Law Bankruptcy

Reorganized debtor had no obligation to, in effect, bond appeal by creditor whose claim for administrative priority expense had been denied, by setting up reserve for payment of alleged priority claim in event that bankruptcy court's decision was reversed on appeal, where plan itself did not expressly require debtor to set up reserve; creditor could protect its position by seeking to stay plan's confirmation pending appeal, and had no due process right to insist on reserve. U.S.C.A. Const.Amend. 14.

3 Cases that cite this headnote

Attorneys and Law Firms

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Larry L. Simms, Washington, DC (Harold S. Horwich, Lorraine M. Weil, ***948** G. Eric Brunstad, Jr., Hebb & Gitlin, Hartford, Ct., on the brief, James P. Ricciardi, Gregory E. Barton, Gibson, Dunn & Crutcher, of counsel), for plaintiff-appellant, Aetna Cas. and Sur. Co.

Before MAHONEY, McLAUGHLIN and JACOBS, Circuit Judges.

Opinion

JACOBS, Circuit Judge:

On May 27, 1993, the United States Bankruptcy Court for the Southern District of New York, Burton R. Lifland, *Chief Judge,* entered an Order confirming the Second Modified Joint Plan of Reorganization (the "Plan") in the bankruptcy proceedings of appellee LTV Corporation and its affiliated debtors (individually and collectively, "LTV" or the "Debtors"). The Plan was substantially consummated on June 28, 1993 or immediately thereafter. In this consolidated appeal, Frito-Lay, Inc., FL Holding, Inc. and Ainwick Corporation (collectively "Frito-Lay") primarily contest the confirmation of a plan that does not afford their claims administrative priority; and both Frito-Lay and Aetna Casualty & Surety Company ("Aetna") contest LTV's failure

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to establish a full reserve for their disputed priority claims, pending appeal of the Plan's confirmation, so that Frito-Lay's and Aetna's rights would not be prejudiced or mooted by the substantial consummation of the Plan.

(A) Frito-Lay and LTV were parties to a series of prepetition contracts known as "safe-harbor" leases-a kind of tax transaction encouraged by the federal tax laws for a brief period in the early 1980s. In the transactions giving rise to Frito-Lay's appeal, Frito-Lay nominally purchased tens of millions of dollars in depreciable assets used by LTV in its business, and at the same time nominally leased the assets back to LTV, paying the purchase price of the assets in accounting-entry installments that netted out as a wash against what LTV undertook to pay on the leasebacks. Frito-Lay also paid LTV substantial sums at the outset-the only part of the transaction in which value actually changed hands. In this way, Frito-Lay purchased tax benefits that LTV, as an unprofitable company, could not use.

After filing for bankruptcy protection, debtor-in-possession LTV retired many of the assets subject to the Frito-Lay leases. Under governing tax law, those retirements reduced the federal tax liability of the bankrupt estate and triggered adverse federal tax consequences for Frito-Lay. It is expected that the same consequences will ensue from likely future dispositions of some or all of the remaining assets. LTV has an undisputed obligation to indemnify Frito-Lay for the adverse tax consequences triggered by the disposition of assets subject to the leases. At each stage of these proceedings, however, Frito-Lay has contended that its indemnity claims for asset dispositions by the debtors-in-possession should be afforded administrative priority under the Plan, and that Frito-Lay's rights to indemnification for prospective, post-bankruptcy asset dispositions similarly should not be impaired.

Frito-Lay appeals from two orders of the United States District Court for the Southern District of New York. The first order, dated June 9, 1993, John E. Sprizzo, *Judge,* affirmed three orders of the United States Bankruptcy Court for the Southern District of New York, Burton R. Lifland, *Chief Judge,* entered July 31, 1989, February 18, 1992 and July 2, 1992, which, *inter alia,* authorized Frito-Lay's claims against LTV as pre-petition, general unsecured claims in the aggregate amount of $39,625,284. The second order, dated June 21, 1993, Michael B. Mukasey, *Judge,* affirmed two orders of the United States Bankruptcy Court for the Southern District of New York, Burton R. Lifland, *Chief Judge,* entered May 27, 1993 and June 7, 1993. To the extent relevant to this appeal, those orders: ruled that indemnification claims arising under Frito-Lay's unsecured safe-harbor leases must be treated as impaired; treated as unimpaired similar indemnification claims that were secured by guaranties under certain safe-harbor leases to which Frito-Lay was *not* a party; denied Frito-Lay's motion to compel LTV to reserve fully for Frito-Lay's asserted administrative priority claims pending appeal; and determined that the Debtors' reorganization plan could be confirmed while treating as unimpaired Inland Steel Company's contingent ***949** claim against the Debtors for post-petition patent infringement.

(B) Aetna Casualty & Surety Company ("Aetna") issued approximately 262 surety bonds in pre-petition transactions to secure LTV's payment of workers' compensation claims to certain LTV employees, and later paid tens of millions of dollars under the bonds after LTV entered bankruptcy and defaulted on the underlying compensation claims. Aetna has been awarded fractional recovery as an unsecured creditor, having unsuccessfully argued before the bankruptcy court that the Plan impermissibly discriminates between (a) the workers' compensation claims that Aetna submitted as subrogee under the surety bonds and (b) the workers' compensation claims-paid as unimpaired under the Plan-that were submitted by LTV employees whose compensation claims were not bonded.

Aetna seeks review of an interlocutory order of the United States District Court for the Southern District of New York, Michael B. Mukasey, *Judge,* dated June 11, 1993, affirming an order of the United States Bankruptcy Court for the Southern District of New York, Francis G. Conrad, *Judge,* entered May 25, 1993, which, *inter alia,* denied Aetna's motion to compel the Debtors to reserve fully for Aetna's asserted administrative priority claims pending their appeal.

On June 14, 1993, Frito-Lay and Aetna moved this Court to stay confirmation of the Debtors' plan of reorganization and to grant expedited review of these appeals. On June 16, 1993, this court granted an interim stay, which preserved the status quo until a regularly scheduled motions panel of this Court could conduct a hearing. After hearing argument on June 22, 1993, the motions panel refused to issue a further stay but granted Frito-Lay's and Aetna's motions to expedite the appeals that we now decide.

BACKGROUND

On July 16, 1986, the Debtors filed the first of their petitions for reorganization under Chapter 11 of the Bankruptcy Code. 11 U.S.C. § 1101, *et seq.* The bankruptcy court confirmed the Debtors' Plan by order entered May 27, 1993. The Plan went into effect on June 28, 1993, and was then or soon thereafter "substantially consummated" as that term is defined in Section 1101(2) of the Bankruptcy Code. 11 U.S.C. § 1101(2) (1988). Section 1101(2) defines "substantial consummation" as: "(A) transfer of all or substantially all of the property proposed by the plan to be transferred; (B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and (C) commencement of distribution under the plan."

JURISDICTION/MOOTNESS

The Debtors argue that the claims of Frito-Lay and Aetna are moot on appeal because (1) the bankruptcy court's May 27, 1993 order confirming the Plan (as affirmed by the district court), directs that "all property, assets and effects of the Debtors' estates not being held for distribution pursuant to the terms of the Plan shall [as of the effective date] re-vest in the respective Debtor companies subject to the provisions of the Plan, the Settlement Agreements and this Order.... free and clear of all claims and interests"; (2) the prospects for rehabilitation and a fresh start would be jeopardized if the reorganized entities were "saddled with lingering appeals" after the Plan's substantial consummation; and (3) granting the relief requested would adversely affect third parties not presently before this Court, including investors that "provided some $600 million of capital to the reorganized entities in reliance on the [Debtors'] financial condition."

[1] **[2]** "[I]f an event occurs while a case is pending on appeal that makes it impossible for the court to grant 'any effectual relief whatever' to a prevailing party, the appeal must be dismissed" by virtue of Article III's "case or controversy" requirement. *Church of Scientology v. United States,* 506 U.S. 9, 113 S.Ct. 447, 449, 121 L.Ed.2d 313 (1992) (quoting *Mills v. Green,* 159 U.S. 651, 653, 16 S.Ct. 132, 133, 40 L.Ed. 293 (1895)). Within the bankruptcy context, "[a]n appeal should also be dismissed as moot when, even ***950** though effective relief could conceivably be fashioned, implementation of that relief would be inequitable." *In re Chateaugay Corp.,* 988 F.2d 322, 325 (2d Cir.1993) (citations omitted).

Frito-Lay and Aetna raise several distinct issues on appeal, and request various forms of relief. We will consider mootness in respect of the various issues as we reach them in our analysis.

FRITO-LAY ISSUES

On appeal, Frito-Lay contests the district court's affirmance of the bankruptcy court decisions that (a) deny Frito-Lay's request for administrative priority on its safe-harbor lease indemnification claims; (b) permit the Plan to classify Frito-Lay's unsecured indemnification claims separately from the indemnification claims of parties that had secured their claims by letters of credit or otherwise; (c) do not estimate the other parties' contingent secured indemnification claims; (d) dismiss Frito-Lay's quasi contract and tort claims, which challenge LTV's right to retire certain of the qualified assets, or to treat them as retired; (e) permit LTV's plan of reorganization to classify as unimpaired Inland Steel Company's contingent claim against LTV (charging post-petition patent infringement), allegedly without sufficient consideration of the impact that claim might have on plan feasibility; and (f) deny Frito-Lay's request that LTV establish a full reserve for Frito-Lay's indemnification claims pending final appellate resolution of Frito-Lay's asserted right to administrative priority. [1]

A. The Indemnity Claims

Frito-Lay contends on appeal that the bankruptcy court and the district court erred in classifying Frito-Lay's contractual indemnity claims as pre-petition and general unsecured. Frito-Lay's indemnity claims are based on twenty-five agreements between Frito-Lay and two corporate predecessors of LTV Steel Company (Republic Steel Company and Jones & Laughlin Steel, Inc.) which agreements were entered into in 1981 and 1982 pursuant to the now repealed "safe-harbor leasing" rules of the 1981 Internal Revenue Code.

1. *Safe-Harbor Leasing.* Section 168(f)(8) of the Economic Recovery Tax Act of 1981 ("Former Section 168(f)(8)") permitted certain corporations to enter into "safe-harbor leases", also known as "tax benefit transfer agreements". *See* Pub.L. 97-34, 95 Stat. 172 (1981); Temp. Income Tax Regs. ("Former Temp. Regs.") § 5c.168(f)(8), 46 Fed.Reg. 51908 (Oct. 23, 1981). Safe-harbor leases entered into pursuant to Former Section 168(f)(8) are tax-driven sale-leaseback arrangements designed so that certain unprofitable

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companies could raise revenue by separately marketing the tax benefits associated with certain types of business property without disposing of the property itself. A tax-benefit transfer agreement satisfying the requirements of Former Section 168(f)(8) affords a "safe-harbor" in the sense that it is treated as a sale-leaseback for federal tax purposes even where the parties do "not comply with State law requirements concerning transfer of title, recording, etc." Former Temp.Regs. § 5c.168(f)(8)-1(c).

In a typical safe-harbor lease under Former Section 168(f)(8), the owner of qualified property transferred the property's tax attributes by nominally selling the property for (1) a single cash payment, based upon the present value of the federal tax benefits associated ***951** with the property, and (2) an installment payment obligation, approximating the property's value net of those tax benefits. At the same time, however, the purchaser leased back that property to the seller in exchange for rental payments that offset the installment note payments dollar for dollar. The purchaser's payments under the note and the seller's rental payments were thus a series of wash transactions. The only cash that actually changed hands was the initial cash payment. At the end of the lease term-still, for federal tax purposes only-the seller/lessee "repurchased" the property for a peppercorn. *See generally Armstrong World Industries, Inc. v. Commissioner,* 974 F.2d 422, 424, 431-32 (3d Cir.1992); *Tax Lease Underwriters, Inc. v. Blackwall Green, Ltd.,* 642 F.Supp. 1492, 1494 (E.D.Mo.1986); Joint Committee on Taxation Staff Pamphlet Analyzing Safe Harbor Leasing, 114 Daily Tax Rep. (BNA) J-29, 32 (June 14, 1982).

Pursuant to the Temporary Income Tax Regulations promulgated under the authority of Former Section 168(f)(8)(G), an asset loses its character as leased property under a tax benefit transfer agreement upon the happening of certain enumerated events. One of these "disqualifying events" is the retirement of the leased property. Former Temp. Regs. § 5c.168(f)(8)-8(b). When a disqualifying event happens, as when LTV retired assets during the bankruptcy proceedings, the seller/lessee-having retained ownership of the leased property for all purposes other than Former Section 168(f)(8)-is deemed to have repurchased the property for federal tax purposes. Former Temp. Regs. § 5c.168(f)(8)-8(d). The overall financial consequences of such a repurchase tend to be beneficial to the seller/lessee and detrimental to the buyer/lessor. For that reason, the buyer/lessor typically secured a contractual indemnification from the seller/lessee for any tax loss resulting from a disqualifying event, as Frito-Lay did here.

2. *The Frito-Lay/LTV Agreements.* Under the Frito-Lay/LTV safe-harbor leases, Frito-Lay purchased certain qualified property from LTV for (a) a cash payment of $189,460,229 (which, according to the parties, was based on the present value of the tax benefits to be transferred), and (b) a nonrecourse, interest-bearing note in an amount based on the property's remaining value. Frito-Lay then "leased" the property back to LTV for a period of twenty-two and a half years in exchange for monthly rental payments equal to the monthly installment payments due under the note. Frito-Lay was to enjoy the federal tax benefits of the qualified property until expiration of the lease term, at which time Frito-Lay would reconvey the assets to LTV for a token payment. The three leases submitted by the parties as representative contracts for purposes of this litigation confirm that, although Frito-Lay owned the qualified property for federal tax purposes during the lease term, LTV at all times retained the other attributes of ownership-including the power to bring about a disqualifying event by selling or retiring the assets. For example, the October 12, 1982 lease between Republic Steel Corporation (as seller/lessee) and Frito-Lay, Inc. (as buyer/lessor) contains the following provision (in which the qualified assets are designated "Items of Equipment"):

> [T]his Agreement shall not (a) effect a transfer of legal or equitable title to any Item of Equipment from Lessee to Lessor, (b) grant to Lessor any possessory right whatsoever in any Item of Equipment, or (c) grant to Lessor the right to claim any possessory right with respect to any Item of Equipment upon the occurrence or nonoccurrence of any event or under any circumstances whatsoever, including, without limitation, upon the occurrence of any breach by Lessee of any of its obligations hereunder. *Subject only to Lessor's right to claim Federal income tax deductions and credits with respect to each Item of Equipment as contemplated by this Agreement, Lessee shall retain*

> *all of the rights, benefits, incidents, burdens and obligations of ownership of each Item of Equipment, including, without limitation, the right to sell, transfer, assign or otherwise dispose of any Item of Equipment* and the obligation to pay all state and local taxes, all insurance premiums and all maintenance charges with respect to each Item of Equipment.... The use and possession of each Item of Equipment by Lessee, ***952** and Lessee's rights therein, are not in any way conditioned on the payment of Basic Rental Payments or any other payments identified in this Agreement.

Section 7.01 (emphasis added). The same lease provides, however, that LTV will indemnify Frito-Lay for any resulting tax loss if LTV's ownership decisions interfere with Frito-Lay's right to claim federal income tax deductions and credits with respect to the qualified assets.

The qualified assets affected by the twenty-five safe-harbor leases were located at eighteen separate LTV production facilities. In 1987, after filing for bankruptcy protection, LTV permanently retired two of those facilities, one in Buffalo, New York, and one in Aliquippa, Pennsylvania. Those retirements caused the disqualification of a group of assets subject to the safe-harbor leases, and resulted in the return of tax benefits to LTV. According to Frito-Lay, the disqualifications compelled it to pay an additional $14 million in respect of its 1987 tax year alone.

3. *Frito-Lay's Request for Priority.* LTV has never disputed the validity of the safe-harbor leases or that LTV's indemnification duties were triggered when Frito-Lay suffered negative tax consequences resulting from the retirements of qualified property at the Buffalo and Aliquippa facilities. What is disputed is Frito-Lay's demand that its indemnification claims be afforded administrative priority status. In an opinion dated June 29, 1989, the bankruptcy court resolved the issue by granting summary judgment to the Debtors, on the ground that the safe-harbor leases do not constitute executory contracts or unexpired leases under Section 365 of the Bankruptcy Code and therefore that the indemnity claims are pre-petition, general unsecured claims which, as such, are not entitled to priority treatment under Sections 503 and 507 of the Bankruptcy Code. *In re Chateaugay Corp.,* 102 B.R. 335 (Bankr.S.D.N.Y.1989). An order consistent with the June 29, 1989 opinion was entered on July 31, 1989.

The district court affirmed the bankruptcy court's grant of partial summary judgment on the ground that, whether or not the safe-harbor leases could be considered executory contracts or unexpired leases, Frito-Lay's indemnity claims could not be afforded priority status because no post-petition act of Frito-Lay conferred a post-petition benefit on the Debtors. *In re Chateaugay Corp.,* 156 B.R. 391, 399 (S.D.N.Y. June 9, 1993); *In re Chateaugay Corp.,* No. 89 Civ. 6687 (S.D.N.Y. Mar. 29, 1990).

The district court's June 9, 1993 order also affirmed the bankruptcy court's July 2, 1992 order, which (a) established the allowed amount of Frito-Lay's *fixed* indemnity claims, which are based on undisputed disqualifications that occurred during the bankruptcy proceedings, and (b) estimated at 80 percent Frito-Lay's *contingent* indemnity claims, which are based on possible future disqualifications and disputed past disqualifications.

4. *Mootness.* LTV's overarching position on appeal is that relief can no longer be granted to Frito-Lay because the Plan has been substantially consummated, and that the appeal should therefore be dismissed as moot. Substantial consummation of a reorganization plan is a momentous event, but it does not necessarily make it impossible or inequitable for an appellate court to grant effective relief. *See, e.g., In re AOV Industries, Inc.,* 792 F.2d 1140, 1148 (D.C.Cir.1986) (substantial consummation is "not a blanket discharge" of "judicial duty to examine carefully each request for relief").

[3] **[4]** In bankruptcy proceedings, the mootness doctrine involves equitable considerations as well as the constitutional requirement that there be a case or controversy. These concerns often cannot be addressed separately; they "are interactive, as 'the finality rule limits the remedies a court can offer.' " *In re Public Service Co.,* 963 F.2d 469, 472 (1st Cir.) (quoting *In re Stadium Management,* 895 F.2d 845, 847-48 (1st Cir.1990)), *cert. denied,* 506 U.S. 908, 113 S.Ct. 304, 121 L.Ed.2d 226 (1992). Constitutional and equitable considerations dictate that substantial consummation will not moot an appeal if all of the following circumstances exist: (a) the court can still order some effective relief, ***953** *Church of Scientology v. United States,* 506 U.S. 9, 113 S.Ct. 447, 449, 121 L.Ed.2d 313 (1992); (b) such relief will

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not affect "the re-emergence of the debtor as a revitalized corporate entity", *In re AOV Industries, Inc.,* 792 F.2d at 1149; (c) such relief will not unravel intricate transactions so as to "knock the props out from under the authorization for every transaction that has taken place" and "create an unmanageable, uncontrollable situation for the Bankruptcy Court", *In re Roberts Farms, Inc.,* 652 F.2d 793, 797 (9th Cir.1981); (d) the "parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings", *Central States, Southeast and Southwest Areas Pension Fund v. Central Transport, Inc.,* 841 F.2d 92, 96 (4th Cir.1988) (citations omitted); and (e) the appellant "pursue[d] with diligence all available remedies to obtain a stay of execution of the objectionable order ... if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from", *In re Roberts Farms, Inc.,* 652 F.2d at 798.

[5] The value of Frito-Lay's potential recovery on its priority claims is in dispute. If successful on the merits, Frito-Lay asserts that it will be entitled immediately to approximately $20 million (the amount of Frito-Lay's claimed tax loss to date); LTV places Frito-Lay's maximum recovery on a priority basis at $875,000 (the amount of tax benefits LTV allegedly derived from retiring its assets). Under either calculation, Frito-Lay argues that relief can be granted so as not to unravel the reorganization plan or adversely affect parties not before this Court. Specifically, Frito-Lay seeks the recoupment of funds that (pursuant to the Plan) re-vested in LTV or were distributed to parties represented on this appeal. In response, LTV states (1) that such payment is inconsistent with the bankruptcy court's May 27, 1993 order (as affirmed by the district court's June 21, 1993 order) which directs that, upon the effective date, all assets not being held for distribution pursuant to the terms of the Plan are to re-vest in the debtor companies "free and clear of all claims and interests", and (2) that such payment would "severely deplete" its $200 million in working capital upon which "other creditors have relied in approving and consummating the Plan." No argument against recoupment of funds is advanced specifically on behalf of appellee The Official Committee of Unsecured Creditors of the LTV Corporation or on behalf of appellee The Official Committee of Unsecured Creditors of the LTV Steel Company, Inc.

Despite the present uncertainty as to how much money is at stake, and what parties might be liable for its payment, the appellees do not dispute that the only way Frito-Lay could win on the merits is upon a finding that Frito-Lay was entitled to funds that, at least to some extent, were wrongfully distributed to or wrongfully re-vested in one or more entities that are now before this Court. That being so, we would be able to fashion effective relief to the extent of remanding with instructions to the bankruptcy court to order the return to Frito-Lay of any funds that were erroneously disbursed to such parties, to the extent that can be done manageably and without imperiling LTV's fresh start. *See, e.g., In re Spirtos,* 992 F.2d 1004, 1007 (9th Cir.1993); *In re International Environmental Dynamics, Inc.,* 718 F.2d 322, 326 (9th Cir.1983). We are not persuaded by LTV's argument that Frito-Lay's appeal is mooted as a result of the bankruptcy court's order that the assets re-vested in LTV are to be held "free and clear of all claims and interests." The district court's affirmance of that order is before us on this appeal.

The bankruptcy court made no determination (as it might have during its consideration of Frito-Lay's stay application) as to how payment of Frito-Lay's claims might affect LTV's re-emergence as a revitalized entity. Although counsel for LTV has assured a prior panel of this Court that his client would endeavor to pay any judgment to Frito-Lay without relapsing into Chapter 11, this Court is in no position to evaluate or act upon that assurance, nor can LTV's counsel speak for the numerous interests that were represented at the confirmation hearings and that would still suffer if the reorganization failed. Similarly, although reorganized LTV presents itself on appeal as an invigorated multi-billion dollar operation with $200 million in working capital and a $400 million line of credit, we are in no position to determine the effect that granting all of the requested relief ***954** would have on parties, such as investors, not before this Court.

[6] Nevertheless, a remand is not necessary. Although the bankruptcy court might determine that full relief is no longer available to Frito-Lay after substantial consummation, we are convinced that at least some effective relief could be granted. Certainly, Frito-Lay would readily accept some fractional recovery that does not impair feasibility or affect parties not before this Court, rather than suffer the mootness of its appeal as a whole. *Cf. MCI Telecommunications Corp. v. Credit Builders of America, Inc.,* 2 F.3d 103, 104 (5th Cir.) ("[A] case is not mooted by the fact that an impecunious judgment debtor may lack the means to satisfy a judgment." (citations omitted.)), *cert. denied,* 510 U.S. 978, 114 S.Ct. 472, 126 L.Ed.2d 424 (1993). A claimant should not be out of court on grounds of mootness solely because its injury is too great for the debtor to satisfy in full.

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Also significant is that Frito-Lay sought to stay confirmation of the Plan in urgent applications before the bankruptcy court, the district court and this Court. Frito-Lay did not prevail on any of those applications, but that result certainly cannot be attributed to any lack of initiative. Although we recognize the value of finality in bankruptcy proceedings and the need to afford reorganized LTV a "fresh start", those considerations are not sufficient to moot this issue on appeal.

5. *Debtors' Right to Reject Contracts and Leases.* Subject to court approval, a bankruptcy trustee or debtor-in-possession may assume or reject an executory contract or unexpired lease of the debtor. 11 U.S.C. § 365(a) (1988). Claims arising under contracts or leases so assumed are afforded administrative priority. Paragraph 8.1 of the Plan addresses LTV's assumption and rejection of contracts under Bankruptcy Code Section 365:

> The Debtors assume on and as of the Effective Date pursuant to Section 365 of the Code any and all executory contracts and leases of real estate except those which shall prior to the Confirmation Date have been rejected pursuant to Section 365 of the Code. For such purpose, *unsecured Tax Benefit Transfer Agreements shall constitute non-executory contracts.*

(Emphasis added.) Bearing these factors in mind, Frito-Lay seeks priority by arguing (1) that the Plan assumes all executory contracts that are not expressly rejected, (2) that Frito-Lay's safe-harbor leases are executory contracts, notwithstanding the Plan's categorization of unsecured tax benefit transfer agreements as non-executory, (3) that it is undisputed that LTV never expressly rejected the Frito-Lay leases, and therefore (4) that the Frito-Lay leases must be considered assumed. Frito-Lay also maintains that the safe-harbor leases are "unexpired leases" under Section 365, but offers no rationale for considering such "unexpired leases" assumed.

In briefing before this Court, the parties hotly contest whether or not the Frito-Lay safe-harbor leases properly can be categorized as executory contracts or unexpired leases; the bankruptcy court found that they are neither. *In re Chateaugay Corp.,* 136 B.R. 79, 83-84 (Bankr.S.D.N.Y.1992); *In re Chateaugay Corp.,* 102 B.R. 335, 350-56 (Bankr.S.D.N.Y.1989). The district court found it unnecessary to resolve the issue, holding that, even if the safe-harbor leases could be considered executory contracts or unexpired leases, the Debtors at no time elected to assume them and, in fact, were not entitled to assume them because Frito-Lay performed no post-petition act that benefited the Debtors. *In re Chateaugay Corp.,* 156 B.R. 391, 399 (S.D.N.Y.1993). *Cf. In re Grayson-Robinson Stores, Inc.,* 321 F.2d 500, 502 (2d Cir.1963) ("[I]n making a determination whether or not to reject, the advantages of giving and receiving further performance are to be weighed against the disadvantages."). Hence, both the district court and the bankruptcy court held that Section 365 and Paragraph 8.1 do not confer priority on Frito-Lay's claims. We affirm on grounds similar to those stated by the district court.

[7] **[8]** The main purpose of Section 365 is to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time ***955** providing "a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so." *Richmond Leasing Co. v. Capital Bank, N.A.,* 762 F.2d 1303, 1310 (5th Cir.1985) (per curiam). The estate's election to assume a contract or lease under Section 365 entitles the other contracting party to assert its claims on a priority basis. Section 365 does not confer any power of election upon the other contracting party. Although LTV never expressly rejected Frito-Lay's safe-harbor leases pursuant to Section 365, LTV never elected (and never secured court approval) to assume those leases, as Paragraph 8.1 of the Plan clearly shows. The Plan was confirmed and is now substantially consummated. We are in no position, were we so inclined, to compel the Debtors to assume the safe-harbor leases *nunc pro tunc.*

[9] **[10]** Even so, a debtor sometimes may incur priority expenses under an executory contract or unexpired lease, without an express election, if the bankrupt estate derives benefits under that contract. *See In re Unishops, Inc.,* 553 F.2d 305, 308 (2d Cir.1977). Frito-Lay seeks the benefit of this equitable principle by attributing to the safe-harbor leases the post-petition tax benefits that LTV received upon disqualification of the relevant assets. We conclude, however, that LTV received no post-petition benefit *under the leases.*

Two things happened that together resulted in a benefit to LTV: LTV retired certain assets; and that act triggered

tax consequences favorable to LTV. Neither event required Frito-Lay to do anything. LTV had full power to dispose of its assets before it signed the leases, and the leases simply acknowledge LTV's retention of that pre-existing power. LTV needed no consent from Frito-Lay to dispose of the qualified assets, and did not use any power conferred by the leases in doing so. The tax benefits that Frito-Lay enjoyed were conferred by the federal Tax Code, and did not spring from any as yet unperformed provision of the leases. Unquestionably, LTV visited a post-petition loss on Frito-Lay, but that is not the same thing as saying that Frito-Lay thereby conferred a contractual benefit on LTV or that a benefit was otherwise conferred on LTV under the leases. Frito-Lay was LTV's victim, but that status is not enough to support an administrative claim.

LTV's disqualification of assets resulted in tax benefits to LTV because the federal Tax Code treats disqualification as a repurchase of the asset by the seller/lessee. Frito-Lay argues that this repurchase, by which LTV is deemed to have acquired property from Frito-Lay, should be treated as an administrative claim as would any other post-petition transaction for the sale of business property. Although such a repurchase is *deemed* to have occurred (under Former Temp. Reg. §§ 5c.168(f)(8)-8(d)) rather than actually performed, Frito-Lay argues that the repurchase had real ramifications, conferred real benefits on LTV, and cannot be brushed aside as a legal fiction or construct. For example, all of the federal tax ramifications that have been so advantageous to LTV and so disadvantageous to Frito-Lay correspond to the consequences that would ordinarily flow from the repurchase of business property involved in a sale-leaseback transaction. Thus, the sale is real enough within the realm of the Tax Code, and it certainly creates real tax and accounting consequences. However, as we have already stated, the events that brought about the repurchase required no contractual performance by Frito-Lay and stemmed from the disposition of property that LTV at all times owned and had full power to sell or retire. Contrary to Frito-Lay's argument, the indemnification provisions of the safe-harbor leases do not constitute restrictions on LTV's unilateral power to dispose of the assets and do not give to Frito-Lay any interest in the assets; the indemnification clauses were necessitated precisely because the safe-harbor leases imposed no such restrictions on LTV and gave no such interest to Frito-Lay. Therefore, Frito-Lay's nominal resale of the leased assets cannot be said to have conferred the kind of post-petition benefit that will support an administrative priority claim in bankruptcy.

By reason of LTV's decision to retire the assets, Frito-Lay became entitled to an indemnification ***956** award to be paid on an impaired basis as a general unsecured claim, as the Plan provides. *See In re Hemingway Transport,* 954 F.2d 1, 8-9 (1st Cir.1992). We therefore affirm the district court's holding that-accepting without deciding that the Frito-Lay/LTV safe-harbor leases are executory contracts or unexpired leases-the debtors-in-possession neither assumed them nor received benefit under them, and that Frito-Lay's indemnification claims are not entitled to administrative priority pursuant to Section 365 and Paragraph 8.1 of the Plan.

[11] Finally, Frito-Lay argues that its indemnification claims are entitled to priority as administrative expenses by virtue of Sections 503 and 507 of the Bankruptcy Code, 11 U.S.C. §§ 503, 507 (1988). It is well settled, however, that a claim will be afforded priority " 'only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business.' " *Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc.,* 789 F.2d 98, 101 (2d Cir.1986) (*quoting In re Mammoth Mart, Inc.,* 536 F.2d 950, 954 (1st Cir.1976)). We have already determined, however, that the safe-harbor leases were entered into pre-petition and that Frito-Lay provided no post-petition benefit to the debtors-in-possession. Rather, as the district court observed, Frito-Lay's claim for administrative priority boils down to an assertion that the debtors-in-possession took actions in the estate's best interest that left Frito-Lay in the position of being unable to satisfy for 100 cents on the dollar its rights under its pre-petition contracts. That merely subjected Frito-Lay to the kind of unfairness that Chapter 11 evenly distributes among similarly situated creditors.

We therefore conclude that LTV was entitled to judgment as a matter of law against Frito-Lay's request for administrative priority made pursuant to Sections 365, 503 and 507 of the Bankruptcy Code.

B. Classification of Others' Indemnity Claims

[12] LTV entered into safe-harbor leases with a number of companies, some or all of which have asserted indemnity claims similar to those asserted by Frito-Lay. The Plan, which classifies Frito-Lay's indemnification claims as unsecured and impaired, classifies all of the other parties' similar claims as unimpaired. The justification offered for this disparity is that all of the indemnity claims-except Frito-Lay's-were secured by letters of credit or surety bonds issued by third-

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party financial institutions that subsequently furnished the estate with debtor-in-possession financing. For convenience, we will refer to these third-party letters of credit and surety bond arrangements collectively as guaranties.

Section 1122(a) of the Bankruptcy Code provides that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C.A. § 1122(a) (1988). Frito-Lay challenges the determination by the bankruptcy court and by the district court that the Debtors had a rational basis for affording priority to the secured indemnity claims and for classifying them separately from Frito-Lay's unsecured claims. Because the relief Frito-Lay seeks is to gain priority treatment for itself, this issue is not moot on appeal for substantially the same reasons stated in our discussion of Frito-Lay's indemnity claims.

LTV's safe-harbor leases with companies other than Frito-Lay provide that throughout the duration of the agreements LTV must maintain guaranties in an amount equal to LTV's maximum potential indemnity obligations. Failure to renew those guaranties constitutes an event of default, entitling the secured lessors to accelerate and to draw upon the guaranties directly for the full amount of LTV's potential indemnification obligations. The guaranties thus assure that the secured lessors will be paid the full indemnity due under their safe-harbor leases, whether their claims are classified in the Plan as impaired or as unimpaired. Frito-Lay contends that the secured lessors cannot be treated as unimpaired because Frito-Lay suffered its tax loss in the same way and for the same reasons as did the other lessors and because the other lessors cannot be treated as "secured" because they hold none of ***957** LTV's property as collateral. Although it is true that the other lessors are secured by obligations of third-party financial institutions, the debtors-in-possession agreed post-petition to reimburse those issuers fully for any draw-downs in order to induce the same issuers to provide the estate with hundreds of millions of dollars in debtor-in-possession financing. In this way, the Debtors were and continue to be obliged to reimburse the issuers of the guaranties 100 cents on the dollar for any draw-downs arising from LTV's secured indemnification obligations. That arrangement was approved by the bankruptcy court in 1987, after a hearing on full notice to all interested parties. We therefore agree with the bankruptcy court and the district court that the discriminatory terms of the Plan attacked by Frito-Lay have a rational basis.

C. Estimation of the Secured Lessors' Claims

[13] A bankruptcy court must estimate "any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case." 11 U.S.C. § 502(c)(1) (1988). Pursuant to Section 502(c)(1), the bankruptcy court estimated Frito-Lay's contingent, general unsecured claims for indemnification, but found it unnecessary to estimate the secured lessors' contingent unimpaired claims. On appeal, Frito-Lay does not argue that the bankruptcy court improperly estimated its claims, but asserts rather that the court was additionally bound to estimate the secured lessors' claims. The clearly stated purpose of Section 502(c)(1) is to allow estimation of claims in order to avoid undue delay in the administration of bankruptcy proceedings; the Plan having been substantially consummated, Frito-Lay's argument that the secured lessors' claims should have been estimated is now moot.

D. The Quasi Contract and Tort Claims

The bankruptcy court granted LTV's motion for summary judgment which, *inter alia,* dismissed Frito-Lay's claims for (1) conversion; (2) unjust enrichment; and (3) fraud. Frito-Lay appeals from the district court's June 9, 1993 affirmance of those rulings. For substantially the same reasons stated in our discussion of Frito-Lay's indemnity claims, Frito-Lay's quasi contract and tort claims have not been rendered moot on appeal.

We review grants of summary judgment *de novo. Healy v. Rich Products Corp.,* 981 F.2d 68, 72 (2d Cir.1992). Summary judgment must be granted "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c). A genuine issue does not exist "unless there is sufficient evidence favoring the nonmoving party for a jury to return a verdict for that party." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 249, 106 S.Ct. 2505, 2511, 91 L.Ed.2d 202 (1986) (citation omitted). We examine the evidence in the light most favorable to the party opposing the motion, and resolve ambiguities and draw reasonable inferences against the moving party. *See Knight v. U.S. Fire Ins. Co.,* 804 F.2d 9, 11 (2d Cir.1986), *cert. denied,* 480 U.S. 932, 107 S.Ct. 1570, 94 L.Ed.2d 762 (1987).

[14] **[15]** **[16]** Frito-Lay's claims for conversion and unjust enrichment are premised on the idea that the Debtors unlawfully appropriated tax benefits belonging to Frito-Lay. Under New York law, which the parties agree is controlling,

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a "denial or violation of the plaintiff's dominion, rights, or possession, is the basis of an action for conversion." *Sporn v. MCA Records, Inc.,* 58 N.Y.2d 482, 487, 462 N.Y.S.2d 413, 415, 448 N.E.2d 1324, 1326 (1983) (quoting 23 N.Y.Jur.2d *Conversion, and Action for Recovery of Chattel* § 3, at 210). "A conversion implies a wrongful act, a misdelivery, a wrongful disposition, or withholding of the property." *Magnin v. Dinsmore,* 70 N.Y. 410, 417 (1877). A quasi contract claim for unjust enrichment is based on "an obligation which the law creates, in the absence of any agreement, when and because the acts of the parties or others have placed in the possession of one person money, or its equivalent, under such circumstances that in equity and good conscience he ought not to ***958** retain it, and which *ex æ quo et bono* belongs to another." *Miller v. Schloss,* 218 N.Y. 400, 407, 113 N.E. 337 (1916).

[17] **[18]** **[19]** Frito-Lay has introduced no evidence that it had a possessory interest, susceptible to conversion or unlawful appropriation, in any of the tax benefits associated with the retired, disqualified assets. [2] It is undisputed that (a) the Debtors retained the right to retire the qualified assets; and (b) once the retirements occurred, Frito-Lay retained no rights under the federal Tax Code to the tax benefits associated with the assets. The indemnity clause (requiring LTV to reimburse Frito-Lay for lost tax deductions and credits) is an implicit recognition of LTV's and Frito-Lay's respective rights. Moreover, Frito-Lay's successful assertion of its contractual right to that indemnification, even though its recovery has been impaired, is fatal to any quasi contractual claim: "[t]he existence of a valid and enforceable written contract governing a particular subject matter ordinarily precludes recovery in quasi contract for events arising out of the same subject matter." *Clark-Fitzpatrick, Inc. v. Long Island R.R. Co.,* 70 N.Y.2d 382, 388, 521 N.Y.S.2d 653, 656, 516 N.E.2d 190 (1987) (citations omitted). It is also settled under New York law that a tort claim will not arise "where plaintiff is essentially seeking enforcement of the bargain." *Sommer v. Federal Signal Corp.,* 79 N.Y.2d 540, 552, 583 N.Y.S.2d 957, 961, 593 N.E.2d 1365 (1992).

According to Frito-Lay's fraud claim, the Debtors misrepresented that the qualified assets were retired in 1987, causing Frito-Lay to overpay its 1987 federal income taxes. The representative safe-harbor leases define "retirement" as "the retirement from service of such item of [qualified] property by [LTV] or any other event or circumstance which may be defined as a retirement in the [temporary regulations or final regulations promulgated under Section 168(f)(8) of the Code]." After reviewing the record, we agree with Chief Judge Lifland that the evidence adduced by Frito-Lay at best raises a question as to whether the Debtors, pursuant to the Tax Code, *abandoned* the qualified property in 1987. However, a finding that the Debtors did not abandon the property in 1987 would not support a finding that the Buffalo and Aliquippa assets were not otherwise *retired* in 1987. Frito-Lay's evidence therefore does not begin to satisfy its burden to raise a genuine question of fact as to whether the property was fraudulently retired.

In sum, the district court properly concluded that the Debtors were entitled to judgment as a matter of law dismissing Frito-Lay's claims sounding in quasi contract and tort.

E. The Inland Steel Company Claim

[20] Inland Steel Company brought an action against the Debtors in the United States District Court for the Northern District of Illinois alleging post-petition patent infringement and seeking $200 million in damages, trebled. In the LTV bankruptcy proceedings, Inland moved to compel the Debtors to reserve fully for their contingent liability; the Debtors cross-moved for permission to estimate Inland's claims at zero for purposes of the Plan and the reserve. The Debtors and Inland ultimately stipulated that Inland's pending claim would remain unimpaired but unreserved, and presented that stipulation for bankruptcy court approval. On May 26, 1993, the bankruptcy court conducted a hearing to determine, *inter alia,* whether the Plan was feasible and should be confirmed. At the hearing, Chief Judge Lifland heard a detailed account of the Inland stipulation, reviewed the agreement, and permitted everyone in attendance to be heard on the subject. Frito-Lay, which was represented at the hearing, did not choose to be heard. The stipulation was so ordered without any objection.

In briefing before this Court, Frito-Lay protests that "*on the very eve of confirmation,* LTV entered into the Inland Settlement, which permitted potential claims of over $600,000,000 (*30 times greater than Frito-Lay's*) to survive post-bankruptcy" (emphases in original). Frito-Lay does not argue ***959** that this feature of the Plan renders it unfeasible. Frito-Lay's appellate position is that "[t]he Plan should not have been confirmed", because the bankruptcy court somehow failed "sufficiently" to consider the impact that the Inland settlement might have on the Plan's feasibility.

On this record, we doubt that Frito-Lay preserved an objection to the Plan's feasibility, we doubt that Frito-Lay has standing

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to object to the Plan's feasibility (its claims presumably already having been paid, and its financial interest in the Plan's feasibility therefore eliminated), and we doubt that the bankruptcy court gave inadequate consideration to the Plan. We do not address any of those matters, however, because effective relief can no longer be fashioned. On June 28, 1993, LTV began consummation of the Plan, which entailed, among other happenings, the distribution of hundreds of millions of dollars in cash, common stock, preferred stock and warrants; the transfer of almost $1 billion in assets to creditors covered by restored pension plans; the merger and liquidation of corporate entities; the amendment of its certificate of incorporation and by-laws; and the recomposition of its Board of Directors. Frito-Lay's objection to the sufficiency of the bankruptcy court's consideration of the Plan's feasibility is now moot.

F. The Reserve Requirement

The district court affirmed the bankruptcy court's June 7, 1993 ruling that LTV was not required to fund a reserve based on the full unimpaired value of Frito-Lay's indemnification claims. Frito-Lay maintains that the Plan requires reorganized LTV to establish full reserves for all litigated claims pending their final resolution. Aetna, in its appeal, argues that such reserves are required by the Bankruptcy Code and the United States Constitution as well as by the Plan. We will discuss all of the reserve arguments together as part of our consideration of Aetna's appeal.

AETNA ISSUE

A. Aetna's Claims for Administrative Priority

Prior to the Debtors' Chapter 11 filing, Aetna issued approximately 262 surety bonds on behalf of LTV to secure particular obligations of LTV, including payment of certain workers' compensation claims. After filing for bankruptcy, the Debtors defaulted on the workers' compensation claims that were subject to Aetna's surety bonds. Aetna has paid roughly $42 million to LTV employees under the surety bonds and has asserted bankruptcy claims in that amount as the subrogee of the employees. Under the Plan, Aetna's claims as subrogee are general unsecured claims and as such are impaired. However, claims submitted directly by LTV employees have been paid 100 cents on the dollar; and it is undisputed that workers' compensation claims submitted directly by LTV employees, in respect of the same injuries paid by Aetna, would have been paid on an unimpaired basis. Aetna maintains that there is no adequate rationale for distinguishing between (1) the derivative claims it asserted while standing in the shoes of injured LTV employees and (2) the direct claims of injured employees who filled their own shoes. In briefing before this Court, the Debtors offered the following rationale for the Plan's distinction:

> Any diminution in the payment of employee entitlements, such as these workers' compensation benefits, would adversely affect employee morale, would undermine labor-management relations and, as the Debtors' past experience indicates, could lead to a serious disruption of the Debtors' operations. Unlike the employees, whose continued assistance and cooperation is vital to the reorganization effort, Aetna has played and will play no productive role in the reorganization effort.

The bankruptcy court, in its May 25, 1993 order, held that the separate classification and different treatment of the workers' compensation claims was proper. We are told that Aetna's appeal of that decision is presently before the district court.

B. The Reserve Requirement

Aetna's sole contention on appeal is that the Plan requires a reserve to be established on the books of reorganized LTV so that, if Aetna ultimately prevails on the merits of its ***960** pending objections to the Plan, (1) the reorganized LTV cannot rely on the provision of the Plan that vests all assets "not being held for distribution" in reorganized LTV "free and clear of all claims and interests of creditors"; and (2) the reorganized LTV will have enough money to satisfy Aetna's claims.[3] The parties agree that setting up a reserve would require only an accounting entry. By order dated June 11, 1993, the district court affirmed the bankruptcy court's May 25, 1993 denial of Aetna's application for a reserve, and certified Aetna's request for an expedited appeal. On June 22, 1993, this Court permitted Aetna's appeal to proceed on an expedited basis.

1. *The Plan's Requirements.* The reserve requirement of the Plan is not easily summarized because it relies on terms

that are defined elsewhere in the Plan by terms that are in turn further defined elsewhere. All told, there are thirteen paragraphs of definitions pertinent to the reserve question. After reviewing the reserve requirement and the related definitions, we agree with the district court that LTV was required to set up reserves only for claims that the Plan classified as unimpaired.

The Plan requires that reserves be established for timely-filed, disputed and pending claims that are in one of the classes categorized under the Plan as being unimpaired (the "Participating Unimpaired Classes"). A claim is disputed (a) if there is an objection as to the *amount* of the claim; or (b) if there is an objection as to the *priority* afforded the claim. With respect to disputes concerning amount, the bankruptcy court fixes the claim for reserve purposes. With respect to disputes concerning priority, a reserve must be established based on the highest claimed priority. Reserves must be established "in an amount equal to the aggregate Evaluated Disputed Claims in the Participating Unimpaired Classes as of the Effective Date." To understand that phrase, the reader must enter the maze of defined terms. After such a review, the district court held that a reserve is required only if the Plan categorizes the disputed claim as already "in the Participating Unimpaired Classes." No reserve for Frito-Lay's and Aetna's disputed claims was therefore necessary.

According to Frito-Lay and Aetna, it is absurd to state that their priority claims must already have been categorized as "in one of the Participating Unimpaired Classes" since LTV's failure to so categorize their claims is the reason the claims are disputed.

Upon careful examination of the reserve requirement, we believe that the district court's interpretation is the only one that is tenable. The reserve requirement assures that a claimant who has already been placed in an unimpaired class, but whose status in that class is subject to an ongoing dispute (due to an objection, for example, by the estate or by an unsecured creditor), will not lose its already established priority and its ability to collect in full merely because another of the Plan's provisions denies payment of disputed claims on the effective date. The Plan does not require LTV to post reserves that presuppose the priority of every claim as to which priority has been asserted. Otherwise, general unsecured claimants asserting priority could obstruct consummation of the Plan pending appellate review by requiring the establishment of reserves so large as to preclude a fresh start.

[21] 2. *Bankruptcy Code and Constitutional Requirements.* Aetna argues in the alternative that if the Plan itself does not expressly require the Debtors to set up a reserve, then such a provision must be read into the Plan in order for it to comply with the Bankruptcy Code and the United States Constitution. Under Paragraph 5.4B of the Plan, all funds not distributed when the Plan goes into effect vest in the reorganized LTV "free and clear of all claims and interests of creditors." Aetna argues that Paragraph 5.4B, absent some mechanism to ensure full recovery to a party that first succeeds in establishing its priority status on appeal, is incompatible with Bankruptcy Code Section 1129(a)(9)(A), which requires full cash payment of all administrative claims, ***961** 11 U.S.C. 1129(a)(9)(A) (1988). Aetna thus contends that its appellate rights under the Code are rendered meaningless, in violation of the Constitution's right to due process.

Aetna's argument is vastly overdrawn. A claimant in Aetna's position may seek to stay a plan's confirmation pending appeal; Aetna has argued unsuccessfully for such a stay to the bankruptcy court, the district court, and a prior panel of this Court. In addition, as our discussion of mootness makes plain, the granting of effective relief is not necessarily foreclosed by the substantial consummation of a reorganization plan. But neither the Bankruptcy Code nor tenets of due process require that a reorganized company in effect bond an appeal by a losing claimant.

Having determined that neither the Bankruptcy Code, the United States Constitution nor the Plan require LTV to reserve fully for claims pending appeal, we refuse otherwise to grant such relief.

CONCLUSION

All judgments of the district court herein appealed from are affirmed.

All Citations

10 F.3d 944, 62 USLW 2419, 24 Bankr.Ct.Dec. 1625, Bankr. L. Rep. P 75,617

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Footnotes

1 By order dated June 24, 1993, this Court denied Frito-Lay's request that our review of the present appeal be based on (a) the briefs filed below, together with (b) supplemental appellate briefs of no more than 10 pages. As a result, the parties briefed this appeal in the usual manner pursuant to Federal Rule of Appellate Procedure 28. Frito-Lay nevertheless advises us, in its 41 page “Supplemental Brief”, that “Frito-Lay and LTV agreed to submit this appeal on the record and briefs filed in the District Court, and to submit supplemental memoranda highlighting the matters addressed therein, and addressing any subsequent matters.” This Court never authorized the parties to deviate from the requirements found in the Federal Rules of Appellate Procedure, and we therefore limit our review to those issues properly raised in the briefs filed on appeal. *See United States v. Restrepo,* 986 F.2d 1462, 1463 (2d Cir.1993), *cert. denied,* 510 U.S. 843, 114 S.Ct. 130, 126 L.Ed.2d 94 (1993); *Gaste v. Kaiserman,* 863 F.2d 1061, 1069 n. 6 (2d Cir.1988).

2 We do not reach the question of whether Frito-Lay has sufficiently pleaded the remaining elements of its claims for conversion and unjust enrichment.

3 For substantially the same reasons stated in our discussion of Frito-Lay's indemnity claims, Aetna's appeal has not been rendered moot.

End of Document

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259 B.R. 114
United States Bankruptcy Court, D. South Carolina.

In re D.M. KAYE & SONS TRANSPORT, INC., Debtor.

Civ.A. No. 00–04867–W.
|
Feb. 1, 2001.

Synopsis
Tractor lessor moved for allowance of administrative expense claim. The Bankruptcy Court, John E. Waites, J., held that: (1) lessor that leased tractors to bankrupt transportation company was entitled to administrative expense claim for rent which became due during first 59 days after commencement of company's Chapter 11 case; and (2) lessor was entitled to administrative expense claim for rent that became due starting 60 days postpetition, until tractor leases were rejected, but was not entitled to payment of claim on superpriority basis.

Motion granted in part.

West Headnotes (15)

[1] **Bankruptcy** Partial assumption; burdens and benefits

Upon assuming its unexpired lease, debtor is entitled to receive benefits under lease, but is at same time responsible for performing its obligations thereunder. Bankr.Code, 11 U.S.C.A. § 365(b)(1).

[2] **Bankruptcy** Use and occupancy claims; administrative rent

If lease is breached after it has been assumed by debtor, then all future payments that are due for remainder of lease become administrative expenses, with administrative priority. Bankr.Code, 11 U.S.C.A. §§ 365, 503.

[3] **Bankruptcy** Rejection of executory contract or lease

If debtor's unexpired lease or executory contract is rejected, then in absence of facts establishing administrative claim, damages from that breach are treated merely as general, unsecured, prepetition claim. Bankr.Code, 11 U.S.C.A. § 365.

1 Case that cites this headnote

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

Bankruptcy statute requiring trustee to timely perform all obligations arising under debtor's unexpired personal property leases, from time starting 60 days after petition was filed until lease is assumed or rejected, provides lessor with presumptive entitlement to rent due sixty days after petition date, whether or not lease is beneficial to estate. Bankr.Code, 11 U.S.C.A. §§ 365(d)(10), 503(b)(1)(A).

[5] **Bankruptcy** Use and occupancy claims; administrative rent

Lessor that leased tractors to bankrupt transportation company was entitled to administrative expense claim for rent which became due during first 59 days after commencement of company's Chapter 11 case, where lessor had not simply allowed debtor to continue using tractors pursuant to its prepetition leases, but had moved for adequate protection and sought to compel deadline for assumption or rejection of its leases, and where debtor had actually used tractors in its business postpetition, such that estate had derived actual benefit from leases. Bankr.Code, 11 U.S.C.A. §§ 365(d)(10), 503(b)(1)(A).

1 Case that cites this headnote

[6] **Bankruptcy** Administrative expenses in general

Due to general presumption in bankruptcy that debtor's limited resources will be equally distributed among its creditors, administrative expense provision is narrowly construed. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

[7] **Bankruptcy** Reorganization cases

Principal purpose of administrative expense provision is to give creditors the incentive to continue dealing with debtor-in-possession and supply it goods and services. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

[8] **Bankruptcy** Presumptions and burden of proof

Burden of proof is upon party claiming entitlement to administrative expense status. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

[9] **Bankruptcy** Reorganization cases

In order to be entitled to administrative expense status, claimant must show both: (1) that its claim arose out of transaction with bankruptcy trustee or debtor-in-possession; and (2) that its claim directly and substantially benefited bankruptcy estate. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

2 Cases that cite this headnote

[10] **Bankruptcy** Reorganization cases

Claim arises out of transaction with bankruptcy trustee or debtor-in-possession, as required for it to be accorded administrative expense status, where there has been postpetition inducement of claimant's performance by debtor-in-possession or trustee. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

1 Case that cites this headnote

[11] **Bankruptcy** Use and occupancy claims; administrative rent

Secured creditor does not gain administrative expense status simply by sitting back and allowing debtor-in-possession to continue using property which the prepetition debtor owned. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

1 Case that cites this headnote

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

Bankruptcy Time for Decision

While bankruptcy statute requiring trustee to timely perform all obligations arising under debtor's unexpired personal property leases, from time starting 60 days after petition was filed until lease is assumed or rejected, provides trustee or debtor-in-possession with "breathing spell" to make reasoned decision to assume or reject lease, it does not compel that decision at any time before confirmation, nor does it require lessor of personal property to supply its property, during the first 59 days, free and clear of any charges or protections until rejection. Bankr.Code, 11 U.S.C.A. § 365(d)(10).

[13] **Bankruptcy** Administrative expenses in general

There must be actual use of creditor's property by debtor, so as to confer concrete benefit on estate, before creditor will be accorded administrative expense status; mere potential of benefit to estate will not suffice. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

[14] **Bankruptcy** Use and occupancy claims; administrative rent

While lessor that had leased tractors to bankrupt transportation company was entitled to administrative expense claim for rent that became due during first 59 days after commencement of company's Chapter 11 case at contractual rental rate, its claim would be limited to rent that accrued from date of hearing on its adequate protection motion; from this date, lessor's rent claim could be said to arise out of postpetition transaction with postpetition debtor. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

[15] **Bankruptcy** Use and occupancy claims; administrative rent

Bankruptcy Superpriority; extension of credit or failure of adequate protection

Pursuant to bankruptcy statute requiring trustee to timely perform all obligations arising under debtor's unexpired personal property leases, from time starting 60 days after petition is filed until lease is assumed or rejected, lessor that had leased tractors to bankrupt transportation company was entitled to administrative expense claim for rent that became due starting 60 days postpetition, until tractor leases were rejected and tractors were returned; however, lessor was not entitled to payment of its claim on superpriority basis, prior to claims of other similarly situated administrative expense claimants. Bankr.Code, 11 U.S.C.A. § 365(d)(10).

1 Case that cites this headnote

Attorneys and Law Firms

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G. William McCarthy, Jr., Columbia, SC, for debtor.

ORDER

JOHN E. WAITES, Bankruptcy Judge.

THIS MATTER comes before the Court upon the Motion for Allowance and Payment of Administrative Claim (the "Motion") filed by Western Star Finance Inc. ("Western Star") on November 6, 2000. In the Motion, Western Star requests that it be entitled to allowance and payment of $129,686.40 as an administrative expense pursuant to 11 U.S.C. § 503(b)(1)(A) [1] for the first fifty-nine (59) days of post-petition rent on the lease of tractors, and further requests timely payments pursuant to § 365(d)(10) for the rent starting on the sixtieth day from the petition date until the rejection of the respective leases. [2] On November 21, 2000, Navistar Financial Corporation ("Navistar") filed an Objection to Western Star's Motion claiming, among other things, that Navistar and other creditors are similarly situated as Western Star; therefore, no administrative claim payments should be made until all such claims have been filed and payment is authorized on a pro-rata basis. Debtor also filed an Objection to Motion for Allowance and Payment of Administrative Claim on November 22, 2000. Debtor objected on the grounds that the policy goals of § 503(b)(1)(A) of the Bankruptcy Code to encourage creditors to do business with a debtor post-petition have not been satisfied in the present case and that, even assuming that Western Star is entitled to a limited administrative claim, the amount requested exceeds the reasonable value of the use of the tractors. After considering the pleadings in the matter and the arguments of the parties and evidence presented at the hearing on the Motion, the Court makes the following Findings of Fact and Conclusions of Law pursuant to Fed.R.Civ.P. 52, made applicable in bankruptcy proceedings by Fed.R.Bankr.P. 7052. [3]

FINDINGS OF FACT

1. D.M. Kaye and Sons Transport, Inc. ("Debtor") [4] is a flatbed and dry van carrier that operates a fleet of tractors and trailers throughout the United States.

2. On June 2, 2000, Debtor filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code.

3. Western Star is a corporation engaged in the equipment leasing business. During the period from March 3, 1999

through and including October 19, 1999, Debtor entered into ten (10) Vehicle Lease Agreements ***117** ("Leases") and TRAC Rider Agreements with Western Star, as lessor, pursuant to which Debtor leased fifty-nine (59) Western Star 4964EX tractors (the "Leased Vehicles"), in exchange for monthly rental payments in the approximate amount of $95,009.43. On or about April 18, 2000, Western Star and Debtor entered into Modified Agreements to alter the schedule of monthly rental payments due under the Leases.

4. Debtor retained possession of the leased vehicles after the filing of the petition and continued to use Western Star's tractors in the ordinary course of business. Debtor is due for monthly tents since and including April 15, 2000.

5. On June 20, 2000, Western Star and The CIT Group/ Equipment Financing Inc. [5] filed an Emergency Motion for Relief from Automatic Stay or, Alternatively for Adequate Protection claiming that Debtor continued possession and use of Western Star and The CIT Group's vehicles and that the creditors lacked adequate protection of their financial interests in the leased property, including a lack of adequate insurance coverage. An Interim Order was entered in conjunction with the Motions for Relief from Stay filed by two other creditors [6] and the Western Star and The CIT Group's motion was continued at the parties' request until July 20, 2000.

6. On July 3, 2000, Western Star filed a second Motion for Relief From Automatic Stay or, Alternatively for Adequate Protection and also filed a Motion to Compel Assumption or Rejection of Lease, for Payment of Rent and/or for Adequate Protection. At the hearing on those motions held on July 20, 2000, counsel for Debtor and Western Star announced a settlement of all pending motions and thereafter noticed said agreement pursuant to Fed.R.Bankr.P. 4001.

7. The Stipulation and Agreement Modifying the Automatic Stay (the "Stipulation and Agreement") which was filed on July 27, 2000 and which was noticed pursuant to Fed.R.Bankr.P. 4001(d), indicated that the Debtor had defaulted under the leases prepetition at which time Western Star terminated the Leases in accordance with their terms. [7] It also provided for the turnover of the tractors to Western Star on the following terms and conditions:

> On or before July 31, 2000, Debtor shall tender to Western Star possession of ten Leased Vehicles. On or before August 6, 2000, Debtor shall tender to Western Star possession of an additional twenty Leased Vehicles On or before August 15, 2000, Debtor shall tender to Western Star possession of twenty-eight Leased Vehicles. With respect to the Leased Vehicle presently undergoing repairs, debtor at its cost shall complete the repairs to said vehicle in accordance with the repair estimate provided by Debtor's adjuster and said Vehicle shall be tendered to Western Star on the earlier of its repair completion or whenever demanded by Western Star in the event repairs in Western Star's opinion are not being completed timely.
>
> The Stipulation and Agreement Modifying the Automatic Stay further provided that, "Prior to tender, debtor may use the Leased Vehicles only in the ordinary course of its business and within generally accepted industry standards." The Agreement made no mention of lease payments ***118** or other adequate protection payments, rather, it chiefly provided for the dates of the return of the leased tractors and reserved all parties' rights in regards to the issue of an administrative expense claim or other claim by Western Star.

8. By Order entered August 22, 2000, the Court approved the Stipulation and Agreement Modifying the Automatic Stay. [8] While the Order did not make any mention as to the rejection of the subject Leases and despite the fact that the Court never expressly approved said rejection, at the hearing on the Motion the parties agreed and acknowledged that there had been a *de facto* rejection of the Leases on the various respective dates of the return of the tractors.

CONCLUSIONS OF LAW

In the Motion, Western Star claims that it is entitled to administrative expense status pursuant to § 503(b)(1)(A) for rent payments under the Leases for the first fifty-nine (59) days following the filing of the petition and to timely rent payments pursuant to § 365(d)(10) for the period starting on the sixtieth day following the filing of the petition and continuing until the rejection of the Leases.

1. Relationship Between §§ 365 and 503

[1] **[2]** **[3]** To resolve the issue, the Court must first examine the relationship between § 365 and § 503. Once the petition for relief under the Bankruptcy Code has been filed, § 365 gives the trustee or the debtor-in-possession the authority, "subject to the court's approval, [to] reject any executory contract or unexpired lease of the debtor" § 365(a). If, after acknowledging that the assumption of the lease or executory contract is in the best interest of the debtor's reorganization,

the lease is assumed, "the debtor is entitled to receive the benefits under the lease but, at the same time, is responsible for performing its obligations thereunder." *Interface Group–Nevada, Inc. v. Trans World Airlines, Inc. (In re Trans World Airlines),* 145 F.3d 124, 136 (3d Cir.1998); *see also* § 365(b)(1). In the case the lease is breached after it has been assumed, "all future payments due under the remainder of the lease become administrative expenses with administrative priority." *Id., see also Marriott Family Rest., Inc. v. Lunan Family Rest. (In re Lunan Family Rest.),* 194 B.R. 429, 450 (Bankr.N.D.Ill.1996) ("Where a contract is assumed by a debtor-in-possession, damages which arise from a post-petition breach of that contract are 'actual, necessary costs and expenses of preserving the estate.' "). On the other hand, if the lease or executory contract is rejected, "absent facts that establish an administrative claim, damages from that breach are merely treated as a general, unsecured, pre-petition claim." *In re Lunan Family Rest.,* 194 B.R. at 450; *In re Trans World Airlines,* 145 F.3d at 136, *General American Transp. Corp. v. Martin (In re Mid Region Petroleum, Inc.),* 1 F.3d 1130, 1132 (10th Cir.1993) ("[T]here is no obligation for the trustee to pay post-petition rent when the leases are rejected, except unpaid-post-petition rent is given unsecured claim status, unless the post-petition rent claim is subject to favored administrative expenses status.")

[4] Furthermore, § 365(d)(10) provides, in pertinent part,

> The trustee shall timely perform all of the obligations of the debtor, except those specified in section 365(b)(2), first ***119** arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property, until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof.

Section 365(d)(10) provides for a "presumptive entitlement" to rent due 60 days after the filing of the petition without first meeting the requirements of § 503(b)(1)(A). *See, e.g. In re Magnolia Gas Co.,* 255 B.R. 900, 917 (Bankr.W.D.Okla.2000); *In re Russell Cave Co., Inc.,* 247 B.R. 656, 659 (Bankr.E.D.Ky.2000); *In re Pan American Airways Corp.,* 245 B.R. 897 (Bankr.S.D.Fla.2000) Thus, while a creditor may be entitled to an administrative claim for rents due during the first 59 days of the case if the requirements of § 503(b)(1)(A) are satisfied, after the expiration of the 59–day period, the trustee is required to timely perform under the lease until assumption or rejection, whether or not the lease is beneficial to the bankruptcy estate. *See, e.g. In re Magnolia Gas Co.,* 255 B.R. at 917.

2. Administrative Claim under § 503(b)(1)(A)

[5] Western Star claims that it is entitled to administrative expense status pursuant to § 503(b)(1)(A) for the rent on the tractors leased to Debtor during the first 59 days of the case. [9]

[6] **[7]** Section 503(b)(1)(A) provides that "[a]fter notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case." Due to the general presumption in bankruptcy matters that "a debtor's limited resources will be equally distributed among creditors," courts have interpreted § 503 narrowly. *Merry–Go–Round Enter. v. Simon DeBartolo Group (In re Merry–Go–Round Enter.),* 180 F.3d 149 (4th Cir.1999), *see also In re Southern Soya Corp.,* 251 B.R. 302 (Bankr.D.S.C.2000). The principal purpose of § 503(b)(1)(A) is to give creditors the incentive to continue dealing with the debtor-in-possession and supply it goods and services. *See, e.g. In re Southern Soya,* 251 B.R. at 302 (citing *In re Merry–Go–Round Enter.,* 180 F.3d at 158), *see also General American Transp. Corp. v. Martin (In re Mid Region Petroleum, Inc.),* 1 F.3d 1130 (10th Cir.1993) (citations omitted) ("§ 503(b)(1)(A) was not intended to 'saddle debtors with special post-petition obligations lightly or give preferential treatment to certain select creditors by creating a broad category of administrative expense.' The policy behind giving priority to administrative expenses in Chapter 11 proceedings is 'to encourage creditors to supply necessary resources to debtors post-petition.' ")

[8] **[9]** In order for a claim to be granted administrative expense status, the party claiming entitlement to such status has the burden of proof. *In re Mid Region Petroleum, Inc.,* 1 F.3d at 1132, *see also In re Merry–Go–Round Enter.,* 180 F.3d at 149. Thus, for a claim to rise to the level of

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administrative claim, Western Star has the burden to show that two factors have been met: (1) that the claim arose out of a transaction between the creditor and the bankrupt's trustee or debtor-in-possession; ***120** and (2) that the claim directly and substantially benefited the estate. *See, e.g. In re Merry–Go–Round Enter.,* 180 F.3d at 157; *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.),* 66 F.3d 1091, 1094 (9th Cir.1995). *In re Mid Region Petroleum, Inc.,* 1 F.3d at 1132; *In re Jartran,* 732 F.2d 584, 587 (7th Cir.1984); *In re Southern Soya Corp.,* 251 B.R. at 302, *Marriott Family Rest., Inc. v. Lunan Family Rest. (In re Lunan Family Rest.),* 194 B.R. 429, 449 (Bankr.N.D.Ill.1996); *In re Air South Airlines, Inc.,* C/A No. 97–07229–W (Bankr.D.S.C. 12/19/2000). [10]

[10] The first requirement is that the claim arise from a transaction with the debtor-in-possession or the trustee. In satisfying the first prong, courts have stated that such requirement is met in situations where there has been a post-petition inducement of a party's performance by a debtor-in-possession or trustee. *See, e.g. In re Lunan Family Rest.,* 194 B.R. 429 (N.D.Ill.1996). In *In re Lunan Family Rest.,* for example, the court concluded that a debt may be promoted to administrative expense status if the creditor provides consideration to the debtor-in possession. *Id.* at 449. The court went on to explain,

> Consideration is furnished to the estate only where the debtor-in-possession induces post-petition performance or where performance on a contract not rejected by the debtor-in-possession is rendered to the estate.
>
>> Thus, the key to the allowance of an administrative expense under this analysis is an inducement to a third party by a debtor-in-possession, followed by consideration from the third party to the debtor-in-possession. If the commitments of the parties arose prepetition, there is no administrative expense payable from the bankruptcy estate.
>
> *In re Cardinal Indus., Inc.,* 142 B.R. 801, 803–04 (Bankr.S.D.Ohio 1992).

Id. at 449 (citation omitted); *see also In re Jartran,* 732 F.2d 584 (7th Cir.1984).

It is clear that where a sale of property is in question, as opposed to a lease for use of said property, and such sale has occurred pre-petition, the defaulted payments may not constitute an administrative expense claim. *See, e.g. Microsoft Corp. v. DAK Ind., Inc. (In re DAK Ind., Inc.),* 66 F.3d 1091 (9th Cir.1995) (holding that a computer software vendor, which had entered into a pre-petition agreement allowing debtor to install software on computers that debtor sold, was not entitled to administrative expense status for royalty payments based on debtor's distribution of software post-petition; rather, the court characterized the parties' agreement as a lump-sum sale of software units and concluded that the debt had arisen pre-petition), *In re Marcus,* 64 B.R. 207 (N.D.Ill.1986) (finding that a transaction involving the sale of tools and parts to debtor was finalized pre-petition and thus concluding that the creditor was not entitled to administrative claim status).

[11] The cases are clear in concluding that a secured creditor does not gain administrative expense status by "merely ***121** sitting back and allowing the debtor-in possession to continue using property which the pre-petition debtor owned." *In re Carpet Center Leasing Co.,* 991 F.2d 682, 687 (11th Cir.1993). However, a claim may meet the post-petition transaction requirement if the debtor-in-possession "actively bargains" for the use of the collateral and the creditor seeks and receives adequate protection of its interest. *See, e.g. id.* (finding that the requirement that there be a post-petition transaction was satisfied because "rather than simply enjoying the benefits of a pre-petition commitment, Debtor actively bargained for the use of the tractors after filing its bankruptcy petition."), *In re Raymond Cossette Trucking, Inc.,* 231 B.R. 80, 84 (Bankr.D.N.D.1999). The Court finds that the facts of this case present a similar situation in that they deal with a lease of equipment and a post-petition Stipulation and Agreement Modifying the Automatic Stay which was actively bargained for by Debtor.

In this case, within a month after the petition was filed, Western Star filed a Motion for Relief From Automatic Stay or, Alternatively for Adequate Protection and also filed a Motion to Compel Assumption or Rejection of Lease, for Payment of Rent and/or Adequate Protection. The Motions resulted in a Stipulation and Agreement, which was noticed to all creditors and parties in interest pursuant to Fed.R.Bankr.P. 4001(d). The Stipulation and Agreement set the terms upon which the leased equipment was to be returned to Western Star. More specifically, it provided for Debtor to tender 10 of the 59 leased tractors to Western Star by July 31, 2000, further turnover of an additional 20 tractors by August 6, 2000; and final tender of the remaining trucks to Western Star on or before August 15, 2000. [11] Furthermore, the Agreement and Stipulation provided, "Prior to tender, debtor may use the Leased Vehicles only in the ordinary course of its business and

within generally accepted industry standards. Further, prior to tender Debtor shall keep the Leased Vehicles insured and shall repair and maintain them as provided by the Leases."

Western Star did not merely sit back and allow Debtor to continue using its tractors pursuant to the pre-petition Leases. The creditor sought to compel the setting of a deadline for the assumption or rejection of the leases and sought rent or adequate protection to offset any decline in value of its interests during the use of the equipment. Similarly, Debtor did not merely reject the Leases and hold the equipment. Rather, in response to creditor's action to compel, Debtor "actively bargained" with Western Star as indicated by the Stipulation and Agreement for a specified and continued use of the equipment until certain dates, without contemporaneous lease payments or payments for adequate protection.

[12] While the effect of § 365(d)(10) provides a "breathing spell" for a debtor-in-possession to make a reasoned decision to assume or reject a lease, it does not compel that decision at any time before confirmation, nor does it require the lessor of personal property to supply its property, during the first 59 days, free and clear of any charges or protections until rejection. By its motions, Western Star requested relief from stay, [12] lease payments ***122** and adequate protection, and a court-ordered date for the assumption or rejection of the leases. It exchanged its rights to these remedies for Debtor's agreement to insure, maintain, repair and return the tractors by turnover on dates certain, and thereby avoided further delay, attorneys' fees, and costs associated with further court proceedings or an involuntary repossession. Similarly, Debtor negotiated for the continuing possession and use of the tractors without payment to Western Star.

After such negotiation, the parties reached an agreement; which was the announced to then Court, noticed to creditors, and approved by Order entered August 22, 2000. Under the circumstances of this particular case, it thus appears that the post-petition transaction requirement of § 503(b)(1)(A) was met. The Court further finds that the post-petition transaction required to satisfy § 503(b)(1)(A) should be recognized as having been entered into on July 20, 2000, when the parties' agreement was announced before the Court.

[13] Having concluded that the first prong requiring a post-petition transaction with the debtor-in-possession or the trustee has been satisfied, the next question becomes whether the use of the trucks benefitted the estate. The language of § 503(b)(1)(A) specifies that administrative priority status is warranted for "actual, necessary costs and expenses of preserving the estate." The Fourth Circuit has interpreted this requirement as follows:

> This ... narrow interpretation requires actual use of the creditor's property by the debtor, thereby conferring a concrete benefit on the estate before a claim is allowable as an administrative expense. Accordingly, the mere potential of benefit to the estate is insufficient for the claim to acquire status as an administrative expense. The Court's administrative expense inquiry centers upon whether the estate has received an actual benefit, as opposed to the loss a creditor might experience by virtue of the debtor's possession of its property.

Ford Motor Credit Co. v. Dobbins, 35 F.3d 860, 866 (4th Cir.1994); *see also* *In re Southern Soya,* 251 B.R. 302 (Bankr.D.S.C.2000). In this case, there is no dispute between the parties as to the fact that the tractors in question were used by Debtor post-petition and provided an actual benefit to the estate by allowing Debtor to continue its business operations; therefore, the Court finds that the second prong of the analysis to determine whether a claim warrants administrative claim status is also met.

Despite the narrow application of § 503(b)(1)(A) contemplated by the Fourth Circuit in *Merry–Go–Round Enter. v. Simon DeBartolo Group (In re Merry–Go–Round Enter.),* 180 F.3d 149 (4th Cir.1999), the Court finds that this holding concurs with the policy reasons behind ***123** that section. As stated by this Court in *In re Southern Soya,* 251 B.R. 302 (Bankr.D.S.C.2000), "[t]he main purpose behind granting administrative expense status to certain expenses of a debtor is to induce creditors and landlords to continue doing business with the debtor or to enter into new loans or contracts." *Id.* This policy is furthered by situations such as in this case where Debtor induced Western Star to forego certain rights and actively bargained for and continued to use the tractors which provided an actual and direct benefit to the estate. [13]

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[14] Therefore, the Court concludes that, as for the claim for the rent due for the first 59–days following the filing of the petition, such claim warrants administrative expense status. In its Objection, Debtor pointed out that the rate requested by Western Star did not represent the reasonable value of Debtor's use of the tractors because, prior to their surrender, the vehicles sat idle during the decommissioning process. The Court finds that Western Star should be granted an administrative claim pursuant to § 503(b)(1)(A) for the post-petition rental payments from July 20, 2000, the date of the hearing at which the existence of an agreement was announced, to July 31, 2000, taking into account the fact that certain trucks may have been decommissioned prior to that date.[14] Furthermore, the Court finds that the lease rental rate is the proper rate for the administrative claim in this particular case. However, since the Court was not presented with the dates on which the various tractors were decommissioned, the Court must schedule a further hearing to determine the exact amount of Western Star's § 503(b) administrative claim. **The hearing is scheduled for February 8, 2001 at 10:30 a.m. before the undersigned Judge at the Donald Stuart Russell Federal Court House, 201 Magnolia Street, Spartanburg, South Carolina.**

3. Claim under § 365(d)(10)

[15] Western Star also requests payment for the rent due starting on the sixtieth day after the petition date until the rejection of the respective Leases. The original claim for rents due pursuant to § 365(d)(10) was in the amount of $27,293.25; however, after taking into account that the tractors were decommissioned for an average of seven days prior to being returned, at the hearing on the Motion the parties submitted a written stipulation that the § 365(d)(10) claim, would be reduced to $12,052.40.[15] As discussed ***124** above, the purpose of § 365(d)(10) is to mandate the performance of the debtor's duties and obligations under an unexpired lease beginning 60 days after filing, regardless of whether the claim meets the requirements of § 503(b)(1)(A). *See, e.g. In re Magnolia Gas Co.,* 255 B.R. 900, 917 (Bankr.W.D.Okla.2000). Accordingly, pursuant to § 365(d)(10), the Court finds that Debtor is obligated to Western Star for the payment for a period between 60 days after the order for relief and the various dates the tractors were returned to Western Star, which represent the date the Leases were rejected.

Western Star claims that, due to the language in § 365(d)(10) indicating that the trustee shall "timely" perform the debtor's obligations, it should be paid immediately for the claim due pursuant to § 365(d)(10). However, due to the circumstances in this case, the Court is inclined to deny the immediate payment of Western Star's claim. Debtor has already filed a Disclosure Statement and Plan of Reorganization on December 21, 2000, and a hearing on the Disclosure Statement is presently scheduled for February 8, 2001. Furthermore, there are several other creditors in this case which are holding administrative expense claims; some creditors's claims, including Navistar's, are for post-petition rent payments under leases which were assumed and later breached. Considering the equities in this case, the Court finds that it is proper to have Western Star's claim pursuant to § 365(d)(10) be considered for payment along with other administrative claims similarly situated at confirmation of a Plan of Reorganization.[16] **In order to set the amount of that claim, a further hearing shall be held on February 8, 2001 at 10:30 a.m. before the undersigned Judge at the Donald Stuart Russell Federal Court House, 201 Magnolia Street, Spartanburg, South Carolina.**

CONCLUSION

From the arguments discussed above, it is therefore

ORDERED that, to the extent stated above, Western Star's request that it be entitled to allowance and payment of an administrative expense pursuant to § 503(b)(1)(A) during the first 59 days after the petition is filed is granted. Due to the lack of specific evidence necessary for the Court to determine the exact amount of Western Star's administrative claim pursuant to this ruling, **a further hearing has been scheduled before the undersigned Judge on February 8, 2001 at 10:30 a.m. at the Donald Stuart Russell Federal Court House, 201 Magnolia Street, Spartanburg, South Carolina.**

IT IS FURTHER ORDERED that, pursuant to § 365(d)(10), Debtor shall pay Western Star, according to a confirmed Plan of Reorganization, the rent due for the Leases of tractors for the period commencing 60 days after the order for relief until the rejection of the Leases. **In order to set the amount of that claim, a further hearing shall be held on February 8, 2001 at 10:30 a.m. before the undersigned Judge at the Donald Stuart Russell Federal Court House, 201 Magnolia Street, Spartanburg, South Carolina.**

AND IT IS SO ORDERED.

All Citations

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Footnotes

1 Further references to the Bankruptcy Code shall be by section number only.

2 At the hearing on the Motion, counsel for Western Star presented the following amended figures as the amounts requested pursuant to both § 503(b)(1)(A) and § 365(d)(10): $182,309.12 for the administrative claim pursuant to § 503(b)(1)(A) and $27,793.25 for the claim pursuant to § 365(d)(10).

3 The Court notes that to the extent any of the following Findings of Fact constitute Conclusions of Law, they are adopted as such, and to the extent any Conclusions of Law constitute Findings of Fact, they are so adopted.

4 For instances which occurred post-petition, the term "Debtor" shall refer to the debtor-in-possession.

5 Western Star is a wholly owned subsidiary of The CIT Group.

6 The Interim Order entered July 7, 2000 set forth Debtor's duty to notify each lienholder and lessor within 24 hours of any incident of any damage to the collateral in the amount of $1,500 or more; specified that each lienholder and lessor had access to inspect their collateral, and further required Debtor and the Watson Group Insurance Agency to notify the lienholders and lessors of any issued cancellation of the insurance policy or any warning of a pending default.

7 Despite the fact that the Stipulation and Agreement indicates that the Leases terminated prepetition, that argument was never raised by either party in conjunction with the Motion presently before the Court.

8 The Order also provided that if Debtor defaulted in its obligations under the Stipulation and Agreement, Western Star could file an affidavit of noncompliance with the Court and that upon such filing and service and, upon the entry of a further order of the Court reflecting Debtor's default, the automatic stay under § 362 would be lifted and modified to allow Western Star to pursue its rights and remedies in and to the leased vehicles as provided in the Leases and under applicable law. However, the Court did not approve the provision in the Stipulation and Agreement providing that the Agreement would bind any subsequent trustee of the debtor if the case were converted to a Chapter 7.

9 The Motion initially requested the allowance of administrative expenses pursuant to § 503(b)(1)(A) in the amount of $129,686.40. At the hearing on the Motion, counsel for Western Star stated that, after further calculations, the amount requested was $182,309.12. However, at the conclusion of the hearing, the parties agreed that, if the Court were to grant administrative expense status for rents due for the entire first 59 days of the case, the administrative claim would be $176,588.02.

10 The Court has found some cases in which the courts allowed the elevation of post-petition rents on pre-petition leases to administrative expense status by concluding that the estate was actually benefitted by the use of the leased equipment. *See, e.g. In re Raymond Cossette Trucking, Inc.,* 231 B.R. 80 (Bankr.D.N.D.1999); *In re Bridgeport Plumbing Prods.,* 178 B.R. 563 (Bankr.M.D.Ga.1994). Both cases dealt with pre-petition leases and focused on the issue of whether the property in possession continued to be used by the debtor-in-possession thus providing an actual benefit to the estate. However, the cases did not analyze the requirement that the claim arose from a post-petition transaction with the debtor-in-possession. Despite the analysis

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adopted by the courts in those cases, this Court adopts the view upheld by the Fourth Circuit in *In re Merry–Go–Round Enter.,* 180 F.3d 149 (4th Cir.1999) that the test to determine whether a claim warrants § 503(b)(1)(A) treatment is a two-pronged analysis which first requires the existence of a post-petition transaction.

11 One of the 59 tractors in Debtor's possession had been damages and required major repair. As to that tractor, the Stipulation and Agreement provided:

> With respect to the Leased Vehicle presently undergoing repairs, debtor at its cost shall complete the repairs to said vehicle in accordance with the repair estimate provided by debtor's adjuster and said Vehicle shall be tendered to Western Star on the earlier of its repair completion or whenever demanded by Western Star in the event repairs in Western Star's opinion are not being completed timely.

12 In 1994, through the Bankruptcy Reform Act, § 363(e) was amended to provide as follows:

> Notwithstanding any other provision of this section, at any time, on request of any entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as in necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

Section 363(e) was thus amended to clarify a lessor's right to adequate protection of its interest in property but to specify that such lessor may not obtain relief from the stay pursuant to § 362(d). *See* 3 *Collier on Bankruptcy,* ¶ 363.05[4] (15th ed. rev.2000) (footnotes omitted) ("The amendment suggests that such a lessor may obtain protection of its interest in the property leased to the debtor, such as protection of the value of the property or enforcement of the debtor's obligation to make rental payments under section 365(d)(1), but may not obtain relief from the stay to retake the property based on a lack of adequate protection"). In this case, the Court also notes that while relief from the automatic stay is generally not granted to lessors for lack of adequate protection, relief may be an appropriate remedy if the leases were terminated pre-petition, as indicated by the Stipulation and Agreement.

13 In the case of *Ford Motor Credit Co. v. Dobbins,* 35 F.3d 860 (4th Cir.1994), the Fourth Circuit noted that in certain situations administrative claim status may be granted even where no new post-petition credit is extended. In a footnote, the court explained:

> It may seem odd that a § 503(b) administrative expense can be created by a debtor's postpetition use ... of collateral which the debtor had also used before going bankrupt. It seems odd because when we think of § 503(b) administrative expense claims, we think of claims "allowed for those who agree to extend postpetition credit to the bankruptcy estate as a loan or in the furnishing of goods or services." ... It may seem like somewhat of a stretch, then, to say that a creditor whose collateral is being used by the debtor against the creditor's wishes somehow is extending postpetition credit to the estate. But, as we said in Grundy, "what constitute actual and necessary costs and expenses of preserving the estate might well be opened to judicial construction." ... It is this flexible judicial construction of § 503(b) which allows us to suggest that a creditor extends postpetition credit when in reality the creditor—who is forced to allow the debtor's continued use of collateral after the debtor slides into bankruptcy—extends no credit at all....

The court then went on to state that the "flexible judicial construction" could only be "stretched" to a certain point, and concluded that a mere potential benefit to the estate could not warrant the granting of an administrative expense claim. In this case, however, the Court finds that an actual and direct benefit was bestowed upon the estate.

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14 Section 365(d)(10) governs the period starting on August 1, 2000, the sixtieth day after the filing of the petition.

15 As stated earlier, despite the fact that the Court never expressly authorized the rejection of the subject Leases, the parties acknowledged that there was a *de facto* rejection. Furthermore, for purposes of determining the claim pursuant to § 365(d)(10), the respective Leases should be deemed rejected on the various dates the trucks were returned to Western Star.

16 The Court is prepared to accept the stipulation of the parties as to the amount of the § 365(d)(10) claim, $12,052.40, submitted into evidence at the July 20, 2000 hearing. However, considering the time constraints under which the parties operated in presenting the stipulation at the prior hearing, the Court will consider further arguments at a hearing scheduled for February 8, 2001 as to the effect of the decommissioning of the tractors on the rent due under the § 365(d)(10) claim.

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635 B.R. 243
United States Bankruptcy Court, E.D. Pennsylvania.

IN RE: EAST PENN CHILDREN'S LEARNING ACADEMY, LLC, Debtor.

Case No. 20-14646 (PMM)
|
Signed December 3, 2021

Synopsis
Background: Debtor, a day care business that sought to reorganize under subchapter v of Chapter 11 and that surrendered its leased premises about six months after its bankruptcy filing, that is, in June of the subject year, objected to proof of claim filed by judgment creditor, its former landlord, which sought lease-rejection damages in the form of rent from July through December of that year.

Holdings: The Bankruptcy Court, Patricia M. Mayer, J., held that:

[1] under Pennsylvania law and terms of parties' five-year lease, judgment creditor was entitled to lease damages of $58,320.00, comprised of unpaid prepetition rent, "stub rent," and unpaid postpetition rent, and

[2] the statutory rent cap calculation, $77,625.86, was more than the lease damages and, thus, the rent cap neither limited nor affected the damages to which landlord was entitled.

Objection sustained; proof of claim reduced and allowed as unsecured claim.

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

West Headnotes (30)

[1] **Bankruptcy** Summary allowance; necessity for objection
Bankruptcy Effect of proof of claim

Properly filed proof of claim is prima facie valid and, absent objection by party in interest, is allowed. 11 U.S.C.A. § 502(a); Fed. R. Bankr. P. 3001(f).

[2] **Bankruptcy** Effect of proof of claim

Under the Bankruptcy Code, a claimant's initial burden of proof is satisfied by filing of properly filed proof of claim. 11 U.S.C.A. § 502(a); Fed. R. Bankr. P. 3001(f).

[3] **Bankruptcy** Presumptions and burden of proof

Under the Bankruptcy Code, once claimant satisfies its initial burden of proof by filing properly filed proof of claim, burden then shifts to objector to show that, despite being prima facie valid, claim is legally insufficient. 11 U.S.C.A. § 502(a); Fed. R. Bankr. P. 3001(f).

[4] **Bankruptcy** Presumptions and burden of proof
Bankruptcy Effect of proof of claim

Under the Bankruptcy Code, if objector presents "bubble-bursting" evidence to show that, despite being prima facie valid, properly filed proof of claim is legally insufficient, then both parties may present further evidence. 11 U.S.C.A. § 502(a); Fed. R. Bankr. P. 3001(f).

[5] **Bankruptcy** Presumptions and burden of proof

Under the Bankruptcy Code, ultimate burden of proof with respect to a proof of claim remains with creditor. 11 U.S.C.A. § 502(a).

[6] **Bankruptcy** Proof; Filing

Failure to comply with bankruptcy rule governing proofs of claim does not necessarily mean that claim should be disallowed. 11 U.S.C.A. § 502; Fed. R. Bankr. P. 3001.

[7] **Bankruptcy** Presumptions and burden of proof

Ordinarily, it is debtor who seeks to impose a rent cap limit on a proof of claim and who, therefore, maintains the burden of proof as to whether that provision of the Bankruptcy Code applies. 11 U.S.C.A. § 502(b)(6).

[8] **Bankruptcy** Presumptions and burden of proof

In unusual scenario in which landlord, whose lease had been terminated by Chapter 11 debtor, argued that the Bankruptcy Code's rent cap allowed it to receive more than it would have absent such provision, the shifting burden of proof applied, and, because debtor called into question the legal premise on which landlord relied, landlord bore the final burden with regard to its determination of the amount of the proof of claim. 11 U.S.C.A. § 502(b)(6).

[9] **Bankruptcy** Rejection of executory contract or lease

Purpose of the Bankruptcy Code's rent cap is to allow a debtor's landlord reasonable damages for the loss of rent due while preventing the landlord from stating a claim so large that other unsecured creditors are left uncompensated. 11 U.S.C.A. § 502(b)(6).

[10] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap effectively limits the claim of a landlord whose lease has been terminated. 11 U.S.C.A. § 502(b)(6).

[11] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap sets forth a formula to determine a maximum amount of pre- and postpetition rent owed by a debtor. 11 U.S.C.A. § 502(b)(6).

[12] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap seeks to limit, rather than determine, the amount of a creditor's claim. 11 U.S.C.A. § 502(b)(6).

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

Bankruptcy Code's rent cap does not impact the amount of a landlord's claim but, instead, it determines only the allowed amount of the claim; the claim, independent of the allowance process under the Code, must be determined first under applicable non-bankruptcy law and then compared with and, if necessary, reduced to the statutory maximum provided in the rent cap provision. 11 U.S.C.A. § 502(b)(6).

[14] **Bankruptcy** Rejection of executory contract or lease

Under the Bankruptcy Code's rent cap provision, the preliminary determination made by the bankruptcy court is the amount of landlord's claim pursuant to debtor's lease and state law. 11 U.S.C.A. § 502(b)(6).

[15] **Landlord and Tenant** Acceleration clauses

Under Pennsylvania law, a "rent acceleration clause" benefits a landlord by providing that, upon a tenant's breach, all rent and expenses owed through the lease expiration are due at once, rather than accruing according to the due dates provided in the lease.

[16] **Landlord and Tenant** Acceleration clauses

Under Pennsylvania law, a rent acceleration clause is permitted as a valid expansion of a lessor's remedy.

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[17] **Landlord and Tenant** Acceleration clauses

Under Pennsylvania law, a rent acceleration clause insures that a landlord will receive all moneys due under the lease without having to harass a reluctant tenant as periodical payments become due.

[18] **Election of Remedies** Necessity and time for election

Under Pennsylvania law, landlord must elect between repossession and actual damages or acceleration of balance due.

[19] **Landlord and Tenant** Right of entry and possession of tenant

Under Pennsylvania law, possession must be made available to breaching tenant during any period landlord seeks to recover rent as it becomes due.

[20] **Landlord and Tenant** Acceleration clauses

Under Pennsylvania law, if a lease does not contain a rent acceleration clause, a landlord may recover future rents on the property only as they become due.

[21] **Landlord and Tenant** Acceleration clauses

Under Pennsylvania law, a landlord who fails to include a rent acceleration clause in a lease agreement must, in order to collect unpaid, accruing rent, seek redress in state court as the amounts come due, that is, on an ongoing basis; the landlord cannot claim accelerated, or expected, payments.

[22] **Bankruptcy** Rejection of executory contract or lease

Under Pennsylvania law and terms of five-year lease executed prepetition by Chapter 11, subchapter v debtor and judgment creditor, its then landlord, which lease did not contain a clause allowing for the acceleration of rent, judgment creditor was entitled to lease damages of $58,320.00, comprised of unpaid prepetition rent of $43,725.86, “stub rent” of $2,438.71 from the month of debtor's bankruptcy filing, and unpaid postpetition rent of $12,320.00 through the month, about six months after the bankruptcy filing, in which debtor surrendered the leased premises.

[23] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap neither limited nor affected the lease-rejection damages to which judgment creditor, which was the former landlord of Chapter 11, subchapter v debtor, was entitled, where statutory rent cap calculation, $77,625.86, determined by adding unpaid prepetition rent of $43,725.86 and postpetition rent due the date of filing for one year, $33,900.00, was more than the lease damages to which judgment creditor was entitled under Pennsylvania law and terms of parties' five-year lease, that is, $58,320.00, comprised of unpaid prepetition rent of $43,725.86, “stub rent” of $2,438.71 from the month of debtor's bankruptcy filing, and unpaid postpetition rent of $12,320.00 through the month, about six months after the bankruptcy filing, in which debtor surrendered the leased premises. 11 U.S.C.A. § 502(b)(6).

[24] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap is a ceiling, not a floor, on the amount of damages that a debtor's landlord could otherwise claim. 11 U.S.C.A. § 502(b)(6).

[25] **Bankruptcy** Rejection of executory contract or lease

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Under circumstances in which a landlord's contractual damages are already less than those that would be determined under the Bankruptcy Code's rent cap provision, the rent cap is not an applicable provision. 11 U.S.C.A. § 502(b)(6).

[26] **Bankruptcy** Rejection of executory contract or lease

Term "rent reserved," as used in the Bankruptcy Code's rent cap formula, which includes the rent reserved by a lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, refers to a calculation of future rent provided for in a lease agreement. 11 U.S.C.A. § 502(b)(6).

[27] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap is based on amount of reserved rent called for by provisions of lease; calculation is not guaranty of damages to which landlord who suffered breach is separately entitled. 11 U.S.C.A. § 502(b)(6).

[28] **Bankruptcy** Rejection of executory contract or lease

Term "without acceleration," as used in the Bankruptcy Code's rent cap formula, which includes the rent reserved by a lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, means simply that reserved rent is to be calculated without application of any acceleration clause. 11 U.S.C.A. § 502(b)(6).

[29] **Bankruptcy** Rejection of executory contract or lease

Terms of underlying lease, and presence or absence of an acceleration clause in such lease, does not affect the Bankruptcy Code's rent cap calculation. 11 U.S.C.A. § 502(b)(6).

[30] **Bankruptcy** Rejection of executory contract or lease

Bankruptcy Code's rent cap is not a damages provision and therefore is not a tool for calculating a landlord's loss. 11 U.S.C.A. § 502(b)(6).

Attorneys and Law Firms

***246** Robert J. Birch, Robert J. Birch, Esquire, Blue Bell, PA, for Debtor.

<u>OPINION</u>

PATRICIA M. MAYER, U.S. BANKRUPTCY JUDGE

I. INTRODUCTION

East Penn Children's Learning Academy, LLC ("EPCLA" or the "Debtor"), a day care business which seeks to reorganize under chapter 11, subchapter v, owes its landlord, Robshe Enterprises, LLC ("Robshe") both pre and post-petition unpaid rent. The Debtor surrendered the property it leased from Robshe and moved to a different location in June 2021, about six (6) months after the bankruptcy filing.

The Debtor's Objection to Robshe's Proof of Claim Number 3 (the "Proof of Claim"), one of three (3) proofs of claim filed by the landlord, presents the question of whether 11 U.S.C. § 502(b)(6) (commonly, and here, referred to as the "Rent Cap") succeeds either in altering or dictating the amount of damages to which Robshe is entitled.

The Debtor argues that the Rent Cap does not change the allowed amount because the damages due under the lease agreement and applicable state court law are lower than the amount that would be provided (or limited) by the Rent Cap. Robshe, to the contrary, asserts that application of the Rent Cap dictates a higher amount of damages.

I agree with the Debtor.

The Rent Cap does not affect the amount of damages here because the lease between the parties lacks an acceleration

clause and the underlying state court damages owed pursuant to the lease are lower than the Rent Cap calculation.

Consequently, the Debtor's Claim Objection will be sustained and, as detailed below, the Proof of Claim will be reduced and allowed as an unsecured claim.

II. FACTUAL BACKGROUND

EPCLA is a day care center and limited liability company owned by Kristen Funk ("Ms. Funk"), who purchased the Debtor in 2017. That same year, on August 28, 2017, Ms. Funk entered into a lease agreement (the "Lease") with Robshe to rent space located at 49 W. Penn Avenue in Alburtis, PA (the "Property").

The Lease commenced on September 1, 2017 and was to terminate on August 31, 2022. The Lease provides for a tiered payment structure, according to which the rent would rise $100.00 the first of September every year (beginning at $2,600.00 per month and rising to $2,900.00 per month as of September 1, 2021). Lease, doc. # 49 at Ex. 1 at Section Three. The rent is subject to a 10% late charge if not paid by the 5 th of the month. In addition, rent that was not paid after thirty (30) days would be assessed an additional penalty ***247** of 5% per month. Section twelve (12) of the Lease provides that, upon default of the tenant, the landlord may "bring suit for ... rent due [and] declare the rights of the [tenant] under the lease terminated, and ... recover possession of [the] premises through legal process." Lease at 2, § 12.

III. PROCEDURAL HISTORY

The Debtor filed for chapter 11, subchapter v, bankruptcy protection on December 4, 2020. The Debtor has no secured creditors; Robshe is its main (unsecured) creditor.

Just prior to the bankruptcy filing, on November 6, 2020, Robshe obtained a judgment (the "Judgment") in the amount of $40,100.00 plus 6% interest against the Debtor in state court in Lehigh County. [1] See Statement of Financial Affairs. The Judgment included unpaid rent through March, 2020.

On March 10, 2021, Robshe filed a Motion to Compel Assumption or Rejection of Unexpired Lease and for Post-Petition Lease Payments, seeking to force the Debtor to accept or reject the Lease and to compel the Debtor to pay post-petition rent in the amount of $12,040.00. (doc. #49, the "Motion to Compel"). On April 27, 2021, the Motion to Compel was granted, allowing an administrative claim for postpetition rent from January 2021 through April 2021 in the amount of $12,320.00 (including interest, as prescribed by the Lease) (doc. #69, the "Administrative Claim Order"). The Administrative Claim Order further provided that the Debtor must vacate the Property by the end of May, 2021. Doc. #69 at 1. This departure deadline was later extended to June 30, 2021. Doc. # 90. The Debtor did leave the premises by this date.

The Debtor, in turn, filed a Motion to Approve a New Lease (with Russell Afflerbach) and to Reject the Lease with Robshe. (doc. # 53, the "Motion to Approve"). The Debtor considered the Motion to Approve to be a rejection of the Lease. See doc. # 61. The Order granting the Motion to Approve, also entered on April 27, 2021, approved the rejection of the Lease by the Debtor. Doc. # 68.

On May 25, 2021, Robshe was granted a separate administrative expense for "stub rent" in the amount of $2,438.71 for the prorated, post-petition rent due from December 4, 2020 to December 31, 2020. Doc. # 89 (the "Stub Rent Order").

Robshe, seeking to make itself whole, filed three (3) of the four (4) proofs of claim in this bankruptcy:

- Claim No. 2 in the amount of $12,320.00, which is a priority administrative claim for rent due from January 2021 through April 2021, see footnote 10, supra;

- Claim No.3 (the Proof of Claim at issue), which was filed on May 7, 2021 and amended twice (on May 26, 2021 and on July 19, 2021). The second amended claim seeks a priority claim in the amount $77,725.86 for damages due to the prepetition unpaid rent and rejection of Lease, broken down as follows:

    - $43,725.86 for unpaid prepetition rent; [2] and

    ***248** • $34,000.00 for the rejection of the Lease pursuant to § 502(b)(6) (the Rent Cap).

- Claim No. 4, an unsecured priority claim in the amount of $2,438.71 for December 2020 for "stub rent." This amount was allowed by the Stub Rent Order.

The Debtor only objects to Claim Number 3, contesting the following charges: [3]

- $2,970.00 for August 2020 rent and late fee. Because the revised Proof of Claim removed this charge, this amount is no longer at issue;
- Rent charged for September and October 2020. However, the amended Claim revises these dates to reflect the dates of September -December, 2021. See Claim 3-3, Part 2; and
- Rent charged after June 2021. The Debtor asserts that it paid rent for May and June, 2021 and vacated the Property in June 2021, thus eliminating any further obligation to pay rent.

Due to the revision of the Proof of Claim, only the final point remains at issue. See Debtor's Br. at 7 (conceding both that the amount owed for prepetition rent as stated in the Proof of Claim is accurate and that the Debtor is liable for rent from January to April 2021). The dispute thus boils down to whether Robshe is entitled to rent owed from May through December 2021. The parties are fighting over a sum of about $23,000.00.

Following denial of its chapter 11 Plan, doc. # 97, the Debtor filed the Objection, to which Robshe responded, doc. # 103. After a hearing on the Objection, held and concluded on August 10, 2021, the parties each filed a Memorandum. See doc. #'s 111 and 116. The matter is now ripe for adjudication.

IV. THE PARTIES' ARGUMENTS

The Debtor asserts that Robshe's claim must be limited to the amount due pre-petition ($43,725.86, which includes the Judgment) and postpetition rent from January to April 2021 in the total amount of $11,200.00. The Debtor argues that any further award of post-petition rent is unwarranted because the Lease does not contain an acceleration clause, which would allow Robshe to make a claim for rent from July through December 2021. According to the Debtor, there is "no need" for a rent cap analysis under § 502(b)(6). Br. at 7.

Robshe counters that the purpose of the Rent Cap provided for in Code § 502(b)(6) is to compensate a landlord for the loss of rental income when its bankrupt tenant rejects a lease. Neither the Code nor Pennsylvania law sets forth a requirement that the relevant lease include an acceleration clause in order for this provision to apply. Rather, the statutory Rent Cap formula allows a total claim for reserved rent for one year from the petition date.

V. STANDARD FOR DETERMING OBJECTION TO PROOF OF CLAIM

[1] [2] [3] [4] [5] [6] The Bankruptcy Code and Rules provide that a properly filed proof of claim is *prima facie* valid and, absent objection by a party in interest, is allowed. 11 U.S.C. § 502(a); F.R.B.P. 3001(f). The claimant's initial burden of proof is satisfied by the filing of such a claim. ***249** In re Chew, 627 B.R. 112, 114 (Bankr. E.D. Pa. 2021) (citing In re Allegheny Int'l, Inc., 954 F.2d 167, 173–74 (3d Cir. 1992)). The burden then shifts to the objector to show that, despite being *prima facie* valid, the claim is legally insufficient. In re Henry, 546 B.R. 633, 634–35 (Bankr. E.D. Pa. 2016). If the objector "presents such 'bubble-bursting evidence, then both parties may present further evidence." In re George, 606 B.R. 236, 239 (Bankr. E.D. Pa. 2019) (citation omitted). The ultimate burden remains with the creditor. In re Revelle, 2021 WL 3669358, at *2 (Bankr. D. Del. Aug. 18, 2021). [4]

[7] [8] Ordinarily, it is the Debtor who seeks to impose a Rent Cap limit on a proof of claim and who, therefore, maintains the burden of proof as to whether this provision applies. In re Dronebarger, 2011 WL 350479, at *6 (Bankr. W.D. Tex. Jan. 31, 2011). Here, we have an unusual scenario in which the landlord, whose lease has been terminated by the Debtor, argues that the Rent Cap allows it to receive *more* than it would absent such provision. Under these circumstances, the shifting burden of proof applies and means that, because the Debtor has called into question the legal premise on which Robshe relies, the creditor bears the final burden with regard to its determination of the amount of the proof of claim. See 4 Collier on Bankruptcy ¶ 502.03[7][d] (16th Ed. 2021) (explaining that it is the landlord's burden to demonstrate damages resulting from termination; such claim is then limited by the rent cap provision).

VI. ANALYSIS

A. The Rent Cap Provision

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[9] Determination of this matter rests on an understanding of the less than clear Rent Cap provision outlined in 11 U.S.C. § 502(b)(6). The purpose of the Rent Cap is to allow a landlord reasonable damages for the loss of rent due while preventing the landlord from stating a claim so large that other unsecured creditors are left uncompensated. See In re Kupfer, 852 F.3d 853, 856 (9th Cir. 2016); In re Ancona, 2016 WL 828099, at *5 (Bankr. S.D.N.Y. Mar. 2, 2016) (citing H.R.Rep. No. 595, 95th Cong., 2d Sess. 63 (1978)); In re PPI Enterprises, Inc., 324 F.3d 197, 207 (3d Cir. 2003) (the Rent Cap reflects Congress' intent to prevent landlords from receiving a windfall over other creditors).

[10] The Rent Cap effectively limits the claim of a landlord whose lease has been terminated. Such a claim will be reduced to the extent that the amount exceeds:

> **(A)** the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of--
>
> > **(i)** the date of the filing of the petition; and
> >
> > **(ii)** the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> **(B)** any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C.A. § 502(b)(6).

[11] The amount of damages, which must be independently determined, is then reduced to the limitation set by the Rent Cap. Section 502(b)(6) sets forth a formula ***250** to determine a maximum amount of pre and post-petition rent owed. In re MDC Sys., Inc., 488 B.R. 74, 82 (Bankr. E.D. Pa. 2013).

Step One: Calculation of the Damages Under the Lease and State Law

This formula points to the need for an initial determination of the landlord's damages prior to consideration of the Rent Cap.

1. Rent Cap is a limiting principle, not a formula for calculating damages

[12] To start, we must take into account the well-established principle that the Rent Cap seeks to *limit* rather than *determine* the amount of a creditor's claim. E.g. Ancona, 2016 WL 828099, at *10

[13] As Judge Frank of this Court explained:

> Section 502(b)(6) does not impact the amount of the landlord's claim; it determines only the *allowed* amount of the claim. The claim, **independent of the allowance process under § 502(b)(6), must be determined first** under applicable non-bankruptcy law and then compared with and, **if necessary**, reduced to the statutory maximum provided in § 502(b)(6).

MDC Sys., Inc., 488 B.R. at 82 (emphasis added). See also In re Smith, 249 B.R. 328, 334 (Bankr. S.D. Ga. 2000) ("A landlord's claim for damages is determined by state law and the terms of the lease, and then limited by § 502(b)(6)").

[14] The preliminary determination is the amount of Robshe's claim pursuant to the Lease and state law. In re Peters, 2004 WL 1291125, at *2 (Bankr. E.D. Pa. May 7, 2004).

How much would Robshe be entitled to without the application of the Rent Cap?

2. Absence of an Acceleration Clause in the Lease

Another important preliminary consideration is that the Lease entered by the parties did not contain a clause allowing for the acceleration of rent.

[15] [16] [17] [18] [19] A rent acceleration clause benefits a landlord by providing that, upon a tenant's breach, all rent and expenses owed through the lease expiration are due at once (rather than accruing according to the due dates provided in the lease). An acceleration clause is permitted in Pennsylvania as a "valid expansion of a lessor's remedy." Kingsly Compression, Inc. v. Mountain V Oil & Gas, Inc., 2010 WL 4929076, at *4 (W.D. Pa. Nov. 30, 2010) citing American Multi–Cinema, Inc. v. Posel Enters., 1992 WL 328891, at *9 (E.D.Pa. October 27, 1992) (citing Pierce v. Hoffstot, 211 Pa.Super. 380, 236 A.2d 828 (Pa.Super.1967)); Restatement (Second) of Property Landlord & Tenant § 12.1

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cmt. k (1977). Such a provision insures that a landlord will receive all moneys due under the lease without "having to harass a reluctant tenant as periodical payments become due." Pierce, 211 Pa. Super. at 384, 236 A.2d 828. [5]

[20] If a lease does not contain an acceleration clause, a landlord "may recover ***251** future rents on the property **only as they become due**." Onal v. BP Amoco Corp., 275 F. Supp. 2d 650, 668 (E.D. Pa. 2003), aff'd sub nom. Onal v. PB Amoco Corp., 134 Fed. Appx. 515 (3d Cir. 2005) (emphasis added); see also Hirsh v. Carbon Lehigh Intermediate Unit #21, 65 Pa. D. & C. 4th 390, 412 (Com. Pl. 2003) (tenant's obligations under a lease terminate upon surrender).

[21] A landlord who fails to include an acceleration clause in a lease agreement must, in order to collect unpaid, accruing rent, seek redress in state court as the amounts come due (i.e. on an ongoing basis); the landlord cannot claim accelerated, or expected, payments.

Such landlord is at a distinct disadvantage if, as here, its tenant breaches the lease prior to the termination of the contract.

3. Calculation of Damages under the Lease between Robshe and the Debtor

[22] The five (5) year Lease entered by Robshe and the Debtor, terminating on August 31, 2022, provides for an annual increase of rent and that the rent must be paid by the fifth of the month.

Therefore, under Pennsylvania law and the terms of the Lease, and considering the uncontested fact that the Property was surrendered at the end of June, 2021, Robshe's damages may be calculated as follows:

- Unpaid prepetition rent, including the Judgment: $43,725.86 (this amount is agreed on by the parties, see Debtor's Mem. at 2); plus

- The allowed priority claim of $2,438.71 for "stub rent" for the relevant portion of rent from December 2020 (following the bankruptcy filing); plus

- Postpetition rent due from January through June 2021 minus the two (2) months (May and June, 2021) rent paid by the Debtor: $12,320.00, [6] equals:

- $58,484.57 (the "Lease Damages").

B. Step Two: Does the Rent Cap Affect and or Limit the Amount of State Court Damages?

[23] The next, determinative, question is whether the Rent Cap succeeds in lowering the Lease Damages.

[24] As discussed, the Rent Cap merely serves to limit the amount of damages that a landlord could otherwise claim; the Cap is a ceiling and not a floor (it is, after all, called a "cap"). Therefore, the provision only comes into play if the Lease Damages are greater than the amount calculated under § 502(b)(6).

They are not.

Here, the Rent Cap may be calculated as follows:

- Unpaid prepetition rent, including the Judgment: $43,725.86; plus

- Postpetition rent due December 2020 (the date of filing) for one year: $33,900.00 [7] equals:

- $77,625.86 (the "Rent Cap Calculation"). [8]

Because the Rent Cap Calculation is more than the Lease Damages, the Rent Cap ***252** neither limits nor affects the actual damages. In re Gantos, Inc., 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995); In re Fin. News Network, Inc., 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993).

[25] In other words, under circumstances such as these, in which the contractual damages are already less than those that would be determined under § 502(b)(6), the Rent Cap is not an applicable provision. In re Iron-Oak Supply Corp., 169 B.R. 414, 419 (Bankr. E.D. Cal. 1994).

C. Robshe's Argument Does not Prevail

With this conclusion in mind, I turn to Robshe's counterpoints.

Robshe does not contest the amount of damages due pursuant to state law. Rather, the landlord's argument that the Rent Cap permits it to receive the amount stated in the Proof of Claim focuses on the wording of the Rent Cap. Specifically, Robshe asserts that the fact that section 502(b)(6) employs a formula that includes "the rent reserved by [a] lease, without

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acceleration, for the greater of one year, or 15 percent, not to exceed three years ....” means that a landlord is entitled to post-petition damages through a period of at least a year (the exact time frame and amount depending on when the petition was filed and whether the property has been surrendered). 11 U.S.C. § 502(b)(6) (emphasis added).

[26] **[27]** The term “rent reserved” is indeed a calculation of future rent provided for in a lease agreement. In re McSheridan, 184 B.R. 91, 98-100 (B.A.P. 9th Cir. 1995), overruled on other grounds by In re El Toro Materials Co., Inc., 504 F.3d 978, 981-82 (9th Cir. 2007) (setting out a three (3) part test to determine what qualifies as “rent reserved” pursuant to the Rent Cap). However, this reading only amounts to a conclusion that the rent specified for the remaining duration of a lease would be included to calculate the rent cap amount rather than the amount of damages to which Robshe is entitled. The Rent Cap is based on the amount of reserved rent called for by the provisions of the lease; the calculation is not, as Robshe concludes, a guaranty of damages to which a landlord who suffered a breach is *separately entitled*. In re Shane Co., 464 B.R. 32, 38 (Bankr. D. Colo. 2012).

[28] **[29]** Robshe also misinterprets the Rent Cap's language that the limit will be determined “without acceleration” to mean that “rent reserved” necessarily includes one (1) year of rent even in a lease without an acceleration clause. Mem. at 4. However, the term “without acceleration” means “simply that reserved rent is to be calculated without application of any acceleration clause.” In re Allegheny Int'l, Inc., 145 B.R. 823, 827 (W.D. Pa. 1992). Therefore, the terms of the underlying lease – and the presence or absence of an acceleration clause in such lease - does not affect the Rent Cap calculation. [9]

D. Note About Final Determination of Proof of Claim

[30] The Debtor's argument (see Mem. at 3) that application of the Rent Cap would allow a double recovery to Robshe is unavailing; the Rent Cap, which does not apply here, is not a damages provision and therefore is not a tool for calculating a landlord's loss.

***253** However, in this case, allowance of the Proof of Claim as stated would provide Robshe with a duplicate claim – a double recovery of *actual damages*. Proof of Claim Number 2, to which the Debtor has not objected, states a $12,320.00 priority administrative claim for rent due from January 2021 through April 2021 and specifically allowed by the Administrative Claim Order. [10] Because that identical, duplicate amount is also requested in Claim 3, I will reduce the Proof of Claim by that amount. In re North Bay Gen. Hosp., Inc., 404 B.R. 443, 466 (Bankr. S.D. Tex. 2009) (duplicate claims not allowed); In re Marino, 201 B.R. 234, 243 (Bankr. N.D. Ill. 1996) (same). [11]

Therefore, the Proof of Claim will be allowed in the amount of $43,725.86, which represents the agreed pre-petition amount owed due to the Debtor's breach of the Lease. All allowed post-petition rent has either been paid by the Debtor or separately allowed as an administrative claim.

Because Robshe fails to offer any basis on which to categorize the $43,725.86 as a priority or administrative claim, the amount will be allowed as a general unsecured claim.

VII. CONCLUSION

The Debtor's Objection to the Proof of Claim will be sustained. The allowed claim represents the sum owed to Robshe for pre-petition damages; the remainder of the stated amount has either been separately allowed, separately paid, or is derived from an incorrect application of the Rent Cap.

The conflation of a Bankruptcy Code damages cap and a state law damages calculation leads Robshe to assert that it is entitled to *more* than would be allowed under the terms of the negotiated lease. Yet the Rent Cap is not meant as such a gift to landlords.

The bottom line is that the Debtor, a small business, abandoned its premises a few months into its bankruptcy, leaving behind a not very impressive amount of unpaid rent. Because the landlord did not bargain for the inclusion of an acceleration clause, and because the Rent Cap does not succeed in altering the amount of damages owed, Robshe cannot collect past the date of surrender.

An appropriate Order will be entered.

All Citations

635 B.R. 243

Footnotes

1 Apparently, prior to Robshe's lawsuit, the Debtor sued Robshe in state court. See doc. # 53 at 1 (details of the Debtor's suit not provided).

2 This figure represents the amount of the Judgment plus the rent for November 2020 and the portion of the December 2020 rent that is not included in the Stub Rent Order.

The fact that pre-petition rent from April 2020 through October 2020 is not sought by Robshe indicates that the Debtor has satisfied its rent obligation for this time period (though the papers do not make this clear). Therefore, I will not consider any rent owed for this period.

3 The Debtor's Objection was filed after the first amendment to Claim No. 3 but before the second amendment to the Claim.

4 One could argue, though the Debtor has not, that the Proof of Claim is insufficient because the Lease – the writing on which the Claim is based – is not attached. See F.R.B.P. 3001(c)(1). However, failure to comply with Rule 3001 does not necessarily mean that a claim should be disallowed. In re O'Brien, 440 B.R. 654, 666 (Bankr. E.D. Pa. 2010) (citing cases).

5 The Debtor is correct that under Pennsylvania law, "a landlord must elect *between* repossession and actual damages *or* acceleration of the balance due." See Finkle v. Gulf & W. Mfg. Co., 744 F.2d 1015, 1021 (3d Cir. 1984) (emphasis in original). Possession likewise must be made available to the breaching tenant during any period the landlord seeks to recover rent as it becomes due.

The relevance of this law, however, is unclear here, where the parties agree both that the Property was surrendered and that the Lease does not call for acceleration of rent.

6 This amount, which includes interest on the rent owed, was allowed by the Administrative Claim Order.

I note that the analysis would be the same even if the two (2) months of rent already paid by the Debtor were included in the calculation.

7 The rent, per the Lease, was $2,800.00 per month through September 1, 2021, when it rose to $2,900.00 per month.

8 This is the appropriate Rent Cap figure because it is greater than the alternative calculation of 15% of the rent due for the remaining term of the Lease. See MDC Sys., Inc., 488 B.R. at 83

9 The Rent Cap, as Robshe points out, does not specifically limit relief to leases which contain an acceleration clause. However, on a practical level, this case demonstrates that the Rent Cap will likely not come into play when, due to the absence of an acceleration clause, the allowed damages are already limited.

10 Claim 2 is itself confusing. It states both a total amount of $68,375.86 for prepetition unpaid rent and "Section 502(b)(6) Rejection of Lease Claim." The Claim is listed on the Claims Register in the amount of $12,320.00 and, given that any remaining amounts are clearly a duplication of Claim 3, I will assume that Proof of Claim 2 states a priority, allowed claim for $12,320.00.

11 Robshe's Proof of Claim Number 4 states an uncontested administrative priority claim for $2,438.71 for "stub" rent for December 2020 and is based on the Stub Rent Order. This amount has not been duplicated in the Proof of Claim.

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KeyCite Yellow Flag - Negative Treatment
Declined to Extend by In re Dunn Industries, LLC, Bankr.D.Md., January 28, 2005

263 B.R. 733
United States Bankruptcy Court, D. Maryland, at Baltimore.

In re FURLEY'S TRANSPORT, INC., Debtor.
Zvi Guttman, Chapter 7 Trustee, Plaintiff,
v.
Xtra Lease, Inc., Defendant.

Bankruptcy No. 98–6–6900–SD.
|
Adversary No. 00–5614–SD.
|
June 13, 2001.

Synopsis
Chapter 7 trustee objected to administrative expense claim asserted by tractor trailer lessor. On trustee's motion for summary judgment, the Bankruptcy Court, E. Stephen Derby, J., held that: (1) debtor's obligations under leases "first arose," for purposes of statute requiring trustee or debtor-in-possession to timely perform all obligations "first arising" more than 59 days following order for relief, not on invoice dates, but only when lessor's invoices, according to their terms, first became due; (2) statute did not preclude lessor from asserting administrative expense claim for charges arising less than 60 days after petition date, as long as it was able to show such charges were actual, necessary costs of estate preservation; and (3) material fact questions precluded entry of summary judgment upon trustee's objection to equipment lessor's administrative expense claim.

Motion denied.

Procedural Posture(s): Motion for Summary Judgment.

West Headnotes (6)

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

Chapter 11 debtor's obligations under personal property leases "first arose," for purposes of bankruptcy statute requiring trustee or debtor-in-possession to timely perform all obligations "first arising" more than 59 days following order for relief, not upon invoice dates, but only when lessor's invoices, according to their terms, first became due. Bankr.Code, 11 U.S.C.A. § 365(d)(10).

4 Cases that cite this headnote

[2] **Statutes** Plain Language; Plain, Ordinary, or Common Meaning

Starting point when construing statute is plain language thereof.

[3] **Statutes** Plain Language; Plain, Ordinary, or Common Meaning

When statute's language is plain, sole function of courts is to enforce it according to its terms.

[4] **Statutes** In general; factors considered

Statutes Plain, literal, or clear meaning; ambiguity

When statutory language is ambiguous, court may look to legislative history for guidance.

[5] **Bankruptcy** Use and occupancy claims; administrative rent

Bankruptcy Debtor's Contracts and Leases

Bankruptcy statute requiring trustee or debtor-in-possession to timely perform all obligations of debtor under any unexpired lease of personal property which first arise more than 59 days following order for relief, until lease is rejected, grants lessors the extraordinary benefit of automatic administrative expense claim for contract charges arising after this date, without need to demonstrate that they constitute actual, necessary costs of preserving estate; statute does not, however, preclude lessors from asserting administrative expense claims for charges arising prior to this date, as long as they are able to show such charges constitute actual, necessary costs of estate preservation. Bankr.Code, 11 U.S.C.A. §§ 365(d)(10), 503(b)(1)(A).

5 Cases that cite this headnote

[6] **Bankruptcy** Judgment or Order

Genuine issue of material fact, as to whether rental charges accruing less than 60 days after petition date under Chapter 11 debtor's tractor trailer leases represented "actual, necessary costs or expenses of preserving the estate," precluded entry of summary judgment upon trustee's objection to equipment lessor's administrative expense claim. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

3 Cases that cite this headnote

Attorneys and Law Firms

***734** Leonard Kohlenstein, Baltimore, MD, for debtor.

Zvi Guttman, The Law Offices of Zvi Guttman, P.A., Baltimore, MD, trustee/plaintiff.

***735** Glen H. Tschirgi, Secured Legal Services Group, Columbia, MD, for defendant.

MEMORANDUM OPINION AND ORDER DENYING PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT

E. STEPHEN DERBY, Bankruptcy Judge.

I. ***Issues Presented***

In this Chapter 7 case that was converted from Chapter 11, two issues are raised by the Trustee's motion for partial summary judgment. First, when does a personal property lease payment obligation first arise for purposes of 11 U.S.C. § 365(d)(10)? Second, does Section 365(d)(10) bar, as a matter of law, a personal property lessor from recovering rental charges first arising under its lease during the 59 day period following the petition date as a Chapter 11 administrative expense under Section 503(b)(1)(A)?

Section 365(d)(10) provides:

> (10) *The trustee shall timely perform all of the obligations of the debtor,* except those specified in section 365(b)(2), *first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property* (other than personal property leased to an individual primarily for personal, family, or household purposes), until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f). Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

11 U.S.C. § 365(a)(10) (emphasis added). This section was added by the Bankruptcy Reform Act of 1994. Pub.L. No. 103–394, 108 Stat. 4106 (1994).

For reasons stated below, the court concludes that under § 365(d)(10), lease obligations to pay a periodic rental charge for personal property first arise on the due date, and not on an earlier invoice date. Further, Section 365(d)(10) does not bar a personal property lessor, such as Defendant, from recovering as an administrative expense lease rental charges arising during the first 59 days of a Chapter 11 case where the rental charges are shown to constitute "actual, necessary costs and expenses of preserving the estate...." 11 U.S.C. § 503(b)(1)(A). Consequently, the Chapter 7 Trustee's motion for partial summary judgment will be denied because there is a genuine issue of material fact to be resolved, namely, whether the rental charges under Defendant's personal property leases were actual, necessary costs or expenses of preserving the estate.

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II. *Background Facts and Pleadings*

On December 2, 1998 (the "Petition Date") the Debtor, Furley's Transport, Inc. ("Furley's"), filed a voluntary petition for reorganization under Chapter 11. The case was converted to one under Chapter 7 on March 15, 1999, and Zvi Guttman, the Plaintiff, was appointed as Chapter 7 Trustee. Xtra Lease, Inc. ("Xtra Lease") has moved for allowance of $33,569.28 as a Chapter 11 administrative expense for use of seven trailers during the period from December 2, 1998 through February, 1999. The instant motion requests a partial summary judgment on the narrow issue of whether § 365(d)(10) precludes Xtra Lease from recovering a Chapter 11 administrative expense pursuant to ***736** 11 U.S.C. § 503(b)(1). Xtra Lease's response to the Trustee's motion raises a related legal issue, namely, when did Xtra Lease's asserted claim first arise under 11 U.S.C. § 365(d)(10)?

Xtra Lease is an over-the-road trailer rental and leasing company. Furley's conducted an over-the-road long haul trucking business. It owned, leased and operated over thirty refrigerated tractor trailer units and a multi-bay on-site truck repair facility. On July 30, 1997 Furley's and Xtra Lease entered into an Equipment Lease Agreement ("Lease Agreement"). On the Petition Date, Furley's possessed seven of Xtra Lease's refrigerated trailers pursuant to the Lease Agreement. According to Xtra Lease, Furley's retained possession of the leased vehicles after filing its petition, and it continued to use Xtra Lease's trailers in the ordinary course of its business from December 2, 1998 through March 3, 1999, at the earliest, and in the case of at least some trailers, through March 8, 1999 when Furley's surrendered the trailers to Xtra Lease pursuant to a Consent Order Terminating the Automatic Stay entered on March 8, 1999. [1] Under the Lease Agreement, Furley's was obligated to pay for each trailer leased (1) a monthly rental fee, (2) a monthly fee based upon excess use of the refrigeration equipment, (3) a fee for brake and tire wear and tear, and (4) the actual costs for repairs beyond reasonable wear and tear. The Trustee admits neither he nor Furley's made any post-petition payments to Xtra Lease.

On September 7, 1999 Xtra Lease filed its Motion for Allowance of Chapter 11 Administrative Expense pursuant to 11 U.S.C. § 503 and Local Bankruptcy Rule 2070–1. In this motion, Xtra Lease asserted it was entitled to an administrative expense under 11 U.S.C. § 503 for rental charges for the trailers used by Furley's from the Petition Date (December 2, 1998) through the end of February, 1999. According to Xtra Lease, the rental fees for this period were $19,397.69. In addition, Xtra Lease asserted it was owed $1,824.24 for wear on the trailer's tires and brakes, $8,101.79 for excess use of the refrigeration units on the trailers, and $4,245.56 for repairs beyond ordinary wear and tear. The Trustee opposed the motion, contending, *inter alia,* that the Lease Agreement was in fact a secured transaction, and not a true lease, under Maryland's Uniform Commercial Code and that Xtra Lease must prove benefit to the estate.

On March 22, 2000 the Trustee initiated this adversary proceeding by filing a complaint to avoid and recover $29,436.43 as preferential transfers under 11 U.S.C. § 547(b). The Trustee also objected under § 502(d) to payment of any otherwise valid and enforceable claim of Xtra Lease. As one of its affirmative defenses, Xtra Lease claims it is entitled to a set-off. On April 17, 2000 the court granted the Trustee's motion to consolidate Xtra Lease's Motion for Allowance of a Chapter 11 Administrative Claim with this adversary proceeding because the two matters involved similar facts and issues. That is, if the court allows Xtra Lease's administrative expense claim, it could offset some or all of the alleged preferential transfers from Furley's to Xtra Lease.

737 III. *Summary Judgment Standard

The standard of review for summary judgment is set forth in *Ramsey v. Bernstein (In re Bernstein),* 197 B.R. 475 (Bankr.D.Md.1996) *aff'd* 113 F.3d 1231 (4th Cir.1997):

> Pursuant to Fed.R.Civ.P. 56(c), made applicable by Bankruptcy Rule 7056, summary judgment is proper where "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law." Fed. R.Civ.P. 56(c). *See also Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 250, 106 S.Ct. 2505, 2511, 91 L.Ed.2d 202 (1986). In determining the facts for summary judgment purposes, the court may rely on affidavits made with personal knowledge that set forth specific facts otherwise admissible in evidence and sworn or certified copies of papers attached to such affidavits. Fed.R.Civ.P. 56(e), made applicable by Bankr.Rule 7056. When a motion for summary judgment is made and supported by affidavits or other evidence, "an adverse party may not rest upon mere allegations or denials..." *Id.* While the court must construe all inferences in favor of the non-moving party, *Anderson v. Liberty Lobby, Inc.,* 477 U.S. at 255, 106 S.Ct. at 2513–14, the court is bound by factual determinations made in prior

actions where collateral estoppel applies. *Allen v. McCurry,* 449 U.S. 90, 94–95, 101 S.Ct. 411, 66 L.Ed.2d 308, (1980).

197 B.R. at 477.

IV. *Discussion*

The Trustee urges that Xtra Lease's claim for administrative expenses should be denied outright because Section 365(d)(10) excused the debtor-in-possession's failure to pay rent during the first fifty-nine days of the case, and Xtra Lease's claim first arose during this period. At most, the Trustee contends, Xtra Lease is entitled to a general unsecured claim for damages upon rejection of the lease pursuant to 11 U.S.C. § 365(g).[2] The Trustee's argument proceeds as follows: Rent arose on the date Xtra Lease invoiced the Debtor. Xtra Lease invoiced the Debtor for December rent pre-petition on November 25, 1998. Invoices for January and February, 1999 rent were issued on December 25, 1998 and January 25, 1999, respectively. Since the December rent arose pre-petition and the January and February rent arose during the first sixty days of the case, Section 365(d)(10) excused the debtor-in-possession's failure to make lease payments and precludes Xtra Lease's administrative expense claim.

The Trustee's interpretation and analysis of Section 365(d)(10) contains at least two flaws. First, he misconstrues when Xtra Lease's payments arose under the Lease Agreement for purposes of Section 365(d)(10). Second, he reads powers into the statute that do not exist. The court will consider each of these issues and will discuss their ultimate impact on Xtra Lease's claims in turn.

A. *Xtra Lease is entitled to an automatic claim pursuant to 11 U.S.C. 365(d)(10) for all obligations under the Lease Agreement that came due from or after 60 days following the order for relief.*

[1] Section 365(d)(10) obligates a Chapter 11 debtor-in-possession to perform ***738** all obligations under personal property leases "first arising" after the fifty-ninth day following the order for relief until the lease is rejected. The order for relief in Furley's Chapter 11 case was December 2, 1998, the Petition Date. 11 U.S.C. § 301. Furley's rejection of the leases was confirmed in the consent order terminating the automatic stay as to Xtra Lease's trailers that was entered on March 8, 1999. Therefore, under Section 365(d)(10), Furley's was liable to Xtra Lease for all obligations under the lease "first arising from or after" January 31, 1999, which was the sixtieth day following the order for relief. This obligation is independent of Section 503. *See In re Russell Cave Co.,* 247 B.R. 656, 659 (Bankr.E.D.Ky.2000). While this recitation is fairly straightforward, the parties have different opinions about *when* Furley's monthly obligations first arose under the Lease Agreement. The Lease Agreement provided that Furley's would be invoiced in advance of the monthly rental period, and it permitted payment at any time within ten days from the invoice date.[3] The Trustee argues that Furley's obligations first arose on the invoice date, but Xtra Lease counters that the due date controls.

[2] **[3]** The starting point is the plain language of the statute. Where "the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *U.S. v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989), *quoting Caminetti v. U.S,* 242 U.S. 470, 485, 37 S.Ct. 192, 61 L.Ed. 442 (1917). The plain language of Section 365(d)(10) refers to "obligations...first arising from or after 60 days after the order for relief." 11 U.S.C. § 365(d)(10). Arguably, however, this language is ambiguous as to when Furley's obligation to pay February rent first arose. Did Furley's obligation to pay within ten days first arise on the invoice date (January 25, 1999), in which case Section 365(d)(10) excuses Furley's failure to pay, or on the due date (February 4, 1999), in which case Section 365(d)(10) does not excuse Furley's failure to pay because it fell on the sixty-fourth day following the order for relief and is therefore outside the fifty-nine day abeyance period provided by Section 365(d)(10).

[4] When statutory language is ambiguous, the court may look to legislative history for guidance. *United States, v. Irvin,* 2 F.3d 72, 76 (4th Cir.1993), *cert. denied,* 510 U.S. 1125, 114 S.Ct. 1086, 127 L.Ed.2d 401 (1994). Here, the legislative history includes a statement from Senator Grassley that confirms the due date, and not the invoice date, controls. According to Senator Grassley:

> The word "first" as used in the section refers to the payments and the performance of all other obligations that initially become due more than 60 days after the order for relief. The purpose of that reference is to make clear the intent that the provision does not affect payments originally

> due prior to 60 days before [sic] the order of relief.

140 Cong. Rec. S14462 (daily ed. Oct. 6, 1994) (statement of Sen. Grassley). Although Xtra Lease invoiced the Debtor within the abeyance period on January 25, 1999, the February lease payment was not *due* for another ten days, or February 4, ***739** which was beyond the abeyance period. Therefore, under Section 365(d)(10), the February lease payment, and all other lease payments due thereafter until the Lease Agreement was rejected, were automatically entitled to Chapter 11 administrative expense status.

B. *11 U.S.C. § 365(d)(10) Does Not Preclude Xtra Lease's Claim for Administrative Expenses Under 11 U.S.C. § 503(b)(1)(A).*

[5] The second issue is whether Section 365(d)(10) bars Xtra Lease's Chapter 11 administrative claim under Section 503(b)(1)(A) for obligations Furley's failed to perform under the Lease Agreement during the first fifty-nine days following the Petition Date. The express language of Section 365(d)(10) is silent on the issue, but the Trustee contends it bars Xtra Lease's administrative claim by negative implication. In other words, by expressly directing the Trustee to timely perform all personal property lease obligations first arising from and after 60 days following the order for relief, Section 365(d)(10) precludes a trustee from performing such lease obligations arising prior to the 60th day.

To support his position the Trustee relies on a single case, *In re Kyle Trucking, Inc.,* 239 B.R. 198 (Bankr.N.D.Ind.1999). However, for reasons discussed below, the facts and analysis in *Kyle Trucking* are distinguishable from the facts in this proceeding. Further, the plain language of Section 365(d)(10), legislative history reflecting the intent of Congress in enacting the section, and more recent published opinions interpreting the section demonstrate that the Trustee's position is incorrect.

In *Kyle Trucking,* the debtor possessed vehicles leased from Associates Lending ("Associates") on the petition date, September 15, 1997. *Id.* at 200. After the court found the agreements between the debtor and Associates were true leases and were not disguised financing devices, it ruled the leases were deemed rejected as of January 13, 1999. *Id.* Although the debtor had been making adequate protection payments to Associates and had placed additional money in escrow pending the court's ruling, Associates claimed it was still owed for lease payments due during the first six months of the bankruptcy case. *Id.* Associates therefore filed a motion for an administrative claim under Section 365(d)(10) for all post-petition lease payments, taxes, late fees and attorney fees, including money due during the first sixty days after the petition date. *Id.* With respect to the lease payments, the court held:

> Where, as in this case, an unexpired lease of personal property is ultimately rejected, the obligations coming due during the 60 days following the order for relief will be included in the lessor's claim for damages arising from the rejection of the lease. Those obligations do not represent an administrative claim.

Id. at 202. To reach this result, the court compared Section 365(d)(10), which Congress added to the Bankruptcy Code in 1994, with the older Section 365(d)(3) [4]. ***740** The older Section 365(d)(3) directs debtors in possession in Chapter 11 cases to timely perform all the debtor's obligations arising from unexpired nonresidential real property leases, but gives courts the discretion to extend the time for performance of obligations arising within sixty days after the date of the order for relief. The *Kyle* court concluded that inclusion of the automatic sixty day abeyance period in Section 365(d)(10) indicated Congress's intent to preclude all personal property lease obligations arising during that period from treatment as an administrative claim.

The facts and analysis in *Kyle* are distinguishable from the facts and issues presented in this proceeding. In *Kyle,* the lessor sought an administrative expense claim *exclusively* under Section 365(d)(10). There is no indication in the opinion that the lessor sought an administrative expense under Section 503(b)(1), particularly for the initial sixty day period after the petition date. [5] In this proceeding, the lessor, Xtra Lease, has filed a claim for administrative expenses under Section 503(b)(1). In addition, *Kyle* held only that Section 365(d)(10), *by itself,* does not allow lessors of personal property to apply for an administrative expense claim for lease payments due during the first sixty days of a Chapter 11 bankruptcy proceeding. The court did not address the issue raised here, namely, whether Section 365(d)(10) *precludes*

Xtra Lease from applying for an administrative expense under Section 503(b)(1).

Section 365(d)(10), like its nonresidential real property counterpart, Section 365(d)(3), grants lessors the extraordinary benefit of an automatic administrative expense, without the usual proofs required under Section 503(b)(1)(A) to show actual, necessary costs of preserving the estate. *See* *In re Russell Cave Co.,* 247 B.R. 656, 659 (Bankr.E.D.Ky.2000)(discussing Section 365(d)(10)); *In re The Elder–Beerman Stores Corp.,* 201 B.R. 759, 763 (Bankr.S.D.Ohio 1996); *In re Brennick,* 178 B.R. 305, 307 (Bankr.D.Mass.1995)(discussing Section 365(d)(3)). Under Section 365(d)(10) that benefit is applicable only from and after the first 60 days, which strikes a balance between the debtor-in-possession's need for time to reject non-beneficial personal property leases without creating administrative claims against the estate, and the lessor's right to get paid for the leased goods. However, the language of Section 365(d)(10) does not do away with a claimant's right to apply for administrative expenses under Section 503(b)(1).

Section 365(d)(10) does not even speak to the first 59 days after the filing of a petition. Instead, it creates an "abeyance period" for creditors to apply for administrative expenses related to unexpired personal property leases up until the sixtieth day after the petition date, after which the Trustee is required to perform the debtor's obligations under the lease. *In re Elder–Beerman Stores Corp.,* 201 B.R. at 764. Senator Grassley's comments on the legislation, quoted above, provide additional support for this interpretation. According to the Senator, the purpose of inserting the word "first" into the statute was "to make it clear the intent that the provision does not affect payments originally due prior to 60 days before [sic] the order ***741** of relief." 140 Cong. Rec. S14462 (Oct. 6, 1994). In addition, Section 365(d)(10) and (d)(3) are the *only* two sections in the Bankruptcy Code "requiring the estate to perform the debtor's obligations at all, much less in a timely manner." *In re Brennick,* 178 B.R. at 308. The reason for this legislative command is "the coercive nature of a lessor's extension of credit." *Id.* Additional legislative history supports *Brennick's* analysis. That history indicates Congress enacted Section 365(d)(10) to (1) shift the burden of bringing a motion to assume or reject the lease to the debtor while (2) giving debtors-in-possession sufficient breathing room after the petition date to "make an informed decision." 140 Cong. Rec. H10, 752–01 (daily ed. October 4, 1994). Nothing in either the statutory language or the legislative history indicates an intent to preclude lessors from filing administrative claims under Section 503(b)(1).

One case that addresses the issue of whether Section 365(d)(10) precludes an administrative claim under Section 503(b)(1) on facts similar to those here is *In re Raymond Cossette Trucking, Inc.,* 231 B.R. 80 (Bankr.D.N.D.1999). Like the Debtor in this proceeding, the debtor in *Raymond Cossette* also leased over-the-road refrigerated trailers. *Id.* The debtor used the trailers for seven months following the date it filed its Chapter 11 petition, until the case was converted to Chapter 7 and the trustee rejected the leased trailers. *Id.* at 82–83. The lessor then filed an administrative expense claim, exclusively under Section 503(b)(1), for the entire seven month period following the petition date. *Id.* at 83. Although the trustee did not contend Section 365(d)(10) precluded the lessor's administrative expense claim, he argued Section 365(g) provided the exclusive remedy for lessors when lessees fail to perform and unilaterally reject the lease. *Id.* The court found the result depended on whether the debtor used and gained some benefit from the property post-petition. *Id.* If the debtor rejected the contract on the petition date and did not use the property to its benefit post-petition, then the lessor would only be entitled to an unsecured claim for damages. *Id., citing* 4, *Collier's on Bankruptcy,* ¶ 503.06 (rev. 15th ed.1998). If, instead, the debtor retained the property and obtained some benefit from it, "then section 503(b)(1)(A) comes into play irrespective of whether damages for breach might otherwise lie." *Id., citing* *In re Thompson,* 788 F.2d 560 (9th Cir.1986); *Kinnan & Kinnan P'ship v. Agristor Leasing,* 116 B.R. 162 (D.Neb.1990).

Other courts have also decided Section 365(d)(10) does not take away a personal property lessor's right to apply for administrative expenses during the first sixty days of a case. *See* *In re Magnolia Gas Co.,* 255 B.R. 900, 917 (W.D.Okl.2000); *In re Eastern Agri–Systems, Inc.,* 258 B.R. 352, 354–55 (Bankr.E.D.N.C.2000) (finding administrative expense claims arising under § 365(d)(10) are independent from administrative expense claims under § 503(b)); *In re Pan Am. Airways Corp.,* 245 B.R. 897, 899 (Bankr.S.D.Fla.2000) (holding that although the lessor was not entitled to an administrative expense claim under § 365(d)(10) for the debtor's use of leased property during the first sixty days of the case, the lessor would be entitled to those expenses under § 503(b)(1) to the extent the lessor could prove the expenses represented the "actual, necessary costs and expenses of preserving the estate."); *In re Russell Cave Co.,* 247 B.R. at 659 (finding lessors may apply for administrative expenses

"relative to unexpired leases of personal property pursuant to § 503(b)(1) up until the 60th day after filing, after which the trustee is required ***742** to perform the debtor's obligations under the lease.").

C. ***Application To This Proceeding***

[6] Based on the foregoing analysis, the court will deny the Trustee's Motion for Partial Summary Judgment because the Trustee has not established he is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(a), made applicable by Fed.R.Bankr.P. 7056. Section 365(d)(10) does not preclude Xtra Lease from applying under Section 503(b)(1) for administrative expenses that arose during the first fifty-nine days of the Debtor's Chapter 11 case. As a result, Xtra Lease will have the opportunity at trial to prove it is entitled to an administrative claim pursuant to Section 503(b)(1)(A) for personal property lease payments that became due during the 59 days after the Chapter 11 petition was filed. In addition, to the extent Furley's failed to perform its obligations under the Lease Agreement that became due after the 59 day period until the date the Lease Agreement was rejected, Xtra Lease will be entitled to an automatic administrative claim pursuant to Section 365(d)(10), unless the Trustee can convince the court to rule otherwise "based on the equities of the case." 11 U.S.C. § 365(d)(10).

Therefore, it is, this 12th day of June, 2001, by the United States Bankruptcy Court for the District of Maryland,

ORDERED, that Plaintiff's Motion for Partial Summary Judgment is **DENIED**.

All Citations

263 B.R. 733, 46 Collier Bankr.Cas.2d 862

Footnotes

1 The Plaintiff asserts the trailers were surrendered on February 22, 1999, while the Defendant contends the trailers were returned sometime between March 3, 1999 and March 8, 1999. Although this is a genuine dispute of fact, it is not a genuine dispute of *material* fact under Fed.R.Civ.P. 56 because the date the trailers were surrendered does not affect the outcome of Plaintiff's motion. Therefore, the dispute does not prevent the court from ruling on the Trustee's motion. *See Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 247–48, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

2 11 U.S.C. § 365(g), in relevant part, provides: "[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease..."

3 ***D. Payment Terms:*** **Lessee** shall be invoiced in advance for all use and other charges hereunder, and shall pay all invoices within ten (10) days from date of invoice. Use charges shall be computed on a pro-rata daily basis for any unit of Equipment which is in **Lessee's** possession or control for any partial billing period, **provided however**, that **Lessee**, upon termination, shall be responsible for and pay to **XTRA LEASE** the use charges for the full billing period during which a unit of Equipment is redelivered to **XTRA LEASE**.

4 Section 365(d)(3) states:

> The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60–day period. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) of (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

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5 The court does not even mention Section 503(b), except when it quotes Section 365(d)(10) (which refers to Section 503(b)).

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Disagreed With by In re Ultra Petroleum Corp., Bankr.S.D.Tex., September 21, 2017

324 F.3d 197
United States Court of Appeals,
Third Circuit.

In re: PPI ENTERPRISES (U.S.), INC.
and Polly Peck Produce, Inc., Debtors
Sheldon H. Solow, d/b/a Solow Building Company
v.
PPI Enterprises (U.S.), INC., Polly Peck Produce, Inc., Arvi Limited and PPI Holdings, B.V.
Sheldon H. Solow, d/b/a Solow Building Company, Appellant.

No. 01–4140.
|
Argued July 15, 2002.
|
Filed March 28, 2003.

Synopsis
Debtor's former landlord objected to debtor's proposed Chapter 11 plan and moved to dismiss bankruptcy petition as not having been filed in good faith. The United States Bankruptcy Court for the District of Delaware, Peter J. Walsh, Chief Judge, 228 B.R. 339, denied motion and overruled objections, and landlord appealed. The District Court, Roderick, R., McKelvie, J., affirmed. On further appeal, the Court of Appeals, Scirca, Circuit Judge, held that: (1) landlord's statutorily capped damages claim was not "impaired," for purposes of deciding whether debtor's proposed plan had been accepted by at least one impaired class, simply because it was capped; (2) statutory cap on landlord's claim for termination damages was properly reduced by sums it had drawn on letter of credit that it held in lieu of security deposit; and (3) petition was filed in "good faith," though filed primarily to cap landlord's damages.

Affirmed.

Procedural Posture(s): On Appeal.

West Headnotes (18)

[1] **Bankruptcy** Conclusions of Law; De Novo Review
Bankruptcy Discretion
Bankruptcy Clear Error

Court of Appeals reviews bankruptcy court's legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof. Fed.Rules Bankr.Proc.Rule 8013, 11 U.S.C.A.

4 Cases that cite this headnote

[2] **Bankruptcy** Eligibility to Vote; Impairment

Term "impairment," as used in bankruptcy statute defining when claim or interest is impaired under debtor's proposed Chapter 11 plan, is term of art, that was crafted by Congress to determine creditor's standing at plan confirmation stage. Bankr.Code, 11 U.S.C.A. § 1124.

4 Cases that cite this headnote

[3] **Bankruptcy** Eligibility to Vote; Impairment

If debtor's proposed Chapter 11 plan does not leave creditor's rights entirely unaltered, creditor's claim is "impaired," and creditor will have vote upon whether plan should be confirmed. Bankr.Code, 11 U.S.C.A. § 1124.

23 Cases that cite this headnote

[4] **Bankruptcy** Eligibility to Vote; Impairment

There is a presumption that proposed Chapter 11 plan impairs creditor's claim, so as to give creditor a vote on whether plan should be confirmed, and burden is on debtor to demonstrate that plan leaves creditor's rights unaltered. Bankr.Code, 11 U.S.C.A. § 1124.

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17 Cases that cite this headnote

[5] **Bankruptcy** Eligibility to Vote; Impairment

Statutory cap on claim that lessor could assert for damages resulting from termination of its lease with Chapter 11 debtor-lessee was not "impairment" of its rights, but part of rights that it possessed in bankruptcy, so that where debtor's Chapter 11 plan proposed to pay lessor's statutorily capped claim in full, together with postpetition interest, lessor's claim was not "impaired," and it had no right to vote upon whether plan should be confirmed. Bankr.Code, 11 U.S.C.A. §§ 502(b)(6), 1124.

9 Cases that cite this headnote

[6] **Bankruptcy** Eligibility to Vote; Impairment

Creditor's claim outside of bankruptcy is not relevant barometer for whether proposed Chapter 11 plan "impairs" its rights, for purposes of deciding whether creditor has right to vote on confirmation of plan. Bankr.Code, 11 U.S.C.A. § 1124.

7 Cases that cite this headnote

[7] **Bankruptcy** Eligibility to Vote; Impairment

To determine whether creditor's claim is "impaired," so as to give it standing to vote upon confirmation of proposed Chapter 11 plan, court must examine whether plan itself is source of limitation on creditor's legal, equitable, or contractual rights. Bankr.Code, 11 U.S.C.A. § 1124.

18 Cases that cite this headnote

[8] **Bankruptcy** Eligibility to Vote; Impairment

Creditors that will receive cash equal to their "allowed claims," together with postpetition interest, under debtor's proposed Chapter 11 plan are not "impaired," and have no right to vote on whether plan should be confirmed. Bankr.Code, 11 U.S.C.A. § 1124.

14 Cases that cite this headnote

[9] **Bankruptcy** Rejection of Executory Contract or Lease

Statutory cap on claim that landlords may assert for damages resulting from termination of their leases with debtor-tenants is designed to limit such lease termination claims to prevent landlords from receiving a windfall at other creditors' expense. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

10 Cases that cite this headnote

[10] **Bankruptcy** Rejection of Executory Contract or Lease

Though debtor-tenant's bankruptcy filing does not relieve landlord of its duty to mitigate its damages for debtor-tenant's breach of lease, statutory cap on landlord's claim for termination damages is not reduced by amount that landlord receives from reletting premises and mitigating its damages. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

12 Cases that cite this headnote

[11] **Bankruptcy** Rejection of Executory Contract or Lease

Statutory cap on landlord's claim for termination damages was properly reduced by sums that it had drawn upon letter of credit that it held in lieu of security deposit. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

12 Cases that cite this headnote

[12] **Bankruptcy** Good Faith; Motive

Debtor's bad faith in filing for Chapter 11 relief constitutes "cause" for dismissal of Chapter 11 petition. Bankr.Code, 11 U.S.C.A. § 1112(b).

8 Cases that cite this headnote

[13] **Bankruptcy** Proceedings

On motion to dismiss Chapter 11 case as not having been filed in good faith, debtor bears burden of establishing its good faith. Bankr.Code, 11 U.S.C.A. § 1112(b).

13 Cases that cite this headnote

[14] **Bankruptcy** Good Faith; Motive

Court must consider totality of circumstances in deciding whether Chapter 11 petition is subject to dismissal as not having been filed in good faith. Bankr.Code, 11 U.S.C.A. § 1112(b).

6 Cases that cite this headnote

[15] **Bankruptcy** Discretion

Bankruptcy court's decision not to dismiss Chapter 11 petition as "bad faith" filing, despite fact that debtor-tenant had filed for bankruptcy primarily for purposes of taking advantage of statutory cap upon landlord's claim for lease termination damages, would be reviewed for abuse of discretion. Bankr.Code, 11 U.S.C.A. § 502(b)(6).

4 Cases that cite this headnote

[16] **Bankruptcy** Discretion

Abuse of discretion can occur when no reasonable person would adopt lower court's view.

4 Cases that cite this headnote

[17] **Bankruptcy** "Bad Faith."

Bankruptcy court's decision not to dismiss, as "bad faith" filing, a liquidating Chapter 11 petition filed by debtor with no ongoing business, only one so-called employee, and no assets other than stock certificates was not abuse of discretion, though debtor filed petition primarily to cap lessor's damages claim for debtor's breach of lease, so as to create value for equity holders at lessor's expense; in filing bankruptcy petition to cap lessor's damages claim, debtor was taking advantage of right specifically granted under the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. §§ 502(b)(6), 1112(b).

10 Cases that cite this headnote

[18] **Bankruptcy** Good Faith; Motive

Determination, for case dismissal purposes, of whether Chapter 11 petition was filed in "good faith" requires fact-intensive, case-by-case inquiry. Bankr.Code, 11 U.S.C.A. § 1112(b).

8 Cases that cite this headnote

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Charlene D. Davis (Argued), The Bayard Firm, Wilmington, DE, for Appellees, Arvi Limited and PPI Holdings, B.V.

Before SCIRICA, ALITO and FUENTES, Circuit Judges.

OPINION OF THE COURT

SCIRICA, Circuit Judge.

This is an appeal by a commercial landlord who contends a Chapter 11 bankruptcy was filed only to frustrate his collection of rent. At issue is an interpretation of Bankruptcy Code § 502(b)(6) and the Code's good faith requirements.

I.

Sheldon Solow owns a Manhattan office tower at 9 West 57th Street. On August 9, 1989, he leased 10,000 square feet to PPI Enterprises ("PPIE"), a Delaware corporation, for its corporate headquarters. The lease ran for ten years, requiring annual payments (in monthly installments) of

$620,000 for five years and $650,000 thereafter. Polly Peck International, PLC, a United Kingdom corporation and the indirect corporate parent of PPIE, guaranteed these commercial lease obligations. [1] Sanwa Bank issued a standby letter of credit to Solow, on behalf of PPIE, in the amount of $650,000.

Over time, Polly Peck's financial status unraveled and insolvency proceedings commenced in Great Britain. On October 25, 1990, the Chancery Division of the High Court of Justice entered an administration order [2] for Polly Peck and appointed three administrators for the company. As Polly Peck's subsidiary, PPIE faced credit cancellations and defaults exceeding $17 million. [3]

In September 1991, PPIE abandoned its corporate headquarters in Manhattan and ceased paying rent to Solow. On October 8, 1991, Solow delivered PPIE written notice of default under the lease. After PPIE failed to cure the default, Solow ***201** gave notice on October 21, 1991, of his intent to terminate the lease. Remaining rent due under the leasehold agreement totaled approximately $5.86 million. Solow subsequently drew on Sanwa Bank's letter of credit, applying it in lieu of monthly rent payments between October 1991 and July 31, 1992. By the latter date, the letter of credit was exhausted.

On October 25, 1991, Solow sued PPIE and Polly Peck in the United States District Court for the Southern District of New York. On November 13, 1992, the district court granted Solow partial summary judgment, holding PPIE wrongly terminated its lease, but did not address possible damages. On March 4, 1996, almost four and one half years after filing its initial lawsuit and after the failure of settlement negotiations, Solow asked the district court to schedule a damages trial. On the eve of that proceeding, PPIE filed for Chapter 11 bankruptcy in Delaware. PPIE stated it had four objectives: (1) concluding the Polly Peck “wind-down”; (2) “liquidating” PPIE; (3) invoking provisions to reject a restriction on its ability to sell the Del Monte stock; and (4) limiting Solow's lease termination damages under Bankruptcy Code § 502(b)(6).

On August 9, 1996, Solow filed a proof of claim with the Bankruptcy Court, reducing his alleged damages to $4,757,824.94. [4] Then, in December 1996, Solow moved to dismiss the Chapter 11 filing for bad faith. Solow alleged PPIE's bankruptcy was a sham filing designed to create value for Polly Peck and its creditors at his expense, and that the bankruptcy served no legitimate purpose. According to Solow, PPIE did not intend its bankruptcy filing to effectuate a corporate reorganization, because the company had no ongoing business, only one remaining employee, and “no assets other than stock certificates representing a 2% interest in Del Monte Foods Company.” After an evidentiary hearing, the Bankruptcy Court in January 1997 denied the motion without prejudice. [5]

On March 31, 1998, PPIE filed its bankruptcy plan (“Plan”), dividing administrative claims and priority tax claims into four classes. [6] After providing for the four-class division, the Plan stated: “The treatment of and consideration to be received by holders of Allowed Claims and Interests pursuant to this Article IV of the Plan shall be in full and complete satisfaction, settlement, release and discharge of such Claims and Interests. The Debtors' obligations in respect of such Claims and Interests shall be satisfied in accordance with the terms of this Plan.”

***202** The Plan treated Solow's claim as a “Class 2 non-insider general unsecured claim.” PPIE contended Plan approval by the classes of creditors was unnecessary since none were impaired. Nonetheless, PPIE solicited votes from Classes 1, 2, and 3. Only two of seven ballots were returned from Class 2 –Solow's “no” vote and one “yes” vote. With no clear majority, Solow contends Class 2 effectively rejected the Plan. [7]

Solow renewed his motion to dismiss on April 6, 1998, contending his vote against the Plan had not counted because his claim was improperly classified as “unimpaired.” Over a four-day period, the Bankruptcy Court heard evidence on the debtors' objection to Solow's claim; Solow's renewed motion to dismiss; and Solow's objections to the Plan's confirmation. On December 30, 1998, the Bankruptcy Court determined Solow's claim was subject to the statutory cap of 11 U.S.C. § 502(b)(6) and reduced by application of the letter of credit; the bankruptcy was filed in good faith; and as an “unimpaired creditor,” Solow was deemed to have accepted the plan. *In re PPI Enters.,* 228 B.R. 339 (Bankr.D.Del.1998) (Walsh, J.).

The United States District Court for the District of Delaware affirmed without opinion and this appeal followed. [8]

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II.

[1] The Bankruptcy Court had subject matter jurisdiction under 28 U.S.C. §§ 1334 and 157. The District Court had jurisdiction over the Bankruptcy Court's order under 28 U.S.C. § 158(a). We have jurisdiction under 28 U.S.C. § 158(d). We review the Bankruptcy Court's "legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof." *In re Cont'l Airlines,* 203 F.3d 203, 208 (3d Cir.2000).

III.

The central issue on appeal is whether the doctrine of impairment precludes Solow from having voting rights against PPIE's Chapter 11 bankruptcy plan.

[2] **[3]** "Impairment" is a term of art crafted by Congress to determine a creditor's standing in the confirmation phase of bankruptcy plans. *In re L & J Anaheim Assoc.,* 995 F.2d 940, 942–43 (9th Cir.1993). Each creditor has a set of legal, equitable, and contractual rights that may or may not be affected by bankruptcy. If the debtor's Chapter 11 reorganization plan does not leave the creditor's rights entirely "unaltered," the creditor's claim will be labeled as impaired under § 1124(1) of the Bankruptcy Code. If the creditor's claim is impaired, the Code provides the creditor with a vote that, depending on the value of the creditor's claim, may be sufficient to defeat confirmation of the bankruptcy plan.

***203** **[4]** The Bankruptcy Code creates a presumption of impairment "so as to enable a creditor to vote on acceptance of the plan." *In re Monclova Care Ctr., Inc.,* 254 B.R. 167, 178–79 (Bankr.N.D.Ohio 2000); *In re Seasons Apartments, L.P.,* 215 B.R. 953, 958 (Bankr.W.D.La.1997). Under 11 U.S.C. § 1124(1), the presumption of impairment is overcome only if the plan "leaves unaltered the [creditor's] legal, equitable, and contractual rights." [9] The burden is placed on the debtor to demonstrate the plan leaves the creditor's rights unaltered.

The Bankruptcy Court here began by reviewing 11 U.S.C. § 502(b)(6). The court determined the Plan did not impair Solow's legal, equitable, and contractual rights, since the limitation on Solow's potential recovery was dictated by § 502(b)(6), which was independent of the Plan. Solow contends application of § 502(b)(6) alters his claim and entitles him to vote against the Plan's confirmation. The question is whether the impairment sections of the Bankruptcy Code require such a result.

A.

1.

[5] We begin with the language of the Bankruptcy Code. *United States v. Ron Pair Enters., Inc.,* 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989). As noted, § 1124(1) provides that a claim is impaired unless the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim ... entitles the holder of such claim." Under § 101(5), a "claim" refers broadly to a creditor's right to recovery. [10] *See also Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991) ("We have previously explained that Congress intended by this language to adopt the broadest available definition of 'claim.' ") (citations omitted).

Solow contends a broad definition of "claim" requires a finding of impairment whether the source of impairment is the plan or a statute. The Bankruptcy Court rejected Solow's argument, finding he "confuse[d] two distinct concepts: (i) plan impairment, under which the debtor alters the 'legal, equitable, and contractual rights to which [the] claim entitles the holder of such claim,' and (ii) statutory impairment, under which the operation of a provision of the Code alters the amount that the creditor is entitled to under nonbankruptcy law." *PPI Enters.,* 228 B.R. at 353.

The Bankruptcy Court relied on *In re American Solar King Corp.,* 90 B.R. 808 (Bankr.W.D.Tex.1988), to reach its conclusion. In *Solar King,* a Chapter 11 corporate debtor sought confirmation of a modified reorganization plan. Certain parties already involved in litigation with the bankrupt company –doubtless concerned about reduced recoveries – challenged the plan. *Id.* at 812–13. The court recognized the operation of § 510(b) [11] in altering the ***204** petitioning creditors' claims, but found the reduction in the creditors' potential, nonbankruptcy recovery did not result in impairment. *Id.* at 819–22. The court reasoned:

> A closer inspection of the language employed in Section 1124(1) reveals "impairment by statute" to be an oxymoron. Impairment results from what the *plan* does,

> not what the statute does. A plan which "leaves unaltered" the legal rights of a claimant is one which, by definition, does not impair the creditor. A plan which leaves a claimant subject to other applicable provisions of the Bankruptcy Code does no more to alter a claimant's legal rights than does a plan which leaves a claimant vulnerable to a given state's usury laws or to federal environmental laws. The Bankruptcy Code itself is a statute which, like other statutes, helps to define the legal rights of persons, just as surely as it limits contractual rights. Any alteration of legal rights is a consequence not of the plan but of the bankruptcy filing itself.
>
> *Id.* at 819–20; *see also In re Smith,* 123 B.R. 863, 867 (Bankr.C.D.Cal.1991) ("[A] plan may limit payment of claims to 'the extent allowed,' without impairing them; for until claims are allowed, or deemed allowed, the holders thereof are not entitled to distribution from the bankruptcy estate."). [12]

[6] **[7]** Generally, we agree with the *Solar King* analysis. The relevant impairment language requires bankruptcy plans to leave unaltered those rights to which the creditor's "claim or interest entitles the holder of such claim or interest." 11 U.S.C. § 1124(1). This language in § 1124(1) does not address a creditor's claim "under nonbankruptcy law." The use of a present-tense verb suggests a creditor's rights must be ascertained with regard to applicable statutes, including the § 502(b)(6) cap. In other words, a creditor's claim outside of bankruptcy is not the relevant barometer for impairment; we must examine whether the plan itself is a source of limitation on a creditor's legal, equitable, or contractual rights.

Under Solow's interpretation, every landlord-creditor's capped claim under § 502(b)(6) would be impaired and entitled to a vote. Yet this would make § 502(b)(6) a nullity, since, unlike some other Code sections, the limitation on damages under § 502(b)(6) is "absolute" and "is a limit based on fairness rather than a rule of convenience." 4 *Collier on Bankruptcy,* § 502.03, at 7a (Alan N. Resnick & Henry J. Sommer, eds., 15th ed.2002). Thus, PPIE could not offer a plan that departed from the § 502(b)(6) limitation. Accordingly, we hold that where § 502(b)(6) alters a creditor's nonbankruptcy claim, there is no alteration of the claimant's legal, equitable, and contractual rights for the purposes of impairment under § 1124(1).

2.

The *Solar King* court adopted a similar rationale when interpreting § 510(b), ***205** which automatically subordinates security purchase and sale claims to the claims of general, unsecured creditors. The rationale for this Code section is that general creditors should not share in the risk of an unlawful issuance of securities. *See* 4 *Collier on Bankruptcy,* § 510.04, at 1. Like § 502(b)(6), this Code section is mandatory, not discretionary. To hold that its mere application in a bankruptcy proceeding causes impairment would nullify its meaning.

Further, as the Bankruptcy Court here noted, Solow's interpretation would create "perverse incentives" for all creditors, effectively urging them to file "inflated claims, disputed claims, or claims of questionable validity." Once those claims were reduced by operation of the Bankruptcy Code, under Solow's analysis, creditors would succeed in having their claims "impaired" and would receive a vote to defeat the plan.

In sum, PPIE's Chapter 11 Plan intends to pay Solow his "legal entitlement" and provide him with "full and complete satisfaction" of his claim on the date the Plan becomes effective. Solow is only "entitled" to his rights under the Bankruptcy Code, including the § 502(b)(6) cap. Solow might have received considerably more if he had recovered on his leasehold claims before PPIE filed for bankruptcy. But once PPIE filed for Chapter 11 protection, that hypothetical recovery became irrelevant. Solow is only entitled to his "legal, equitable, and contractual rights," as they now exist. Because the Bankruptcy Code, not the Plan, is the only source of limitation on those rights here, Solow's claim is not impaired under § 1124(1). [13]

B.

[8] Solow also contends Congress's 1994 repeal of 11 U.S.C. § 1124(3), a separate exception to the presumption of impairment, supports his broad definition of "claim." Before 1994, § 1124(3) specified that a creditor receiving full payment of an "allowed claim" was not impaired. This subsection, eliminated in 1994, provided:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or

> interest of such class, the plan –(3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to –(A) with respect to a claim, the allowed amount of such claim....

11 U.S.C. § 1124(3) (repealed).

Interpreting this statute in 1994, one bankruptcy court held that § 1124(3) allowed a solvent debtor to pay the "allowed" claims of unsecured creditors in full, excluding postpetition interest, without risking impairment. *In re New Valley Corp.,* 168 B.R. 73, 77–80 (Bankr.D.N.J.1994). [14] The *New Valley* court held that a portion of a creditor's claim that was not "allowed" under the Bankruptcy Code need not be paid after a bankruptcy filing, even if the claim would be recoverable in a non-bankruptcy context. *Id.* This decision contrasted with several cases holding that unsecured creditors of a solvent debtor ***206** must be paid in full, including postpetition interest, under the "fair and equitable" test of § 1129(b)(2). *E.g., Consol. Rock Prods. Co. v. du Bois,* 312 U.S. 510, 61 S.Ct. 675, 85 L.Ed. 982 (1941); *Debentureholders Protective Comm.,* 679 F.2d at 264.

After the *New Valley* decision, Congress repealed § 1124(3). Relevant legislative history recited:

> The principal change in this section is set forth in subsection (d) and relates to the award of post petition interest. In a recent Bankruptcy Court decision (*New Valley*), unsecured creditors were denied the right to receive post petition interest.... In order to preclude this unfair result in the future, the Committee finds it appropriate to delete section 1124(3) from the Bankruptcy Code. As a result of this change, if a plan proposed to pay a class of claims in cash in the full allowed amount of the claims, the class would be impaired, entitling creditors to vote for or against the plan of reorganization.

H.R.Rep. No. 103–835, at 47–48 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3356–57.

Solow contends this repeal established that creditors receiving cash equal to their "allowed claims," even including postpetition interest, were still impaired by bankruptcy filings. He claims the repeal was not limited to fact situations involving postpetition interest and that Congress "went beyond" the *New Valley* "problem," providing creditors with voting rights if a bankruptcy plan alters their nonbankruptcy rights in any manner. Some bankruptcy courts appear to have adopted this rationale. *See, e.g., Seasons Apartments,* 215 B.R. at 955–56 ("While the Congressional Record reveals that Congress was most concerned about solvent debtors avoiding post-petition interest on unsecured claims, Congress repealed the entire subsection."); *In re Crosscreek Apartments, Ltd.,* 213 B.R. 521, 536 (Bankr.E.D.Tenn.1997) ("In light of the deletion of subsection (3) to § 1124 by the Bankruptcy Reform Act of 1994, the court concludes that it is no longer a valid argument to assert that the plan proponent can render a claim unimpaired by paying the claim in full at confirmation."); *Equitable Life Ins. Co. of Iowa v. Atlanta–Stewart Partners,* 193 B.R. 79, 80 (Bankr.N.D.Ga.1996) (concluding Congress's repeal of § 1124(3) was an "extreme remedy" for the *New Valley* issue but that legislative history demonstrates "Congress intended to do away with the concept that a creditor receiving payment in full is unimpaired"). [15]

The Bankruptcy Court here rejected such a broad reading of the 1994 repeal, concluding, "[M]y reading of the legislative history indicates that Congress merely intended to eliminate the anomalous result created by the *New Valley* decision. Thus, I conclude that Congress did not intend to eliminate unimpairment for purely money claims. It intended that to be unimpaired, the claim must receive postpetition interest." *PPI Enters.,* 228 B.R. at 352 (citation omitted); *see also In re Rocha,* 179 B.R. 305, 307 n. 1 (Bankr.M.D.Fla.1995) ("[A] solvent debtor must now pay post-petition and pre-confirmation interest on a claim to have a class considered 'unimpaired.' Section 1124(3) has been deleted in its entirety, which had previously allowed a class of creditors to be considered 'unimpaired' without paying interest on the claim."). The Bankruptcy Court also held that §§ 1124(1) and ***207** 1124(3) offered different tests for nonimpairment: "Section 1124(3) created nonimpairment status by a cash

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payment equal to the allowed amount of the claim but without postpetition interest. Such treatment could not qualify for nonimpairment under § 1124(1) because the failure to pay postpetition interest does not leave unaltered the contractual or legal rights of the claim." *PPI Enters.,* 228 B.R. at 352.

In other words, § 1124(1) and § 1124(3) were different exceptions to the presumption of impairment, and the repeal of one should not affect the other. We agree with the Bankruptcy Court's analysis. Contrary to Solow's representations, the legislative history does not reflect a sweeping intent by Congress to give impaired status to creditors more freely outside the postpetition interest context. Instead, as the Bankruptcy Court noted, the legislative history accompanying the repeal of § 1124(3) indicated the "principal change" in the repeal "relates to the award of post petition interest." The congressional committee specifically referenced the *New Valley* decision without referencing the text of § 1124(1) or the many cases addressing its provisions, including *Solar King.* Therefore, the legislative history supports our holding.

IV.

Having determined Solow's claim is not impaired, we must consider the operation of § 502(b)(6). As the Bankruptcy Court noted, PPIE asserts that Solow's claim under § 502(b)(6) entitles him to $100,612.07. Solow counters that capping his claim still would award him $863,937.67. These disparate views are due to conflicting interpretations of § 502(b)(6).

A.

[9] **[10]** Section 502(b)(6) caps a landlord's claim in bankruptcy for damages resulting from the termination of a real property lease. [16] Under § 502(b)(6), a landlord-creditor is entitled to rent reserved from the greater of (1) one lease year or (2) fifteen percent, not to exceed three years, of the remaining lease term. The cap operates from the earlier of the petition filing date or "the date on which [the] lessor repossessed or the lessee surrendered, the leased property." The landlord also retains a claim for any unpaid rent due under such lease prior to the earlier of those dates. This language reflects Congress's intent to limit lease termination claims to prevent landlords from receiving a windfall over other creditors. *See* H.R.Rep. No. 95–595, at 353 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309 ("[The cap] limits the damages allowable to a landlord of the debtor.... It is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering ***208** a dividend from the estate. The damages a landlord may assert from termination of a lease are limited...."); 4 *Collier on Bankruptcy,* § 502.03 at 7a ("[The cap is] designed to compensate the landlord for his loss while not permitting a claim so large as to prevent other general unsecured creditors from recovering a dividend from the estate."). [17]

Just over two years into the parties' ten-year lease, PPIE breached the leasehold agreement by failing to pay rent. Solow gave PPIE ten days to cure its breach. When PPIE did not respond, Solow initiated termination proceedings and filed suit seeking damages for the term of the lease. Since Solow terminated the lease long before PPIE filed its bankruptcy petition, the Bankruptcy Court correctly fixed the date on which Solow accepted PPIE's surrender of the leased property as the starting point for its § 502(b)(6) calculation. [18]

B.

[11] Once the § 502(b)(6) calculation is complete, the prevailing view, and the view adopted by the Bankruptcy Court here, favors deduction of a security deposit from the § 502(b)(6) cap of a landlord's claim. *E.g., Atl. Container,* 133 B.R. at 988 ("[It is] well-settled that a security deposit held by a lessor on a rejected lease must be applied against the maximum claim for lease termination damages allowed to the lessor under § 502(b)(6)."). Equating a letter of credit with a security deposit, the Bankruptcy Court held that "because Solow drew down the letter of credit for $650,000 subsequent to termination of the lease, Solow's § 502(b)(6) claim should be reduced by that amount." [19] *PPI Enters.,* 228 B.R. at 350.

The Bankruptcy Court relied upon *Oldden v. Tonto Realty Corp.,* 143 F.2d 916, 921 (2d Cir.1944), which established the pre-Code practice of deducting security deposits from § 502(b)(6) calculations. *See also* H.R.Rep. No. 95–595, at 354 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6310 ("[A landlord] will not be permitted to offset his actual damages against his security deposit and then claim for the balance under [§ 502(b)(6)]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under [the statute]."). *Oldden* stands for the proposition that a bankruptcy filing limits damages for breach of a

leasehold agreement and requires a return of the tenant's security deposit. 143 F.2d at 921. Nonetheless, it bears noting that *Oldden* involved a security deposit given directly to the creditor from the debtor, not from a third party. We must consider whether this factor ***209** requires different treatment under § 502(b)(6).

Solow contends § 502(b)(6) applies only to funds collected by the landlord directly from the tenant, and that any other funds recovered by a landlord, whether from a letter of credit or a new tenant, are immaterial. *Accord Atl. Container,* 133 B.R. at 990 (post-petition rent, use, and occupancy payments "should not be applied against the Landlord's maximum allowable lease termination claim"); *see also In re Conston Corp.,* 130 B.R. 449, 453–54 (Bankr.E.D.Pa.1991). In this context, Solow suggests a security deposit and a letter of credit are fundamentally different. Solow argues he never had the functional equivalent of a security deposit and instead simply maintained contractual rights to the letter of credit's proceeds, which should not affect his recovery under § 502(b)(6).

This distinction is important because if Sanwa Bank had defaulted on its letter of credit to Solow, Solow would have pursued a separate legal action against Sanwa Bank; he would have no claim against PPIE based on the letter of credit. Because the letter of credit allegedly is independent of his claim against PPIE, Solow contends the $650,000 should not be deducted from the § 502(b)(6) cap calculation.

Under similar circumstances, some courts have adopted the "independence principle" to separate proceeds from a letter of credit from the debtor's estate. *E.g., Kellogg v. Blue Quail Energy Inc.,* 831 F.2d 586, 589–90 (5th Cir.1987) (holding that "the independence principle [is] the cornerstone of letter of credit law"); *Musika v. Arbutus Shopping Ctr., L.P.,* 257 B.R. 770, 772 (Bankr.D.Md.2001) (determining the § 502(b)(6) cap without regard to the letter of credit); *see also* 5 *Collier on Bankruptcy*, § 549.04[1] ("Property of the estate does not include the proceeds of a letter of credit paid to a creditor of the debtor who is a beneficiary of the letter."); Geoffrey L. Berman et al, *Last in Line: Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6),* 20 Am. Bankr.Inst. J. 16 (Dec.2001). Under this view, the independence principle should generally govern in situations where a third-party issuer, not the tenant itself, provides the letter of credit.

Yet there is another view. PPIE argues that once the letter of credit is drawn down, Sanwa Bank, as guarantor, will pursue recovery of its $650,000 loss directly against PPIE. Under Solow's interpretation, this means Solow would keep the $650,000 and PPIE would be liable for that same amount to Sanwa Bank. In effect, this result would be an end run around § 502(b)(6), since Solow would receive a windfall at PPIE's, and other creditors', expense, and PPIE would be liable twice for the same amount of money. The more appropriate outcome under the relevant case law and legislative history, PPIE contends, is to treat the letter of credit as a payment from PPIE to Solow, thus reducing PPIE's burden under § 502(b)(6) in bankruptcy.

Chapter 11 is intended to permit the debtor to rehabilitate itself while simultaneously protecting creditors. The parties here posit competing legal and equitable arguments that reflect the dual purposes of bankruptcy. Although there are reasons to the contrary, we are not inclined to disturb the rationale followed since *Oldden.* As the Second Circuit explained in *Oldden:*

> Although the instant case is admittedly different in that the tenant here pledged his own property to cover the possibility of default, and the rights of a third party are in no way involved, yet in both situations there is an attempt on the part of the landlord to insure performance by ***210** the tenant. The difference is purely technical.... [I]n one case the insurance is security put up by the tenant himself, while in the other it is the credit standing of a third party procured by the tenant; this difference is insufficient to justify divergent rules as to the respective allowable claims. If the total damages are limited in the one instance, they should likewise be limited in the other instance.

143 F.2d at 921.

Nonetheless, we need not decide the underlying question because it is clear the parties intended the letter of credit to operate as a security deposit. Article 33A of the parties' lease required PPIE to give Solow a security deposit in the

amount of $650,000. Article 50 of the rider attached to the lease clarified PPIE's obligation:

> 50. *Cash Security: Letter of Credit*
>
> A. In lieu of the cash security provided for in Article 33A, Tenant may deliver to Landlord, as security pursuant to Article 33A, an irrevocable, clean, commercial letter of credit in the amount of $650,000 issued by a bank ..., which shall permit Landlord (a) to draw thereon up to the full amount of the credit evidenced thereby in the event of any default by Tenant ... or (b) to draw the full amount thereof to be held as cash security pursuant to Article 33A hereof if for any reason the Letter is not renewed....
>
> B. If Landlord shall use or apply any of the cash security deposited pursuant to Article 33A or any of the cash drawn by Landlord under the Letter of Credit ..., Tenant shall, promptly on Landlord's demand therefor, deposit with Landlord the amount of cash required to restore the cash security deposited with Landlord to the level specified in Article 33A or in lieu thereof, shall deliver to Landlord a Letter of Credit in the amount and complying with the requirements specified in Part A above.

Interpreting this language, we find the parties intended the letter of credit to serve as a security deposit. Entitled “Cash Security: Letter of Credit,” the rider expressly provided the letter of credit was “in lieu” of PPIE's cash security obligation in the leasehold agreement. The rider also provided that PPIE would be liable to Solow for replenishment of the security if he was forced to draw upon the letter of credit. We will affirm the Bankruptcy Court's treatment of the letter of credit under § 502(b)(6).

V.

[12] **[13]** Finally, we consider whether PPIE's Chapter 11 bankruptcy filing met certain legal prerequisites. Under § 1112(b), bankruptcy courts may dismiss Chapter 11 filings for “cause” if a petition is filed in “bad faith.” The Bankruptcy Court denied Solow's motion to dismiss for alleged bad faith [20] and his objection to the confirmation of PPIE's plan under § 1129(a)(3). [21] At issue is whether this bankruptcy filing contravened the purposes of the Bankruptcy Code under its ***211** good faith requirements. The debtor bears the burden of establishing good faith. *In re SGL Carbon Corp.,* 200 F.3d 154, 162 n. 10 (3d Cir.1999).

[14] **[15]** **[16]** In *SGL Carbon,* we recognized that “no list is exhaustive of all the factors which could be relevant when analyzing a particular debtor's good faith.” 200 F.3d at 166 & n. 10 (internal quotations omitted). We directed courts to consider the totality of the circumstances in assessing the good faith of a Chapter 11 petition. *Id.* at 165. Although *SGL Carbon* was decided a year after the Bankruptcy Court's decision, the Bankruptcy Court properly assumed an implicit good-faith requirement for Chapter 11 filings. *PPI Enters.,* 228 B.R. at 344–45; *accord SGL Carbon,* 200 F.3d at 162. As noted, the Bankruptcy Court conducted four days of evidentiary hearings on this matter and made factual findings. [22] We review for abuse of discretion. *SGL Carbon,* 200 F.3d at 159 (abuse exists upon clearly erroneous finding of fact, errant legal conclusions, or improper application of fact to law). “An abuse of discretion can occur when no reasonable person would adopt the ... [lower] court's view.” *Rode v. Dellarciprete,* 892 F.2d 1177, 1182 (3d Cir.1990).

[17] The Bankruptcy Court determined it was not necessarily “bad faith” for debtors to file for bankruptcy to avail themselves of certain Code provisions. *PPI Enters.,* 228 B.R. at 345 (“[I]n evaluating a debtor's good faith, the court's only inquiry is to determine whether the debtor seeks to abuse the bankruptcy law by employing it for a purpose for which it was not intended.”); *see, e.g., In re W & L Assocs., Inc.,* 71 B.R. 962, 967–68 (Bankr.E.D.Pa.1987) (§ 365); *In re Bofill,* 25 B.R. 550, 552 (Bankr.E.D.N.Y.1982) (rejection of contract). The Bankruptcy Court found “the primary purpose of the petition was to cap Solow's claim pursuant to § 502(b)(6).” *PPI Enters.,* 228 B.R. at 343. “Because PPI[E]'s intention to cap Solow's claim using § 502(b)(6) [was] not a use of the Code for a purpose for which it was not intended – indeed, PPI[E][was] using § 502(b)(6) for exactly its intended purpose – ... PPI[E]'s filing does not violate the good faith filing doctrine.” *Id.* at 345 (internal quotations omitted). [23] The Bankruptcy Court also noted that PPIE filed its Chapter 11 petition in an attempt to divide its assets during the dissolution of its parent company. The Court found this an appropriate use of Chapter 11 since the Code clearly contemplates liquidating plans under 11 U.S.C. § 1123(b)(4), whereby a debtor may develop a Chapter 11 plan to sell off all of its assets.

[18] A good faith determination must be a fact-intensive, case-by-case inquiry. ***212** Here, the Bankruptcy Court analyzed the purpose of § 502(b)(6) and the totality of the circumstances, and determined that PPIE's bankruptcy filing

did not contravene the good faith requirement. Under the circumstances, we see no abuse of discretion.

VI.

For the foregoing reasons, we will affirm the District Court.

All Citations

324 F.3d 197, 49 Collier Bankr.Cas.2d 1749, 41 Bankr.Ct.Dec. 16, Bankr. L. Rep. P 78,824

Footnotes

1 There are two debtors in these jointly administered cases: PPIE and Polly Peck Produce, Inc., a wholly owned subsidiary of PPIE. The joint Chapter 11 plan, and the order confirming it, contemplate that these two estates will be consolidated upon the effective date of the plan. Therefore, we will jointly refer to the two entities as "PPIE."

2 Administration under the Insolvency Act of 1986 is the closest analogue in British law to Chapter 11 bankruptcy relief.

3 Meanwhile, Solow contends PPIE engaged in transactions designed to reduce his eventual damages claim. In January 1990, PPIE acquired a two percent interest in Del Monte Food Co. for $12.6 million. PPIE transferred the stock to Polly Peck for an accounting credit. In January 1991, Polly Peck's administrators sold Standard Fruit capital stock owned by PPI Holdings B.V., PPIE's direct parent, to a third party, conveying the $15 million in proceeds to Sanwa Bank. Although PPIE owed no obligation to Sanwa Bank, the payment was treated as an intercompany "loan" to PPIE. Solow suggests no legitimate lender would have made such a loan, given PPIE's inability to repay. In July 1991, allegedly to avoid paying $87,000 in withholding taxes, the administrators "sold" Polly Peck's interest in Del Monte to PPIE for $12.6 million, the same amount Polly Peck had paid PPIE two years earlier. PPIE's vice president for finance then reduced the balance sheet value of the Del Monte stock to $3.5 million. But the inter-company "indebtedness" of $12.6 million remained unchanged, so it continued to accumulate interest. PPIE eventually owed $50 million in "inter-company debt" to BV and Polly Peck.

4 The reduction is attributable to two factors: (1) Solow had re-let a portion of the Manhattan premises, mitigating his potential relief, and (2) as noted, Solow had received $650,000 under the Sanwa Bank letter of credit.

5 In the meantime, Del Monte agreed to re-purchase its stock from PPIE for $1.6 million, subject to higher offers. Solow objected, arguing stock transfer restrictions inhibited bidding by third parties. After Del Monte lifted the restriction, Del Monte and Solow engaged in an exchange of bids, with Solow eventually winning at a price of $11 million. A few months later, Solow resold the Del Monte stock for at least $30 million to Texas Pacific Group, generating a profit that exceeded $19 million.

6 Class 1 consisted of "priority claims"; Class 2 included "non-insider general unsecured claims." Members of Classes 1 and 2 were to be paid, at 100 cents on the dollar, in "cash and other consideration as required." Class 3, encompassing "affiliate claims," and Class 4, encompassing "interests," were to be paid in "remaining cash and the assignment of certain debtor claims or causes of action." Those with Class 3 "affiliate claims," Solow alleges, were the "insiders" owing more than $50 million to PPI Holdings B.V., PPIE's direct corporate parent, and Polly Peck.

7 Once claims have been formed and certain classes have been identified as "impaired," at least one impaired class must vote in favor of a Chapter 11 plan. Otherwise, the court will not confirm the plan. Section 1129(a)

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provides: "The court shall confirm a plan only if all of the following requirements are met ... (10)[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." Within the impaired class voting for the plan, "creditors holding at least two-thirds in amount and more than half in number of the allowed claims" must approve it. 11 U.S.C. § 1126(c).

8 Under the Amended and Restated PPIE Memorandum of Agreement, the debtors and the "insiders" settled to "avoid litigation." BV (PPIE's direct corporate parent) and Arvi Ltd. (an affiliate of BV) will receive all remaining cash and an assignment of causes of action.

9 A second exception to the presumption is found in 11 U.S.C. § 1124(2) but it is not relevant here.

10 The section defines "claim" as:

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

11 U.S.C. § 101(5).

11 That section provides:

> For the purposes of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor, for damages arising from the purchase or sale of such a security, for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

11 U.S.C. § 510(b).

12 Solow contends *Solar King* is inapposite. Because *Solar King* was decided six years before the repeal of 11 U.S.C. § 1124(3), he suggests the court did not have "the benefit of history demonstrating Congress's intent to enfranchise claimants not fully returned to non-bankruptcy status." But, as we discuss, the legislative history surrounding the 1994 repeal of § 1124(3) does not support this view.

13 Because we hold the Plan did not impair Solow's claim, we need not reach whether the proceedings required a vote of the creditors to confirm the Plan.

14 An impaired creditor in a solvent debtor case can demand postpetition interest under the "fair and equitable" test of § 1129(b)(2). *See Debentureholders Protective Comm. of Cont. Inv. Corp. v. Cont. Inv. Corp.,* 679 F.2d 264, 269 (1st Cir.1982). "Unimpaired" creditors have no such rights.

15 The *Atlanta–Stewart Partners* and *Seasons Apartments* courts did not discuss the plain language of § 1124, at issue here, focusing instead almost exclusively on the statute's legislative history.

16 Section 502(b)(6) provides:

> [I]f an objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim ... and shall allow such claim in such amount, except to the extent that if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds –

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(A) the rent reserved by such lease, without acceleration, for the greater of one year, or fifteen percent, not to exceed three years, of the remaining term of such lease, following the earlier of –

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6).

17 The landlord retains a duty to mitigate the tenant's breach, but any mitigation of damages secured by reletting the premises will offset only the landlord's overall potential recovery, and does not affect the § 502(b)(6) cap. The "overwhelming majority of courts" have held that the § 502(b)(6) statutory cap is not reduced by any amount a landlord has received by reletting the leased premises and mitigating its damages. *5th Ave. Jewelers,* 203 B.R. at 381; *see also* *In re Atl. Container Corp.,* 133 B.R. 980, 990 (Bankr.N.D.Ill.1991).

18 In determining the final § 502(b)(6) calculation, the Bankruptcy Court should make a finding of fact as to the exact date of Solow's termination or PPIE's formal surrender of the leasehold agreement, and start the calculation from that point.

19 Solow also contends that even if he had a security deposit, and not a letter of credit, the Bankruptcy Court's application of the security deposit rule was erroneous because he drew down the letter of credit's proceeds before the Chapter 11 filing. But the § 502(b)(6) cap starts to operate on the date on which the lessee surrendered the leased property, and the Bankruptcy Court correctly rejected Solow's argument.

20 Solow characterized the filing as:

> involv[ing] a struggle between [Solow] and the [Polly Peck] Administrators in their many guises ... over the right to [PPIE]'s remaining asset, the Del Monte stock. Recognizing that Mr. Solow was gaining the upper hand in that struggle, the Administrators retreated to this Court solely to frustrate and delay Mr. Solow's collection efforts. But such a case involving a debtor with no ongoing business, a single asset and only a few real creditors warrants dismissal.

21 That section requires a plan be proposed "in good faith and not by any means forbidden by law."

22 Although the Bankruptcy Court may not have applied the test in a formulaic way, the Court evaluated the relevant factors before reaching its judgment. The Court mirrored our *SGL Carbon* analysis in noting that "courts have not identified with any consistency which circumstances of the debtor's filing are indicia of good faith." *PPI Enters.,* 228 B.R. at 344; *see also* Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement,* 85 NW. U.L.Rev. 919, 944 (1991).

23 Moreover, as the Bankruptcy Court noted, Chapter 11 does not require reorganization, and even if PPIE had filed for Chapter 7 protection, it still would have been able to benefit from § 502(b)(6). *PPI Enters.,* 228 B.R. at 347 ("[Section] 502(b)(6) is not tethered to Chapter 11 cases. It applies equally to Chapter 7 cases."); 4 *Collier on Bankruptcy,* § 502.03, at 7a ("Under section 502(b)(6), whether the landlord's claim arises in the course of a liquidation of a debtor or whether it arises in connection with debtor reorganization under chapter 11, a single standard applies.").

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KeyCite Yellow Flag - Negative Treatment
Declined to Follow by In re MDC Systems, Inc., Bankr.E.D.Pa., January 17, 2013

375 B.R. 165
United States Bankruptcy Court,
W.D. Pennsylvania.

In re TITUS & McCONOMY, LLP, a Pennsylvania Limited Liability Partnership, formerly known as and/or also known as Titus & McConomy, a Pennsylvania General Partnership, Debtor.
Titus & McConomy, LLP, a Pennsylvania Limited Liability Partnership, formerly known as and/or also known as Titus & McConomy, a Pennsylvania General Partnership, Movant,
v.
TrizecHahn Gateway, LLC, Respondent.

No. 03–25332 BM.
|
Sept. 21, 2007.

Synopsis
Background: Chapter 11 debtor-tenant objected to amended proof of claim filed by landlord, based on debtor's alleged breach of lease agreement, contending that claim was subject to Bankruptcy Code's cap on lease termination damages.

Holdings: The Bankruptcy Court, Bernard Markovitz, J., held that:

[1] collateral estoppel applied to bar debtor's arguments respecting date of lease termination;

[2] date of petition filing governed calculation of statutory cap on landlord's allowable claim; and

[3] disallowance of landlord's request for postpetition interest was warranted.

Allowed claim amount determined.

See also 930 A.2d 524.

West Headnotes (16)

[1] **Bankruptcy** Rejection of executory contract or lease

Prior to beginning calculation of landlord's allowable claim under statutory cap on damages resulting from termination of real property lease, bankruptcy court must determine precise date on which landlord terminated lease or debtor surrendered leasehold, and then begin calculating from that date. 11 U.S.C.A. § 502(b)(6).

[2] **Bankruptcy** Rejection of executory contract or lease

State law determines what qualifies as repossession or surrender of a leasehold for purposes of Bankruptcy Code's cap on lessor's damages resulting from termination of real property lease. 11 U.S.C.A. § 502(b)(6)(A).

1 Case that cites this headnote

[3] **Landlord and Tenant** Presumptions and burden of proof

Under Pennsylvania law, tenant has the burden of showing, by clear and convincing evidence, that actions of landlord amounted to acceptance of tenant's surrender of leased property.

1 Case that cites this headnote

[4] **Landlord and Tenant** Vacation, Surrender, or Abandonment of Premises

Landlord and Tenant Covenants and agreements

Under Pennsylvania law, mere abandonment of the leasehold by a tenant is not sufficient to qualify as surrender for purposes of landlord-tenant law; rather, surrender occurs in this context only if there is an express agreement by the landlord and the tenant to that effect, or an unequivocal act on the part of the landlord

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which implies that it agreed to a surrender of the property by the tenant.

[5] **Landlord and Tenant** Vacation, Surrender, or Abandonment of Premises

To establish surrender of leasehold under Pennsylvania law, tenant must demonstrate that landlord's resumption of possession was not merely for the purpose of protecting the property in the tenant's absence, and must also demonstrate that the landlord's repossession of the property was adverse to its re-occupation by the tenant and to a resumption of their landlord-tenant relationship.

[6] **Landlord and Tenant** Continued liability for rent

Failure on part of landlord to protest or to inform tenant that its abandonment of leased property is not accepted does not relieve tenant of liability for rent under Pennsylvania law.

[7] **Judgment** Bankruptcy

Under Pennsylvania law, collateral estoppel applied in bankruptcy proceeding to determine allowable amount of landlord's claim for unpaid rent to preclude Chapter 11 debtor-tenant from asserting that its lease terminated either as of date on which landlord resumed possession of debtor's basement storage space, or as of date on which landlord began gutting floor of building that debtor had occupied to reconfigure space for new tenant, given that issues were previously raised by debtor, without success, in landlord's prior state-court action and state court relied, at least in part, on its findings concerning these issues to enter final judgment, and that debtor had full and fair opportunity to litigate issues in state court. 28 U.S.C.A. § 1738.

[8] **Bankruptcy** Application of state or federal law in general

Judgment Full Faith and Credit

Judgment Bankruptcy

Federal court must defer to and apply the law of issue preclusion of the state in which the judgment to be accorded full faith and credit was rendered.

[9] **Res Judicata** Collateral estoppel and issue preclusion in general

Issue preclusion applies under Pennsylvania law when (1) the issue decided in the state-court proceeding is identical to the issue in a later proceeding, (2) there was a final judgment on the merits, (3) the party against whom issue preclusion is invoked was a party to or is in privity with a party to the previous proceeding, and (4) that party had a full and fair opportunity to litigate the issue in the previous proceeding.

[10] **Res Judicata** Collateral estoppel and issue preclusion

Party asserting issue preclusion has burden of establishing that all requirements are satisfied.

[11] **Bankruptcy** Rejection of executory contract or lease

Date on which Chapter 11 debtor-tenant filed its bankruptcy petition governed calculation of statutory cap on landlord's allowable claim for unpaid rent, given debtor's failure to establish that lease had terminated prepetition. 11 U.S.C.A. § 502(b)(6)(A)(i).

[12] **Bankruptcy** What constitutes decision, deemed acceptance, assumption or rejection

Bankruptcy Effect of Acceptance or Rejection

Chapter 11 debtor-tenant's deemed rejection of real property lease resulting from debtor's failure to assume or reject lease was breach of lease and, under Bankruptcy Code, was deemed to have occurred immediately before debtor filed its bankruptcy petition. 11 U.S.C.A. § 365(d)(4)(A), (g)(1).

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[13] **Bankruptcy** Presumptions and burden of proof

Landlord asserting claim for unpaid rent bore burden of establishing amount of Chapter 11 debtor-tenant's share of taxes and operating costs.

[14] **Judgment** Bankruptcy

Landlord was collaterally estopped from claiming, in bankruptcy proceeding to determine allowable amount of its claim for unpaid rent, that it was entitled to recover legal fees from debtor under terms of lease agreement, given state appellate court's determination, in landlord's prepetition action to collect rent, that lease provision obligating debtor to pay landlord's reasonable legal fees in collection action was ambiguous and did not support award of fees to landlord.

[15] **Bankruptcy** Post-petition interest

Disallowance of landlord's request for postpetition interest on its claim for unpaid rent was warranted in Chapter 11 case of debtor-limited liability partnership, notwithstanding language in debtor's disclosure statement respecting possible contributions from debtor's general partners suggesting an ability to pay such interest, inasmuch as paying interest to landlord would be unfair to debtor's other unsecured creditors, which, despite being placed in different class under confirmed plan, were similarly situated to landlord, even though its claim comprised more than 99 percent of all allowed general unsecured claims. 11 U.S.C.A. § 502(b)(2).

[16] **Bankruptcy** Post-petition interest

Bankruptcy statute providing that claim will not be allowed to the extent that it is for unmatured interest has two-fold purpose: (1) to avoid unfairness among competing creditors, and (2) to avoid administrative inconvenience. 11 U.S.C.A. § 502(b)(2).

Attorneys and Law Firms

***167** Douglas Anthony Campbell, Ronald B. Roteman, Campbell & Levine, LLC, Pittsburgh, PA, for Debtor.

John P. Vetica, Jr., Coraopolis, PA, Neil H. Levin, for Respondent.

MEMORANDUM OPINION

BERNARD MARKOVITZ, Bankruptcy Judge.

TrizecHahn Gateway, LLP (“Trizec”), LLP, has filed a proof of claim in the amount of $3,274,037.99 for an alleged breach of a lease agreement by debtor Titus & McConomy (“T & M”).

Debtor has objected to Trizec's proof of claim. According to debtor, Trizec's proof of claim is subject to the “cap” on a lessor's damages set forth at § 502(b)(6) of the Bankruptcy Code. The allowed amount of Trizec's claim, debtor asserts, is capped at $645,127.88 plus interest at the rate of twelve percent per annum on the portion of its claim that is subject to § 506(b)(6)(B).

We conclude for reasons which follow that Trizec has an allowed claim in the amount of $2,071,369.20.

FACTS

Debtor was a law firm. It is now defunct and has dissolved.

Trizec is the owner of an office building located in Pittsburgh, Pennsylvania, which is known as Four Gateway Center.

Debtor and Trizec entered into a lease agreement on October 5, 1995, for space in Four Gateway Center which debtor used as its place of business. The term of the lease ran from October 1, 1995, through June 30, 2005.

As of February of 2000, the leasehold consisted of the entire twentieth floor, a portion of the twenty-first floor and storage

space located in the basement of the building. The latter comprised only 3.3 percent of the entire leasehold.

The base rent for the entire leasehold from December 31, 1997, through October 1, 2000, was $461,184.00 per annum payable in equal monthly installments. The base rent increased to $446,757.00 for the remainder of the lease term and also was ***168** payable in equal monthly installments. In addition to base rent, debtor was obligated to pay as additional rent its pro rata share of any increases in taxes and operating costs.

Debtor decided in August of 1999 to dissolve and wrap up its business affairs. In a letter dated August 18, 1999, debtor notified Trizec that the majority of its partners were leaving the firm and that its space would be available and should be re-let. Debtor then abandoned the twentieth and twenty-first floors, but left behind files in the basement storage area.

Even though it had abandoned the leasehold, debtor continued paying rent for a period of time thereafter. The last rent payment by debtor was for January of 2000. As of the end of February of 2000, debtor was one month in arrears on its rent.

Trizec notified debtor on April 18, 2000, that debtor was in default of its obligations under the lease.

Trizec sent another letter to debtor on July 14, 2000, in which it informed debtor that file boxes and other miscellaneous items remained in the basement storage space and requested that debtor remove them. Debtor responded in a letter to Trizec dated July 18, 2000, that it would be “happy” to remove the items and inquired whether it could gain access to the twentieth floor to also remove files located there.

Debtor removed the items from the basement storage space on or about August 3, 2000. For its part, Trizec released debtor from its obligation to pay rent for the basement storage space as of August 1, 2000. It did not, however, do the same for the twentieth and twenty-first floors.

At some unspecified time in the year 2000, Trizec commenced a civil action in the Court of Common Pleas of Allegheny County, Pennsylvania, against debtor and its general partners [1] to recover all amounts remaining due under the lease agreement. It amended the complaint later on to also recover its cost of altering and re-letting the twentieth floor.

Trizec leased the space debtor had abandoned on the twenty-first floor to another tenant in March of 2001. Because that other tenant already had a separate lease for the remainder of the twenty-first floor and took “as is” the portion debtor had abandoned, Trizec did not incur any rebuilding or re-letting costs.

Trizec leased the twentieth floor to a new tenant commencing in January of 2003. It gutted and rebuilt the entire twentieth floor to make it suitable for the new tenant.

Debtor filed a voluntary chapter 11 bankruptcy petition on April 29, 2003, thereby automatically staying the above state court action brought by Trizec.

The schedules accompanying the petition indicated that debtor had assets with a total value of $2,386,000.00. Trizec was identified as having a disputed general unsecured claim in the amount of $2,375,000.00 arising from the above lease. Its claim is the sole disputed claim in debtor's bankruptcy and comprised in excess of 99.27% of the total scheduled pre-petition debt.

Trizec ultimately filed a timely proof of claim in an unliquidated amount. It was based on debtor's alleged breach of the lease. Debtor objected to the proof of claim and asserted among other things that the claim, if allowed, was subject to the “cap” on damages for termination of a ***169** lease found at § 502(b)(6) of the Bankruptcy Code.

Debtor's second amended plan of reorganization, which was confirmed on October 23, 2003, provided for treatment of four classes. They were, respectively: (1) administrative expense claims; (2) Trizec's claim; (3) “other” claims; and (4) the interests of debtor's general partners. Even though Trizec and the “other” claimants held general unsecured claims, Trizec was the sole member of class (2). According to the plan, classes (1), (2) and (3) were unimpaired.

On the effective date of the plan, Trizec and the “other” claimants in Class (3) were to receive in cash the allowed amount of their claims. In the event debtor lacked sufficient funds to pay the claims in full, its general partners were to contribute funds to the extent of their personal liability for the deficiency.

Within thirty days after adjudication of the present objection to Trizec's claim, debtor was required by the plan to deposit funds in an amount equal to the amount of Trizec's claim in

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an interest-bearing escrow account. Jurisdiction was retained for this court to hear and decide debtor's objection to Trizec's claim and to determine the allowed amount, if any, of Trizec's claim.

After the portion of Trizec's state court civil action relating to debtor's general partners had been removed to the district court and then remanded to state court, Trizec brought a motion in this court for relief from the automatic stay. Trizec sought permission to prosecute in state court its claim against debtor for breaching the lease and to liquidate damages. The motion was granted on February 25, 2004.

A final decree issued in debtor's bankruptcy case on May 11, 2004. The case was closed the following day.

After conducting a bench trial, a member of the Court of Common Pleas issued a series of memorandum opinions and orders.

The state court issued a memorandum opinion and order on March 30, 2005. Among other things, the state court determined that Trizec had not terminated the lease when it took back the basement storage space debtor had leased and used a portion of it to build an egress corridor. The court further determined that Trizec had not terminated the lease when it gutted the entire twentieth floor and re-configured it to suit the needs of a new tenant.

In the accompanying order, the state court judge awarded Trizec damages in the amount of $2,961,575.96 plus counsel fees to be determined at a later time. This amount consisted of: (1) unpaid rent in the amount of $1,637,117.30 for the twentieth and twenty-first floors floor for the period from February 1, 2000 through April 30, 2005; (2) unpaid rent for a basement storage area other than the one mentioned previously; and (3) debtor's share of the cost of rebuilding and re-letting the twentieth floor totaling $242,893.77. To this aggregate amount the state court added interest in the amount of $1,079,962.65.

The state court issued another order on June 27, 2005, in which it awarded Trizec counsel fees in the amount of $326,663.58 and additional interest in the amount of $35,908.21 for the period from May 1, 2005, through June 27, 2005. The amount of the verdict in favor of Trizec was increased from $2,961,575.96 to $3,324,107.55 and judgment in that amount was entered at that time.

Finally, the state court issued an order on May 30, 2006, wherein it reduced the ***170** amount of interest included in the previous order by $50,069.96. It concluded for reasons that need not detain us that no interest should be awarded for the period from September 1, 2004, through December 20, 2004. The amount of the above judgment was accordingly reduced from $3,324,107.55 to $3,274,037.99. An amended judgment in that amount issued on June 27, 2006.

Debtor thereafter appealed the order of June 27, 2005, to the Superior Court of Pennsylvania. It did not, however, file a supersedeas bond to stay the effect of the above order pending resolution of the appeal.

After the Court of Common Pleas issued the above order and before the Superior Court had acted on the appeal, Trizec brought a motion in this court to reopen debtor's bankruptcy case so that Trizec could file an amended proof of claim in the amount of $3,274,037.79. The motion was granted on October 10, 2006.

Debtor objected to the amended proof of claim. Among other things, debtor asserted that the allowed amount of Trizec's amended proof of claim was subject to the “cap” on damages for termination of a lease found at § 502(b)(6). According to debtor, it had surrendered possession of the leasehold premises in October of 1999 or early in the year 2000.

Debtor's objection to Trizec's amended proof of claim has been heard and is now ready for resolution.

After debtor's objection to Trizec's proof of claim was heard by this court, the Superior Court of Pennsylvania decided debtor's appeal of the order of the Court of Common Pleas that was issued on June 27, 2005. *Trizechahn Gateway v. Titus,* 930 A.2d 524 (Pa.Super.2007). Among other things, the Superior Court vacated the portion of the lower court's order awarding Trizec counsel fees in the amount of $326,623.58. It also vacated the portion awarding Trizec interest and remanded for the limited purpose of recalculating interest. Insofar as the order pertained to debtor, the order of the Court of Common Pleas was affirmed in all other respects. 930 A.2d at 552–53.

ANALYSIS

Debtor indicated at the hearing on its objection to Trizec's proof of claim that only two issues remain in dispute. They

are: (1) the allowable amount of Trizec's claim in light of the cap on damages found at § 502(b)(6).; and (2) whether Trizec may collect post-petition interest on its claim.

Section 502 of the Bankruptcy Code provides in part as follows:

> (a) A claim, ... proof of which is filed under section 501 of this title is deemed allowed, unless a party in interest ... objects.
>
> (b) ... [I]f such objection to a claim is made, the court ... shall determine the amount of such claim ... as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—....
>
>> (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>>
>> (A) the rent reserved by such lease, without acceleration, for the greater of one year or 15 percent, not to exceed three years, following the earlier of—
>>
>> (i) the date of the filing of the petition; and
>>
>> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>>
>> ***171** (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6).

Congress enacted this provision to prevent a landlord with a claim for damages resulting from the breach of a lease for real property from reaping a windfall. S.Rep. No. 95–989 at 353 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6309. It is designed to compensate a landlord for its losses while preventing the allowed amount of the claim from being so large as to prevent other unsecured creditors from receiving any distribution from the bankruptcy estate. 4 Collier on Bankruptcy § 502.03[7][a] (15th ed.).

Subsection 502(b)(6) sets out a procedure for determining the allowed amount of the landlord's claim. The amount of the landlord's claim must be determined first. After that, how much of that amount is allowable must be determined. Subsection 502(b)(6) sets forth a cap on how much of that amount is allowable [2] .

[1] Prior to beginning the § 502(b)(6) calculation, a bankruptcy court must determine the precise date on which the landlord terminated the lease or the debtor surrendered the leasehold and then begin calculating from that date. *Solow v. PPI Enterprises (US), Inc. (In re PPI Enterprises (US), Inc.),* 324 F.3d 197, 208 n. 18 (3d Cir.2003).

On What Date Does The Calculation Begin?

According to debtor, § 502(b)(6)(A)(ii) applies here. Debtor maintains that the lease terminated on August 3, 2000, when Trizec accepted debtor's surrender of the basement storage space and repossessed it for its own use. Alternatively, debtor maintains that Trizec accepted debtor's surrender of the leasehold on June 1, 2002, when Trizec began gutting the twentieth floor and rebuilding it to the specifications of the successor tenant who took over that space later on.

Trizec maintains that § 502(b)(6)(A)(i) rather than § 502(b)(6)(A)(ii) applies here. According to Trizec, the leasehold was neither repossessed by it nor surrendered by debtor on either of these dates. It claims that the lease terminated by operation of law immediately before debtor filed its bankruptcy petition on April 29, 2003.

[2] State law, in this instance the law of Pennsylvania, determines what qualifies as repossession or surrender of a leasehold for purposes of § 502(b)(6)(A). *Fifth Avenue Jewelers, Inc. v. Great East Mall (In re Fifth Avenue Jewelers, Inc.),* 203 B.R. 372, 378 (Bankr.W.D.Pa.1996).

It is not disputed that debtor abandoned the twentieth and twenty-first floors prior to August 3, 2000, and abandoned the basement storage space on that date. It also is not disputed that the last rent payment debtor made occurred on January 1, 2000, and was for that month alone. Debtor was current on its rent obligations to that date.

[3] The tenant has the burden of showing, by clear and convincing evidence, that the actions of the landlord amounted to acceptance of the tenant's surrender of the property *Stonehedge Square LP v. Movie Merchants, Inc.,* 454 Pa.Super. 468, 475, 685 A.2d 1019, 1023 (1996), *aff'd,* 552 Pa. 412, 715 A.2d 1082(1998).

[4] Mere abandonment of the leasehold by a tenant is not sufficient to qualify as ***172** surrender for purposes of landlord-tenant law; something more is required. *Id.* Surrender occurs in this context only if there is an express agreement by the landlord and the tenant to that effect or an

unequivocal act on the part of the landlord which implies that it agreed to a surrender of the property by the tenant. *Ralph v. Deiley,* 293 Pa. 90, 94, 141 A. 640, 642 (1928).

[5] The matter does not end there. The tenant must also demonstrate that the landlord's resumption of possession was not merely for the purpose of protecting the property in the tenant's absence. The tenant also must demonstrate that the landlord's repossession of the property was adverse to its re-occupation by the tenant and to a resumption of their landlord-tenant relationship. *Kahn v. Bancamerica–Blair* Corp., 327 Pa. 209, 213–14, 193 A. 905, 907 (1937).

[6] Failure on the part of the landlord to protest or to inform the tenant that its abandonment of the property is not accepted does not relieve the tenant of liability. *Ralph,* 293 Pa. at 94, 141 A. at 642. The onus does not lie with the landlord in this regard.

[7] As it does in this proceeding, debtor maintained in the proceeding in the Court of Common Pleas that Trizec's taking back of the basement storage space after debtor had abandoned it on August 3, 2000, amounted to repossession of the leasehold by Trizec which relieved debtor of any further liability under the lease. The Court of Common Pleas categorically rejected this contention in its memorandum opinion dated March 30, 2005. There was no credible evidence, it concluded, that Trizec's action with respect to this space amounted to a re-taking [3] of the basement storage space which served to relieve debtor of further liability under the lease after August 3, 2000 (Memorandum Opinion, pp. 14–15).

The Court of Common Pleas also rejected debtor's assertion, which debtor has resurrected in this proceeding, that Trizec's gutting of the twentieth floor starting on June 1, 2002, to re-configure it for a new tenant constituted a "re-taking" of the leasehold and served to relieve debtor of further liability under the lease. Trizec's demolition of the twentieth floor, the Court of Common Pleas concluded, was not adverse to debtor's reoccupation of the twentieth floor and to a resumption of its tenant-landlord relationship with Trizec. It so concluded because debtor was in the process of dissolving by then and its partners had gone their separate ways. (Memorandum Opinion, p. 16).

Debtor will not be heard to raise these issues in this proceeding, hoping that this court will find in its favor. In effect, debtor seeks to have this court reverse the decision of the Court of Common Pleas (as well as the Superior Court of Pennsylvania). Even if we were convinced that the Court of Common Pleas decided these issues incorrectly, which we are not, we could not do so. Debtor is collaterally estopped from raising the same issues in this proceeding.

[8] A federal court must accord determinations made by a state court the "same full faith and credit as they have by law or usage in the courts of such State ... from which they are taken". 28 U.S.C. § 1738. Moreover, it must defer to and apply the law of issue preclusion of the state in which the judgment was rendered. *Marrese* ***173** *v. American Academy of Orthopaedic Surgeons,* 470 U.S. 373, 380, 105 S.Ct. 1327, 1331–32, 84 L.Ed.2d 274 (1985).

[9] Issue preclusion applies under Pennsylvania law when: (1) the issue decided in the state court proceeding is identical to the issue in a later proceeding; (2) there was a final judgment on the merits; (3) the party against whom issue preclusion is invoked was a party to or is in privity with a party to the previous proceeding; and (4) that party had a full and fair opportunity to litigate the issue in the previous proceeding. *Greenleaf v. Garlock, Inc.,* 174 F.3d 352, 357–58 (3d Cir.1999).

[10] As the party asserting that issue preclusion here, Trizec has the burden of establishing that all of these requirements are satisfied. *Suppan v. Dadonna,* 203 F.3d 228, 233 (3d Cir.2000).

Each of these requirements is satisfied in this instance. The issues debtor now raises in this proceeding are identical to issues it raised, without success, in the Court of Common Pleas. The Court of Common Pleas relied, at least in part, on its findings concerning these issues, in issuing a final judgment in the civil action Trizec had commenced. Its findings concerning these specific issues were left undisturbed by the Superior Court. As it is in the present proceeding, debtor was a party to the civil action tried by the Court of Common Pleas wherein it had a full and fair opportunity to litigate these issues.

It follows that debtor is precluded from asserting in this bankruptcy proceeding that the lease it had with Trizec terminated on August 3, 2000, or on June 1, 2002. [4]

[11] The Court of Common Pleas determined that the above lease remained in effect until its term expired on June 30, 2005. It did not have to consider whether, *for bankruptcy*

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purposes, it was deemed to have terminated as a matter of law at a time prior to June 30, 2005. The Court of Common Pleas was not confronted, as is this court, with determining the starting date for calculating the cap on Trizec's claim found at § 502(b)(6).

If the starting date for calculating the cap on Trizec's claim for damages is not August 3, 2000, or June 1, 2002, what is?

Aside from August 3, 2000, and June 1, 2002, debtor offered no other date prior to April 29, 2003, when debtor filed its bankruptcy petition, as the starting point for calculating the cap on the allowed amount of Trizec's claim. Debtor implicitly conceded in its post-hearing brief that if the starting date is neither of these dates, it is April 29, 2003.

We conclude that § 502(b)(6)(A)(i) rather than § 502(b)(6)(A)(ii) applies here and will determine the amount of the cap on the allowed amount of Trizec's claim using April 29, 2003, as the basis for our calculation.

[12] If a trustee (or a chapter 11 debtor) does not assume or reject an unexpired lease of real property of which the debtor is the lessee by the earlier of 120 days after entry of the order for relief or of an order confirming a plan of reorganization, the lease is deemed to be rejected and the trustee (or chapter 11 debtor) must immediately surrender the property to the lessor. 11 U.S.C. § 365(d)(4)(A).

***174** The earlier of these dates occurred 120 days after entry of the order for relief. Debtor's plan of reorganization was not confirmed until 177 days after entry of the order of relief.

Such rejection constitutes a breach of the lease. Because debtor neither assumed the above lease under § 365 of the Bankruptcy Code nor in its plan of reorganization, debtor's breach of the lease is deemed as a matter of law to have occurred immediately before debtor filed its bankruptcy petition on April 29, 2003. 11 U.S.C. § 365(g)(1).

What remains to be determined now that the starting date for calculating the cap on Trizec's damages has been determined is the allowed amount of Trizec's claim in light of the cap on damages imposed by § 502(b)(6)

Subsection 502(b)(6)(A) deals with the allowed amount of Trizec's claim for the specified period following the filing of the bankruptcy. Subsection 502(b)(6)(B), on the other hand, deals with the allowed amount of Trizec's claim for the period preceding the bankruptcy filing. We will proceed chronologically here and first will determine the allowed amount of Trizec's claim for pre-petition damages and then will determine the same for its post-petition damages.

§ 502(b)(6)(B) Unpaid Pre-petition Rent

Debtor paid no rent for the twentieth and twenty-first floors from February of 2000 through April of 2003, a period of thirty-nine months. The last rent payment by debtor was made in January of 2000 and was for that specific month. Until then, debtor was current on its rent and other obligations arising under the lease.

Debtor and Trizec agree that the base rent due under the lease for these floors during this period was $33,744.00 per month. [5]

Using this monthly amount, we calculate that unpaid rent due under the lease for this period totals $1,316,016.00 ($33,744.00 x 39 = $1,316,016.00).

Pre-petition Taxes and Operating Costs

Trizec seeks to recover as additional rent debtor's share of taxes and operating costs for thirty-nine months prior to the petition date. According to Trizec, these expenses total $97,123.18, or $2,490.34 per month ($97,123.18 ÷ 39 = $2,490.34).

Debtor does not dispute that it owes its share of taxes and operating costs; it does, however, dispute the monthly amount Trizec claims was due. According to debtor, its share of these expenses amounted to $1,711.00 per month during the thirty-nine months preceding the filing of its bankruptcy petition.

[13] Trizec, which has the burden of proof on this matter, offered nothing to support its claim as to the amount of taxes and operating costs due during this period. We therefore will calculate the total amount of debtor's share of these expenses at the rate of $1,711.00 per month as debtor proposes.

Using this monthly amount, we calculate that debtor owes additional rent in the amount of $66,729.00 for the thirty-nine-month period prior to the commencement of debtor's bankruptcy case on April 29, 2003 ($1,711.00 x 39 = $66,729.00).

*175 *Legal Fees*

Paragraph 15(g) of the lease provided that debtor was obligated to pay reasonable legal fees in the event Trizec took legal action to enforce debtor's obligations under the lease.

[14] Relying on this provision, Trizec maintains that it incurred legal fees in the amount of $101,176.50 in enforcing debtor's obligations under the lease and asserts that this amount should be included in the total amount that was due under the lease prior to the petition date.

The Court of Common Pleas concluded that Trizec was entitled to legal fees in the amount of $326,823.58 through April 30, 2005. Later on it concluded that Trizec was entitled to additional legal fees in the amount of $35,908.21 for the period beginning on May 1, 2005, and ending on June 27, 2005.

The Superior Court concluded that paragraph 15(g) was ambiguous and held that the Court of Common Pleas erred as a matter of law in awarding legal fees to Trizec The portion of the lower court's order awarding these fees was vacated. *Trizechahn,* 930 A.2d at 544–46. Trizec is collaterally estopped from claiming in this proceeding that debtor owes it these legal fees.

We would deny Trizec's claim for legal fees in this proceeding even if the Superior Court had not so held for the simple reason that Trizec produced no evidence in this proceeding indicating the amount of legal fees it incurred. Absent such evidence, we would have to conclude that Trizec is not entitled to legal fees in any amount.

Pre-petition Interest

Paragraph 1(a) of the lease agreement provided as follows:

> Interest at the per annum rate of twelve percent (12%) will be charged retroactive to the first day of the month for rents not paid by the tenth (10th) of the calendar month.

Relying on this provision, the Court of Common Pleas awarded Trizec interest on unpaid rent in the amount of $1,017,222.20 for the period beginning on February 1, 2000, and ending on June 27, 2005.

The Superior Court noted in deciding debtor's appeal that the lease did not have an acceleration clause entitling Trizec to call the entire balance of rent due under the lease in the event it declared a default. It then concluded that the lower court had erred as a matter of law in calculating the amount of interest owed on an accelerated basis as of February 1, 2000. The question of how much interest was owed was remanded to the lower court with the instruction to re-calculate the amount in accordance with the provisions of the lease. *Trizechahn,* 930 A.2d at 543–44. The Court of Common Pleas to date has not done so.

Because the question of interest owed is before this court now, we will have to determine for ourselves the amount of interest to which Trizec is entitled for the period commencing on February 1, 2000, and ending on April 29, 2003. [6]

Debtor concedes that Trizec is entitled to pre-petition interest for purposes of ***176** § 502(b)(6)(B) pursuant to the rate set forth in paragraph 1(a) of the lease agreement. It has not, however, offered an opinion as to what that amount might be.

Trizec has submitted an exhibit in which it has calculated the amount of pre-petition interest debtor owes. According to Trizec's calculation, interest at the rate of twelve percent per annum owed on unpaid rent from February 1, 2000, through April 29, 2003, in the amount of $33,744.00 per month totals $263,203.20. We are satisfied that Trizec has correctly calculated the amount of interest to which it is entitled for this period. It will be included among the damages to which Trizec is entitled under § 502(b)(6)(B).

To summarize what we have determined to this point, we conclude that Trizec may recover the following in accordance with § 502(b)(6)(B): (1) unpaid pre-petition rent in the amount of $1,316,016.00; (2) unpaid pre-petition taxes and operating costs in the amount of $66,729.00; and (3) pre-petition interest in the amount of $263,203.20. Trizec is not entitled to recover any legal fees it incurred during this period. Together these amounts total $1,645,948.20 ($1,316,016.00 + $66,729.00 + $263,203.20 = $1,645,948.20).

§ 502(b)(6)(A) *Post-petition Rent*

Under § 502(b)(6)(A), Trizec is entitled to unpaid post-petition rent, without acceleration, for the greater of one year or fifteen percent, not to exceed three years, of the remaining term of the lease following the petition date.

The lease agreement would have expired by its own terms on June 30, 2005, some twenty-six months after debtor filed its bankruptcy petition. One year (twelve months) of the remaining term of the lease is greater than fifteen percent of the remaining term, which equals 3.9 months (26 x .15 ÷ 3.9).

Trizec maintains that it is entitled to unpaid post-petition rent for the twentieth and twenty-first floors in the amount of $404,928.00. Debtor, it should be noted, does not contest this amount.

We agree with Trizec on this point. We previously determined that the rent due for these two floors came to $33,744.00 per month. The amount of post-petition rent to which Trizec is entitled under § 502(b)(6)(A)(i) is $404,928.00 ($33,744.00 x 12 = $404,928.00).

Post-petition Taxes and Operating Costs

Trizec seeks to recover as additional rent debtor's share of taxes and operating costs that Trizec incurred during the first year following debtor's filing of its bankruptcy petition. According to Trizec, these costs total $56,650.23, or $4,720.85 per month ($56,650.23 ÷ 12 = $4,720.85).

As was the case with the purported amount for taxes and operating costs Trizec claimed debtor owed during the pre-petition period ($97,123.18 or $2,940.34 per month), Trizec produced nothing supporting its assertion that debtor owed $56,650.23 (or $4,720.85 per month) in post-petition taxes and operating costs for the year following the petition date. Debtor concedes that Trizec may recover such post-petition expenses but maintains that the monthly amount it owes totals $1,711.00.

Lacking any hard information concerning the monthly amount of these post-petition expenses, we will utilize the monthly amount debtor concedes it owes. It follows that, for purposes of § 502(b)(6)(A)(i), debtor's share of post-petition taxes and operating costs that Trizec is entitled to recover totals $20,532.00 ($1,711.00 x 12 = $20,532,00).

*177 *Post-petition Interest*

[15] Trizec requests post-petition interest in the amount of $1,097,157.18. It seeks to recover interest not only on unpaid rent due for the twelve-month-period following the petition date, but also on unpaid *pre*-petition rent that continues to accrue after debtor filed its bankruptcy petition. In effect, Trizec maintains that “the meter continues to run” with respect to unpaid pre-petition rent.

Debtor objects to Trizec's request for post-petition interest. Such interest, debtor maintains, constitutes unmatured interest and is not permitted by § 502(b)(2) of the Bankruptcy Code, which provides as follows:

> (b) ... [I]f such objection to a claim is made, the court ... shall determine the amount of such claim ... as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—....
>
> (2) such claim is for unmatured interest.

11 U.S.C. § 502(b)(2).

Aside from making this conclusory statement, debtor has presented nothing to establish that this provision applies in light of the facts presented in this case. Debtor has left the court to fend for itself in determining whether § 502(b)(2) is dispositive here.

Prior to enactment of the Bankruptcy Code, it was the general practice that interest on a debt stopped accruing once a bankruptcy case commenced. *Sexton v. Dreyfus,* 219 U.S. 339, 344, 31 S.Ct. 256, 259, 55 L.Ed. 244 (1911). The practice traced its ancestry to a centuries-old practice of English bankruptcy courts. *Id.*

This was not, however, an iron-clad rule; it was subject to exception in certain instances.

For instance, post-petition interest was allowable when the debtor proved to be solvent. *U.S. v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 246, 109 S.Ct. 1026, 1033, 103 L.Ed.2d 290 (1989). When a bankruptcy estate had sufficient assets to pay all creditors in full and to pay post-petition interest, equitable considerations came to the fore and dictated that interest be

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paid to any oversecured creditor before any of the assets were returned to the debtor. *Vanston Bondholders Protective Committee v. Green,* 329 U.S. 156, 164–65, 67 S.Ct. 237, 241, 91 L.Ed. 162 (1946). The "touchstone" at work in such cases was the striking of a balance of the equities between creditor and creditor and between creditors and the debtor. *Id.*

Interest did not stop accruing when it did because the debt somehow had lost its interest-bearing quality as a result of the bankruptcy; it instead was due to the possibility that the bankruptcy estate might not have sufficient assets to pay all creditors in full. *American Iron & Steel Manufacturing Co. v. Seaboard Air Line Railway,* 233 U.S. 261, 266, 34 S.Ct. 502, 504, 58 L.Ed. 949 (1914). If estate assets were not sufficient to pay claims "of equal dignity" in full, distribution was made only on the principal of a debt. If, on the other hand, estate assets were sufficient to pay all debts in full, interest was to be paid in addition to principal. *Id.*

This pre-Code prohibition against paying post-petition was codified at § 502(b)(2). Pre–Code exceptions to the prohibition, however, also apply to § 502(b)(2).

[16] Subsection 502(b)(2) has a two-fold purpose; (1) to avoid unfairness among competing creditors; and (2) to avoid administrative inconvenience. *National Energy & Gas Transmission, Inc. v. Liberty Electric Power,* 492 F.3d 297, 301 (4th Cir.2007)(citing ***178** *Bruning v. U.S.,* 376 U.S. 358, 362, 84 S.Ct. 906, 908–09, 11 L.Ed.2d 772 (1964)).

Subsection 502(b)(2) was enacted to guide in the administration of a bankruptcy estate "to bring about a ratable distribution of assets among the bankrupt's creditors". *Id.* (citing *Vanston Bondholders,* 329 U.S. at 161, 67 S.Ct. at 239). See also *Hanna v. U.S. (In re Hanna),* 872 F.2d 829, 830 (8th Cir.1989).

As a rule of administrative convenience, § 502(b)(2) makes it possible to easily calculate the amount of claims; it also assures that creditors on the "bottom rungs" are not prejudiced by delays in distribution of the bankruptcy estate assets. *In re Hanna,* 872 F.2d at 830. But post-petition interest may be allowed when these concerns are not present. *Id.* See also *In re National Energy & Gas Transmission,* 492 F.3d at 303.

The circumstances presented in this case lead to the conclusion that Trizec's claim for post-petition interest should be disallowed. Subsection 502(b)(2), not its exceptions, applies to this portion of Trizec's proof of claim.

Debtor's confirmed plan of reorganization provided that Trizec, which has a general unsecured claim, as well as all other creditors having general unsecured claims, were unimpaired and were to receive payment in full of the allowed amount of their claims.

How this was to be accomplished was explained in debtor's disclosure statement, which provided that the plan would be funded from an interest-bearing certificate of deposit debtor had [7] and from the proceeds of other property of the bankruptcy estate. If these were not sufficient to pay all allowed claims in full, the deficiency was to be funded by cash contributions from debtor's general partners to the extent of their personal liability under non-bankruptcy law. After all allowed claims were paid in full, any estate assets remaining were to be transferred to debtor's general partners or placed in a trust for their benefit.

This provision concerning possible contributions from debtor's general partners was echoed in debtor's confirmed plan of reorganization.

A fair interpretation of the above language in debtor's disclosure statement would suggest that debtor would be able to pay Trizec post-petition interest on its claim.

Assuming that debtor has this capacity, it follows that paying post-petition interest on Trizec's proof of claim *without doing the same with respect to the allowed claims of other general unsecured creditors* would be *unfair* to these other creditors.

Although Trizec is the sole member of its class according to debtor's plan of reorganization, the type of claim it has is no different than the claims of other creditors having allowed general unsecured claims. Trizec is similarly situated with respect to the others but occupies a class all by itself.

One way in which Trizec's claim differs from the others is in the percentage of the amount of its allowed general unsecured claim in comparison to the percentage of the amount of all other allowed general unsecured claims. The amount of Trizec's claim comprises 99.23% of all such claims while the amount of all other such claims comprises only .73%. This disparity does not, however, affect the outcome here.

***179** As was noted previously, one of the purposes of § 502(b)(2) is avoiding unfairness in the treatment of competing creditors. *In re Energy & Gas Transmission,* 492 F.3d at

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301. It would be intrinsically unfair to other creditors having allowed general unsecured claims if Trizec were paid interest on its allowed general unsecured claim merely because of the percentage of its claim relative to the total of all allowed general unsecured claims.

The relative size of Trizec claim, in other words, is not relevant. Treating Trizec differently than all other creditors having allowed general unsecured claims would be inequitable. Equity, we believe, would not condone such disparate treatment of creditors having allowed general unsecured claims. The portion of Trizec's claim for post-petition interest therefore must be denied.

To summarize what we have concluded in this memorandum opinion, Trizec is entitled under § 502(b)(6)(A) to recover $404,928.00 for unpaid post-petition rent and $20,532.00 for unpaid post-petition taxes and operating costs. It is not entitled to any post-petition interest. Taken together, these amounts total $404,928.00 + $20,532.00 + $0.00 = $425,460.00. Adding this amount to the amount to which Trizec is entitled according to § 502(b)(6)(B)—i.e., $1,645,909.20-, it follows that the allowed amount of Trizec's claim under § 502(b)(6) totals $2,071,369.20 ($1,645,909.20 + $425,460.00 = $2,071,369.20).

An appropriate order shall issue.

ORDER OF COURT

AND NOW, this ***21st*** day of ***September,*** **2007,** for reasons set forth in the above memorandum opinion, it hereby is **ORDERED, ADJUDGED** and **DECREED** that the claim of TrizecHahn Gateway be and hereby is **ALLOWED** in the amount of **$2,071,369.20.**

It is **SO ORDERED.**

All Citations

375 B.R. 165, 48 Bankr.Ct.Dec. 250

Footnotes

1 Matters Trizec raised in the civil action in state court concerning debtor's individual partners are not relevant here and will not be addressed in this memorandum opinion.

2 Debtor and Trizec appear to agree that we can dispense with the first of these steps and can proceed directly to the second step. We need not determine the amount of Trizec's claim before determining how much of the it is allowable under § 502(b)(6)

3 We understand the term "re-taking" in this context to be interchangeable with the term "repossession".

4 If we had to decide these issues for ourselves, we would decide them as the Court of Common Pleas did. We would reject debtor's assertion that Trizec accepted debtor's surrender of the leasehold on August 3, 2000, when debtor removed its files from the basement storage space, or on June 1., 2002, when Trizec began gutting the twentieth floor to make it suitable for a new tenant.

5 In its calculation of the rent due under the lease for this thirty-nine month period, Trizec did not include unpaid rent due under the lease from February of 2000 through July of 2000 for the basement storage space. Following Trizec's lead, we will not include unpaid rent for the basement storage space in calculating the allowed amount of its claim as of the petition date.

6 We would have to determine the amount of pre-petition interest to which Trizec is entitled for purposes of § 502(b)(6)(B) even if the Superior Court had upheld the decision of the lower court as to the amount of interest debtor owed. The lower court determined the amount of interest to which Trizec was entitled for the period beginning on February 1, 2000, and ending on June 27, 2005. The issue now before this court concerns

the amount of interest to which Trizec is entitled for the period beginning on February 1, 2000, and ending on April 29, 2003.

7 The amount of the certificate of deposit was not indicated in the disclosure statement. As a consequence, it is not known whether the certificate of deposit sufficed to pay in full all creditors having allowed claims.

End of Document

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