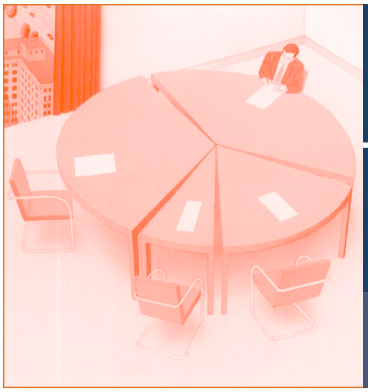

BANKRUPTCY WATCH

May 2004

A publication of the Lowenstein Sandler Bankruptcy, Financial Reorganization and Creditors' Rights Practice Group

Commercial Lease Rejection: When does the Debtor-tenant's obligation end?

by Sheila E. Carson, Esq.

Although a landlord of non-residential real property is entitled to payment of obligations arising under the lease during the time period between the commencement of a debtor-tenant's bankruptcy case and the date the lease is either assumed or rejected by the debtor-tenant, the magnitude of the recovery depends on the date - or timing - of rejection and on the jurisdiction in which the bankruptcy case is pending. Consider the following scenario: the debtor (a tenant) exercises its right to reject the lease in accordance with the Bankruptcy Code, effective as of the second day of the month. The debtor contends that it is obligated to pay only 2 days' rent for the month (through rejection) with the remainder of the month's rent included in the landlord's rejection damage claim. However, courts have been unable to agree as to whether the debtor is obligated to pay only the 2 days' rent, as an administrative claim (paid in post-petition 100% dollars) or the entire month's rent which came due (on the first day of the month) before the lease was rejected.

Recently, in *In re Ames Department Stores, Inc.*, a bankruptcy court in the Southern District of New York (part of the Second Circuit) held that a debtor is obligated to pay only the pro-rata accrual for its occupancy obligations during the period between the bankruptcy filing and the rejection period. In our scenario, the Southern District agreed with the debtor's position that rent for only the first two days must be paid as an administrative claim.

In reaching its conclusion, the court rejected the landlord's argument that the debtor was required to comply with lease obligations (payment for the month in advance) because such obligations were burdensome to the debtor and were the reason for the lease rejection in the first place. The court noted that rejection of a lease is a court-authorized breach and that where an exercise of business judgment makes such breach advisable, the debtor can be relieved of the duty of continuing to perform under the lease and the landlord's claim for damages resulting from the rejection will be treated as a pre-petition, general unsecured claim as provided by the Bankruptcy Code.

Although the court noted that prior to rejection a debtor must comply with post-petition lease obligations, the court commented that the right to reject burdensome leases is one of the most fundamental rights given to a debtor in bankruptcy. To compel a debtor to comply with the obligations under a burdensome lease which the debtor has elected to reject frustrates the policy reasons for allowing a debtor to

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reject a lease under the Bankruptcy Code. Notably, the court also rejected any distinction between rent and other types of lease obligations - a distinction recently made by the Seventh Circuit in *HA-LO Industries v. Centerpoint Properties Trust*. Hence, the New York decision applies to all types of lease obligations, not only the obligation to payment.

As previously mentioned, jurisdiction is key to maximizing the landlord's recovery when a lease is rejected. On similar facts to those in the New York case, the HA-LO court held that the debtor was obligated to pay in full the entire month's rent, despite the debtor having rejected the lease on the second day of the month. In reaching its decision, the HA-LO court distinguished its own prior ruling in *In re Handy Andy Home Improvement Centers, Inc.*, where the court permitted pro-ration of real estate taxes that accrued prior to the bankruptcy filing, but were billed afterward, thereby following what has become known as the billing date approach.

Jurisdiction is key to maximizing the landlord's recovery when a lease is rejected.

Although most courts now apply the pro-ration method, a substantial minority of courts require that a debtor pay in full all bills received from the landlord between the date the debtor files its Chapter 11 petition and the date of rejection, regardless of the language in the lease and regardless which time period to which the bills actually relate. The Third Circuit is aligned with courts such as HA-LO, which have opted for the "billing date" approach. The Third Circuit has held that an obligation arises under a lease when the legally enforceable duty to perform arises under the lease.

Because of the continued differences in the law on this issue, it is critical that landlords and their counsel pay close attention to the applicable law and facts when faced with the perils of a tenant in bankruptcy. As shown, not only is the timing of rejection a key factor, but location of the bankruptcy also has a significant influence.

Debtor's Assumption of Contract or Lease Relieves Creditor of Preference Liability

By S. Jason Teele, Esq.

Section 547 of the Bankruptcy Code (the "Code") provides that payments made to creditors within the 90 days before a debtor commences its bankruptcy case are potentially avoidable as "preferential" by a trustee or by a debtor-in-possession. An issue arises when payments are made to creditors on account of contract obligations that are subsequently assumed. Because Code § 365 requires a debtor to cure all arrears before assuming a contract or lease, are such required payments preferential?

The Court of Appeals for the Third Circuit recently addressed this question in *In re Kiwi International Air Lines, Inc.* and ruled that pre-bankruptcy payments to creditors on account of contract or lease obligations that the debtor assumes during the bankruptcy case are not avoidable as preferential transfers.

Kiwi was a commercial airline offering both scheduled and chartered air transportation to the public. In the 90 days before commencement of the bankruptcy case, Kiwi made payments (the "Prepetition Payments") totaling nearly $3.9 million to three creditors under existing contracts and a lease. Kiwi assumed and assigned the contracts and lease to the

buyer as part of the sale of its assets during the bankruptcy case.

After Kiwi's Chapter 11 reorganization case was converted to a Chapter 7 liquidation, the Chapter 7 trustee sought to avoid and recover the Prepetition Payments. The Bankruptcy Court and District Court held that the trustee could not recover the Prepetition Payments, because the agreements were later assumed pursuant to Code § 365. On appeal to the Third Circuit, attempting to prove that the payments were preferential, the trustee established that the creditors received transfers of an interest of the debtor in property (1) to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) made while the debtor was insolvent; and (4) made within 90 days before the bankruptcy petition was filed. However, the trustee could not establish that the payment enabled the creditor to receive more than it would receive if the payment had not been made and the creditor had received a distribution in a Chapter 7 liquidation, a required element to establish a preference.

Where a prepetition payment is made that would have been required to have been made by the Bankruptcy Code during a bankruptcy proceeding, the creditor is not deemed to have received more that it would have in a liquidation.

Hence, where a prepetition payment is made, that would have been required to have been made under section 365 of the Bankruptcy Code in order to assume the lease or contract during a bankruptcy proceeding, a creditor is not deemed to have received more that it would have in a liquidation. A creditor whose contract or lease is assumed by a debtor pursuant to Code § 365, either postpetition or within the 90-day preference period, escapes the potential disgorgement of any prepetition payments under the subject contract or lease.

Face Value of a Lien Is Considered in a Bankruptcy Sale

By Scott Cargill, Esq.

A recent decision by a New Jersey Federal District Court may restrict a debtor's ability to sell assets "free and clear" of liens when a secured party holding a lien with a value in excess of the sale price objects to the sale. In *In re WDH Howell, LLC*, the Chapter 11 debtor sought to sell environmentally contaminated commercial real estate that was the subject of a lien by a secured creditor. The face amount of the lien was approximately $11 million. In accordance with the Bankruptcy Code, the bankruptcy court approved the successful bid for the property in the amount of approximately $8.3 million, free and clear of all liens, claims and encumbrances. The bankruptcy court found that the sale price was greater than the "aggregate value" of all liens on the property. The secured creditor objected to the sale, arguing that the "aggregate value" of the liens was the liens' face amount; *i.e.*, $11 million. The debtor, however, took the position that the "value" of a lien meant the "economic value" of the secured claim; *i.e.*, the property's fair market value. The bankruptcy court determined that because the price offered by the successful bidder represented the property's fair market value, the sale could go forward. The secured creditor appealed the bankruptcy court's decision. Finding that the law was unsettled on this issue, the District Court reversed

the bankruptcy court and agreed with the secured creditor that value of the lien meant the liens' face value, not its economic value. Hence, because the sale price was less than the face value of the lien, the sale could not be approved over the objection of the secured creditor.

The decision may have significant implications for parties seeking to purchase assets from a Chapter 11 estate. Potential buyers should inquire as to the face amount of existing valid and perfected liens on the property. If the face value of these liens significantly exceeds the anticipated purchase price, inquiry should be made at an early stage to determine if the secured party will consent to the sale. If the secured party will not consent, the potential bidder should consider terminating negotiations early, prior to incurring significant due diligence and other costs associated with participation in a bankruptcy auction process. Conversely, for parties holding security interests on property that a Chapter 11 debtor wishes to sell, the District Court's ruling may enhance the secured creditor's leverage to increase the purchase price in order to avoid an objection by the secured creditor that could block consummation of a sale transaction.

If you have any questions about the issues raised in this newsletter or about bankruptcy law in general, please feel free to contact **Kenneth A. Rosen**, Chair of the Bankruptcy, Financial Reorganization and Creditors' Rights Practice Group, *at 973.597.2548 or at krosen@lowenstein.com.*

BANKRUPTCY WATCH

Editor: Ira M. Levee, Esq.

For additional information, please contact the authors directly.

Practice Highlights

The Bankruptcy, Financial Reorganization and Creditors' Rights Practice Group has provided counsel to companies and creditors' committees in a wide variety of industries. The group's attorneys represented the following in bankruptcy proceedings:

- Unsecured creditors' committee - General Media (Penthouse Magazine) (**Paul Kizel** and **S. Jason Teele**)
- Immedica (now known as Advanced Biomaterial Systems, Inc.) - obtained a 100% distribution for unsecured creditors through a sale of the debtor's assets (**Bruce Buechler** and **Lance T. Eisenberg**)
- AT&T on the Spiegel, Inc. creditors' committee (**Vincent A. D'Agostino** and **Scott Cargill**)
- Defrauded shareholders of NorthWestern Corporation - defeated the debtor's motion to enjoin the shareholders from pursuing their claims against the debtor's current and former officers and directors and non-debtor affiliates (**Michael S. Etkin** and **Ira M. Levee**)
- General Nutrition Corporation in the Nutraquest, Inc. and Twinlab Corporation proceedings (**Michael S. Etkin**, **Ira M. Levee** and **Sheila E. Carson**)
- Unsecured creditors in Tabloid Graphics Services, Inc. - negotiated a distribution to the unsecured creditors despite the fact that several secured creditors were undersecured (**Kenneth A. Rosen** and **Lance T. Eisenberg**)
- Creditors' committee in AM Communications - challenged the bank's lien which resulted in the establishment of a $500,000 fund to pay claims (**John K. Sherwood** and **Jeffrey Kramer**)
- British Telecom on the Verestar creditors' committee (**Vincent A. D'Agostino** and **Scott Cargill**)
- Unsecured creditors' committee in LTWC - negotiated a 40% distribution to unsecured creditors. The firm currently represents the LTWC Plan Administrator. (**Ira M. Levee** and **Sheila E. Carson**)
- International Association of Machinists and Aerospace Workers AFL-CIO in the United Airlines and Hawaiian Airlines proceedings. In the United proceeding, the Union, along with another union, convinced the Court to appoint an examiner to investigate the airline's reduction of employee benefits (**Sharon L. Levine**)

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May 2004

Inside this Issue:

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events

Upcoming Programs:

2004 Advanced Education Workshop

Presented by the Turnaround Management Association

June 14-15, 2004

Toronto, Ontario

"Flying Through Turbulent Skies: A Comparative Overview of the Air Pockets Encountered."

Topic presented by:

Sharon L. Levine

For more information or to register, please visit www.turnaround.org.

Insolvency and Reorganization Conference

Presented by the New Jersey Society of Certified Public Accountants

July 15, 2004

Newark, New Jersey

"The Changing Landscape of Accounting Liability."

Topic presented by:

Bruce D. Buechler

For more information or to register, please visit www.njscpa.org.

You can also visit us online at *www.lowenstein.com.*

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