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BANKRUPTCY LAW

Courts Split Over 'Obligations of the Debtor'

Billing versus proration approach for commercial leasehold obligations still at odds

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The significant amendments to the Bankruptcy Code ushered in by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 did not resolve a split in the circuits concerning what constitutes "obligations of the debtor" for purposes of Section 365(d)(3) of the Bankruptcy Code, which arose when the Third Circuit issued its decision in *Centerpoint Properties v. Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001). The language of Section 365(d)(3), which some courts have concluded is ambiguous and others have concluded is not, remained unchanged.

In 2001, the *Centerpoint* decision triggered a split among the Courts of Appeal as to when a commercial leasehold obligation "arises" for purposes of the debtor's timely performance pursuant to Section 365(d)(3) of the Bankruptcy Code. In resolving what it deemed a "syntactical ambiguity" in an otherwise "plain and straightforward" text, the Third Circuit joined a distinct minority of lower courts in concluding that an obligation arises under a lease for purposes of 11 U.S.C. § 365(d)(4) when the legally enforceable duty to perform arises under

the lease. The *Centerpoint* ruling was directly contrary to the 1998 decision of the Seventh Circuit in the case of *In the Matter of Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998), which sided with the prevailing interpretation of Section 365(d)(3) and adopted the proration approach.

On its face, Section 365(d)(3) of the Bankruptcy Code requires a trustee or debtor in possession to "timely perform all the obligations of the debtor...arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1)." 11 U.S.C. § 365(d)(3). This section was enacted by Congress as a special interest provision designed to ameliorate a perceived inequity imposed on commercial landlords by the occasion of a bankruptcy filing and was not changed by the amendments.

Prior to the enactment of 365(d)(3), landlords were usually in a state of limbo during the time period between the petition date and the debtor's decision to assume or reject an unexpired lease. While being constrained by the automatic stay from evicting the debtor for noncompliance with the terms of the lease, landlords were often at risk of not being fully compensated pursuant to the lease terms because if the debtor did not voluntarily

pay the post-petition rent when due, the landlord's post-petition claim had to be proven to be "actual and necessary" to preserving the debtor's estate under the provisions of Section 503(b)(1). In drafting Section 365(d)(3), one of the bill's sponsors noted that "[i]n this situation, the landlord is forced to provide current services — the use of its property, utilities, security, and other services — without current payment. No other creditor is put in this position." H.R. Rep. No. 882, 95th Cong., 2d Sess., reprinted in 1984 U.S.C.C.A.N. 576.

In attempting to resolve what Congress meant when it referred to "obligations of the debtor arising under a lease after the order for relief," the Third Circuit in *Centerpoint* undertook a close parsing of what it deemed straightforward statutory language. Specifically, the court determined that the term "obligation" should be interpreted in its "commonly understood sense;" that is, as "[t]hat which a person is bound to do or forbear..." Thus, in the context of a lease contract, the court reasoned that the "most straightforward understanding" of an obligation is "something that one is legally required to perform under the terms of the lease [which] arises when one becomes legally obligated to perform." This, the Court asserted, is the interpretation that best comports with the funda-

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mental tenet of Section 365(d)(3): that “it is the terms of the lease that determine the obligation and when it arose.”

In *Centerpoint*, the landlord moved to compel performance by the debtor, Montgomery Ward, of its obligations under an unexpired commercial lease. The obligations at issue concerned Montgomery Ward’s reimbursement of real property taxes assessed against the leased property. The lease provided that “upon receipt” of an invoice from the landlord, the debtor would pay as additional rent all real property taxes on the lease premises. The lease further provided that the real estate taxes would be prorated between the landlord and the debtor for the initial year under the lease as of the commencement date and for the final year as of the date of expiration of the lease term, in order to reconcile to the calendar year billing for the taxes. The parties also agreed to a provision requiring that Montgomery Ward escrow certain payments owed in arrears for 1996 and 1997 taxes 30 days prior to the expiration of the lease term.

When Montgomery Ward filed for bankruptcy in July 1997, taxes on the leased premises were owed for all of 1996 and part of 1997, totaling over \$1 million. Four days after the filing, the landlord forwarded Montgomery Ward three invoices for taxes owed for the first and second halves of 1996, and for 1997. Montgomery Ward refused to remit payment for either of the first two invoices, but did pay a portion of the third invoice for 1997 taxes, representing the prorated portion of taxes attributable to the period subsequent to Montgomery Ward’s bankruptcy filing. Montgomery Ward deemed the other invoiced amounts to be prepetition unsecured claims of the estate.

The Third Circuit recognized that the landlord’s liability for the taxes accrued in large part prior to Montgomery Ward’s bankruptcy filing. However, relying on the express terms of the lease, the Third Circuit found that Montgomery Ward’s obligation to reimburse the landlord did not accrue until after the filing. As a result of the Third Circuit’s ruling, the landlord was able to recover approximately 20 months of tax

obligations, most of which arose prepetition by billing for the “obligations” after the debtor had filed for bankruptcy and prior to the rejection and termination of the lease.

The Third Circuit admitted that it reached the conclusion that Section 365(d)(3) is unambiguous with “some reluctance” given it would create a split among the Circuits on this issue. Nonetheless, the Third Circuit took comfort in its holding by noting the recent Sixth Circuit decision of *Koenig Sporting Goods, Inc. v. Morse Road Company*, 203 F.3d 986 (6th Cir. 2000), which it claimed also adopted the billing date approach.

However, as swiftly pointed out in a noteworthy dissent by Third Circuit Judge Mansmann, the facts in *Koenig* were readily distinguishable from those in *Centerpoint* in that *Koenig* involved just one month of advance rent, rather than a year and a half of back taxes. The *Koenig* court itself recognized the importance of the distinction between a short advance rent payment and a long back rent payment.

In her dissent, Judge Mansmann criticized the majority decision for “elevat[ing] the accident or artifice of the billing date above the economic reality of the accrual,” resulting in an inappropriate burden to the bankruptcy estate and unfairly favoring landlords over similarly situated prepetition creditors. In Judge Mansmann’s view, “[n]othing in the text [of Section 365(d)(3)] is inconsistent with the common-sense view that when an obligation arises may be fixed by its intrinsic nature and/or by the extrinsic circumstances of its accrual.” This, Judge Mansmann argues, is in line with both the “true” fundamental tenet of Section 365(d)(3), “that landlords, like other post-petition creditors, should receive full and timely payment of post-petition services,” and the overarching bankruptcy policy of treating all like creditors similarly, the approach adopted by the Seventh Circuit in *Handy Andy*.

In adopting the proration approach in its *Handy Andy* decision, the Seventh Circuit reasoned that “[s]tatutory language like other language should be read in context”...and “[t]he context consists not merely of other sentences but also of the

real-world situation to which the language pertains.” The facts in *Handy Andy* were actually very similar to the situation in *Centerpoint*. A commercial landlord of a Chapter 11 debtor sought payment of real property taxes that had accrued prepetition but were billed to the debtor during the postpetition, prerejection period. *Handy Andy*’s lease required it to pay all real estate taxes on the property during its term and provided that if the lease ended during rather than at the end of the tax period, the taxes would be prorated between the parties, so that *Handy Andy* would only be responsible for those taxes that accrued before termination of the leases. Although the landlord had the option of transmitting the property tax bill directly to *Handy Andy*, it chose to pay the taxes itself and seek reimbursement.

The Seventh Circuit determined that the proration approach was more sensible than the “billing date” approach because it tracked the purpose of giving postpetition creditors a high priority in the distribution of the debtor’s estate. As the Seventh Circuit noted “[i]n economic terms, the prioritizing of postpetition debt enables the debtor...to ignore sunk costs — treat bygones as bygones — can continue operating as long as the debtor’s business is yielding a net economic benefit.”

In ruling against the landlord, the Seventh Circuit recognized that the landlord’s claim related entirely to the prepetition period of the debtor and, therefore, was no different from the debtor’s debts to trade creditors for supplied bought prepetition but never paid for. Since a trade creditor cannot, by virtue of continuing to sell to the debtor after a bankruptcy filing, obtain priority for what the debtor owes him for goods and services sold to the debtor prepetition, the landlord was in no different situation by virtue of Section 365(d)(3). It is noteworthy that, in applying the proration approach, both the district and bankruptcy courts in *Centerpoint* adopted the rationale of the Seventh Circuit in *Handy Andy*, no Court of Appeals decisions have adopted the *Centerpoint* billing date approach, while the Tenth Circuit BAP in its decision *In re Furr’s Supermarkets, Inc.*, 283 B.R. 60 (BAP 10th Cir. 2002), sided with the

Seventh Circuit in *Handy Andy*.

By embracing a strict “billing date” approach, the Third Circuit unnecessarily created uncertainty for landlords and debtor-tenants and recognized that its decision left “room for strategic behavior on the part of landlords and tenants.” Unlike the proration approach, the “billing date” standard invariably creates a windfall for either the landlord or the tenant, depending on the timing of an arbitrary due date. Typical lease agreements do not necessarily establish a date certain by which the tenant must remit payment to the landlord for its pro rata share of taxes and other charges because

these charges do not always accrue at definitive dates. Rather, in the usual case, the tenant is required under the lease to tender payment “upon receipt” or within a certain number of days after receipt of an invoice from the landlord. While the Third Circuit suggested that “strategic behavior” could be “constrained by forethought and careful drafting,” it did not take into account the difficulty that arises from attempting to draft language comprehensive enough to encompass every possible billing date scenario, especially in long-term lease situations.

In contrast, the Seventh Circuit’s “real-world” approach is both pre-

dictable and fair. By disassociating the debtor’s obligation from the artificial, and generally malleable, “billing date,” the proration standard ensures that landlords will be on an equal footing with other trade creditors in the event of a tenant-bankruptcy. This approach comports with both the purpose behind Section 365(d)(3) and the fundamental policy of creditor equality that pervades the Bankruptcy Code as a whole. Further, as noted by Judge Mansmann, the proration approach does no violence to the express statutory language chosen by Congress. ■