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IN RE BURGER BOYS: ARE LANDLORDS BEING GRILLED IN THE SECOND CIRCUIT?

Michael N. Gottfried and Andrew N. Goldman[†]

INTRODUCTION

A business which files for chapter 11 relief invokes a restructuring process rooted in equity. Its corporate mission is transformed from the paramount one of maximizing shareholder wealth to the three-fold concerns of (i) equitably reordering the existing debtor-creditor, creditor-creditor and, where the debtor is solvent, the debtor-equity relationships, (ii) maximizing assets available for distribution to these constituents, and (iii) positioning the asset, liability and cashflow structure of the surviving business (if one is to survive) in a manner that ensures its long-term viability. Stated differently, the interests of shareholders leave the forefront in the bankruptcy arena and in their stead steps up the interests of creditors. This fundamental transformation of corporate focus is the quid pro quo for creditors suspending, and ultimately losing, the right to collect most types of debts of the debtor's business that arose prior to the bankruptcy filing ("pre-petition").

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The views expressed herein are solely those of the authors and should not be attributed to the law firms at which the authors practice or to the bankruptcy judges for whom each clerked.

The process codified in title 11 of the United States Code¹ (the "Code") has powerful and invasive features² designed to permit the efficient and fair reordering of a vast array of creditor and equityholder interests. Inevitably, disputes will arise between the debtor and parties whose interests are being adversely affected by the prosecution of the bankruptcy proceeding. This Article focuses on one such class of disputes that is often at the fore of chapter 11 proceedings; namely the cantankerous disputes between a debtor and its landlord involving the respective rights of each with regard to one or more unexpired leases of nonresidential real property.

The Bankruptcy Code alters the rights and obligations of parties to an unexpired nonresidential lease of real property in many different ways. For example, the commencement of a bankruptcy proceeding affords a debtor an immediate, but temporary, spell from any pending litigation, including litigation involving its landlord. The Code also provides the debtor with a fixed period of time, which is initially set by statute at sixty days from the commencement of the case (the "Assumption Period"), to determine whether to retain, relinquish or assign its rights to each of its leases of nonresidential real property. This window of time, which is codified in section 365(d)(4) of the Code, affords the debtor a period of time within which to conduct due diligence before determining whether or not a particular lease serves its long-term strategic interests.³

While a debtor is afforded the opportunity to implement an orderly restructuring of its affairs, the bankruptcy process does not contemplate that a debtor will avail itself of the tem-

¹ 11 U.S.C. §§ 101-1330 (1994).

² The most notable of which are (i) the automatic stay of most collection proceedings during the pendency of the bankruptcy case, and (ii) the right of a debtor under appropriate circumstances to discharge certain of its preexisting debts at the conclusion of the bankruptcy case. *See* 11 U.S.C. §§ 362(a), 1141 (1994).

³ Section 365(d)(4) states:

Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

11 U.S.C. §365(d)(4) (1994).

porary reprieve from paying preexisting debts and thereafter unfurl new prejudice upon those landlords that voluntarily choose, or are involuntarily forced, to do business with the debtor while it is within the shelter of the chapter 11 process. Rather, landlords (and other creditors) are provided the comfort of knowing that the debtor will remain current on obligations which arise after the commencement of the bankruptcy case ("post-petition") while the debtor attempts to implement an orderly process designed to rehabilitate its business. To this end, section 365(d)(3)⁴ of the Code mandates that a debtor timely perform all of its obligations under a lease arising post-petition, irrespective of whether a pre-petition default exists under the lease or whether the debtor is in arrears for any preexisting lease obligations.⁵ Yet, crucially, as will be discussed below, section 365(d)(3) of the Code does not identify the consequences of a debtor's failure to comply with this provision.⁶

Although the Code initially fixes the Assumption Period at sixty days from the commencement of the case, section 365(d)(4) empowers a bankruptcy court to extend the Assumption Period for "cause" if the circumstances of a particular case so warrant. The Code does not, however, define the term "cause." Consequently, courts have been left to develop a standard for determining the appropriateness of a request for an extension of the Assumption Period. Not surprisingly, given that "cause" has been a judicially-developed doctrine, the statutory silence in section 365(d)(4) of the Code has provided ample

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) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

11 U.S.C. § 365(d)(3) (1994).

⁵ See, e.g., *In re Coastal Dry Dock & Repair Corp.*, 62 B.R. 879, 883 (Bankr. E.D.N.Y. 1986).

⁶ See 11 U.S.C. § 365(d)(3).

fodder for litigation concerning the appropriateness of a particular request for an extension of the Assumption Period.

Recently, the United States Court of Appeals for the Second Circuit (the "Second Circuit") rendered an opinion on the standard for obtaining an extension of the Assumption Period. The decision significantly affects the rights of debtors and landlords in bankruptcy cases in this jurisdiction and will undoubtedly lead to more litigation. In *South Street Seaport Ltd. Partnership v. Burger Boys, Inc. (In re Burger Boys, Inc.)*,⁷ the Second Circuit held that a debtor's request for an extension of the Assumption Period could not be denied merely because the debtor failed to pay a significant amount of post-petition rent in derogation of the express mandate of section 365(d)(3) of the Bankruptcy Code. The Second Circuit based its conclusion on the fact that section 365(d)(4) of the Code, by its terms, does not require a debtor to be in its current post-petition obligations in order to obtain an extension of the Assumption Period. The Second Circuit also rested its decision on its prior holding in *Theatre Holding Corp. v. Mauro*.⁸ *Theatre Holding* discussed, under prior law, the factors for courts to consider in determining the proper amount of time within which a debtor could assume or reject an unexpired nonresidential lease. Without recognizing that Congress' inclusion of sections 365(d)(3) and (d)(4) of the Code in 1984 may have made the *Theatre Holding* factors obsolete, the Second Circuit in *Burger Boys* concluded that a bankruptcy court must consider multiple factors, only one of which is whether a debtor is current in its post-petition obligations under a lease, in determining whether an extension of the Assumption Period is appropriate.⁹

The Second Circuit in *Burger Boys* may have reached the right conclusion, but did so through flawed reasoning and a myopic reading of section 365(d) of the Code. As a result, it revitalized a standard for determining the appropriate length of the Assumption Period—the *Theatre Holding* standard—which Congress intended to substantially modify through enactment in 1984 of sections 365(d)(3) and (d)(4) of the Code.¹⁰ The *Burger Boys* decision has the potential to sig-

⁷ 94 F.3d 755 (2d Cir. 1996).

⁸ 681 F.2d 102 (2d Cir. 1982).

⁹ *Burger Boys*, 94 F.3d at 760.

¹⁰ Under prior law, debtors had until the hearing on confirmation to decide

nificantly injure landlords' economic rights because, applied literally, the holding judicially amends the previously widely-held view that debtors must pay post-petition rent during the pendency of a bankruptcy case in order to obtain the benefit of continued occupancy and additional extensions of the Assumption Period. Under the *Burger Boys* standard, landlords are no longer assured of timely rent payments while their ability to enforce their rights under a lease is suspended by the operation of section 362(a) of the Code. Unchecked, the Second Circuit's decision could allow a debtor to defer *sine die* the decision to assume or reject an unexpired lease of nonresidential real property and shift to the landlord the economic risk of carrying a lease during the pendency of a bankruptcy proceeding.

Like the statutory provision which it interprets (section 365(d)(4) of the Code), the *Burger Boys* decision is incomplete and clouded by ambiguity. It fails to adequately analyze and reconcile the statutory structure of section 365(d) of the Code and its legislative amendments, which significantly altered the administration of leases of nonresidential real property. Applied rotely, the holding of *Burger Boys* threatens to roll back the law surrounding the time allotted a debtor to assume or reject an unexpired lease to its pre-1984 state, which in turn would undermine the equilibrium that is essential to the equitable reordering of the debtor-creditor relationship in many chapter 11 cases. This Article discusses the Second Circuit's decision in *Burger Boys* and offers a framework for interpreting sections 365(d)(3) and 365(d)(4) of the Code in a manner that would realign the rights of debtors and their landlords with respect to unexpired leases of real property in a manner consistent with congressional intent.

I. THE FACTS OF *BURGER BOYS*

In May 1983, Burger Boys Inc., the owner and operator of a restaurant in lower Manhattan, entered into a long-term lease with South Street Limited Partnership (the "Landlord")

whether to assume or reject their leases of nonresidential property; subject, however, to a landlord's right (and burden) to compel an earlier decision. See *Theatre Holding*, 681 F.2d at 104.

for commercial space in the South Street Seaport.¹¹ When Burger Boys signed the lease, the building had numerous tenants, most of whom were also purveyors of food. In fact, there were more than forty tenants in the building at one point, approximately twenty-two of which were restaurants.

To facilitate the renovation of its building, the Landlord offered the tenants incentives to either break their leases or relocate to another of the Landlord's nearby properties. Burger Boys declined both of those offers and elected to remain on the premises. Eventually, Burger Boys was the only tenant left in the building, with nine years remaining on its lease. Because of the extensive renovations which were in process, Burger Boys' business floundered and they stopped paying rent. In October 1993, the Landlord commenced nonpayment eviction proceedings against Burger Boys in the civil court of the City of New York (the "State Court Action").¹² In that action, Burger Boys asserted six affirmative counterclaims alleging, among other things, that the Landlord breached the terms of the lease by its actions to remove the neighboring tenant restaurants and, as a result, no rent was owing.¹³

On the eve of trial in the State Court Action, Burger Boys filed for relief under chapter 11 of the Bankruptcy Code.¹⁴ As a result of the chapter 11 filing, the Landlord's eviction proceeding (and for that matter, the entirety of the State Court Action) was suspended by the automatic stay provision of section 362(a) of the Code.¹⁵ Nearly six months into the chapter 11 case, Burger Boys commenced suit (the "Adversary Proceeding") against the Landlord in the bankruptcy case, asserting causes of action which mirrored its counterclaims in the State Court Action.¹⁶ The Landlord responded to the commencement of the Adversary Proceeding by requesting that the bankruptcy court abstain from hearing the issues raised in the Adversary Proceeding and remand the dispute back to the state court for adjudication of all issues surrounding the parties' rights under the lease. The bankruptcy court ultimately agreed to ab-

¹¹ *Burger Boys*, 94 F.3d at 758.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 11 U.S.C. § 362(a) (1994).

¹⁶ *Burger Boys*, 94 F.3d at 758.

stain.¹⁷ Burger Boys appealed that decision to the District Court for the Southern District of New York, which affirmed the bankruptcy court's abstention ruling.

Throughout the dispute over the proper forum for adjudicating the underlying nonpayment dispute, Burger Boys sought and obtained from the bankruptcy court multiple extensions of the Assumption Period. After the appeal was taken from the abstention order, the bankruptcy court extended Burger Boys' Assumption Period to the date which represented the sixtieth day after the district court rendered a final decision on the appeal, provided that Burger Boys remained current on its post-petition rental obligations.¹⁸

While the appeal was pending, Burger Boys stopped paying its monthly rent. Thereafter, the district court affirmed the bankruptcy court's decision to abstain.¹⁹ Burger Boys then filed another motion seeking yet a further extension of the Assumption Period, which the Landlord opposed both on the merits of the request and for being untimely filed. By order dated June 7, 1995 (the "Interim Order"), the bankruptcy court overruled the Landlord's objection to the timeliness of the extension motion and scheduled a hearing (the "Continued Hearing") several weeks after the date of the Interim Order to determine whether a further extension of the Assumption Period was warranted.²⁰ The Interim Order, however, provided that the Continued Hearing (and thus, the continued viability of the lease) was conditioned on Burger Boys becoming current on its post-petition obligations under the lease. This required Burger Boys to tender payment of approximately \$77,000 before the period set forth in the Interim Order expired.²¹

When Burger Boys failed to comply with the terms of the Interim Order, the bankruptcy court entered an order (the "Lease Rejection Order") deeming the lease rejected as a matter of law. As the bankruptcy court explained in a subsequent unpublished written decision, Burger Boys "failed to tender a

¹⁷ *Id.*

¹⁸ *In re Burger Boys, Inc.*, 183 B.R. 682, 684 (S.D.N.Y. 1994).

¹⁹ *Burger Boys*, 94 F.3d at 758.

²⁰ *Id.* at 759.

²¹ Transcript of District Court Hearing on Appeal at 16, *Burger Boys* (No. 95-5077).

dime" to the Landlord, nor did it even offer to pay any amount of the post-petition arrears into an escrow account.²² Burger Boys appealed the Lease Rejection Order and sought a stay pending appeal of the same. The bankruptcy court denied the request for a stay pending appeal; Burger Boys, however, obtained a stay of the Lease Rejection Order from the district court.

Subsequently, the district court affirmed the decision of the bankruptcy court on the issue of whether the request for an extension of the Assumption Period was timely made.²³ It disagreed, however, with the bankruptcy court's decision to deem the lease rejected as a matter of law as a result of Burger Boys' failure to tender the post-petition arrears within the time set forth in the Interim Order.²⁴ The district court concluded, among other things, that the bankruptcy court's order requiring Burger Boys to pay the post-petition arrears within three weeks was "draconian" and its determination that the lease was rejected as a matter of law clearly erroneous. The district court thereafter granted Burger Boys a short period of time in which to decide whether to assume or reject the lease; the district court, however, declined to order Burger Boys to tender any amounts to the landlord during that period.²⁵

The Landlord thereafter appealed to the Second Circuit. The Second Circuit, among other rulings, affirmed the district court's conclusion that the bankruptcy court had erred in deeming the lease rejected as a matter of law due to the debtor's failure to timely pay the post-petition rent.

In so concluding, the Second Circuit relied heavily on its prior decision in *Theatre Holding Corp. v. Mauro*.²⁶ In *Theatre*

²² See Decision and Order of Bankruptcy Court Denying the Debtor's Request for a Stay Pending Appeal at 5, *Burger Boys* (No. 93-B-22447).

²³ Transcript of District Court Hearing on Appeal at 17-18, *Burger Boys* (No. 95-5077).

²⁴ *Id.* at 18-19, *Burger Boys* (No. 95-5077).

²⁵ Ironically, the district court thereafter ordered Burger Boys to reach a decision as to whether it intended to assume its lease within fifteen days and to tender to the court registry within fifteen days of its decision to assume the lease the full amount of the post-petition arrears. Transcript of District Court Hearing on Appeal at 20, *Burger Boys* (No. 95-5077).

²⁶ 681 F.2d 102 (2d Cir. 1982). It should be noted that the Second Circuit in *Burger Boys* agreed with a bankruptcy court decision, *In re Wedtech Corp.*, 72 B.R. 464, 471 (Bankr. S.D.N.Y. 1987), for its rote conclusion that the factors discussed in *Theatre Holding* were still relevant to the court's extension determina-

Holding, which the Second Circuit decided before Congress' enactment of sections 365(d)(3) and (d)(4) of the Code, the Second Circuit had set forth an array of factors for the bankruptcy court to consider in determining how much time was "reasonable" for a debtor to decide whether to assume or reject its nonresidential real property leases. Those factors included, among others, whether the debtor was current in its post-petition rent obligations. While the *Burger Boys* decision referenced the 1984 amendments to the Code, the Second Circuit nonetheless concluded, with little analysis and without any discussion of the effect of sections 365(d)(3) and (d)(4) on its *Theatre Holding* factors, that those *Theatre Holding* factors were still "relevant to a bankruptcy court's decision on a debtor's motion for extension of time to assume or reject a lease."²⁷ Because the bankruptcy court only considered one of those factors in its determination (i.e., the timely payment of post-petition rent), the Second Circuit concluded that the bankruptcy court had erred as a matter of law.

II. ANALYSIS

The central dispute resolved by the *Burger Boys* decision involves a narrow legal issue: is a debtor's timely compliance with its post-petition lease obligations a prerequisite to—or just one factor the bankruptcy court must consider in—the court's granting of a debtor's request for an extension of the Assumption Period? The combination of Congress' inclusion of section 365(d)(3) of the Code, and that section's silence concerning the appropriate remedy—if any—for a debtor's failure to pay rent post-petition, supports two conflicting but defensible conclusions. It is entirely reasonable to conclude, as the Second Circuit did, that timely performance of post-petition

tion even after enactment of sections 365(d)(3) and (d)(4) of the Bankruptcy Code. What the Second Circuit overlooked, however, was that both *Wedtech* and a decision upon which *Wedtech* relied, *In re Beker Industries Corp.*, 64 B.R. 890, 898 n.5 (Bankr. S.D.N.Y. 1986), each had studied the issue and concluded that the "holding [of *Theatre Holding*] had been legislatively overturned with respect to nonresidential leases of real property by the passage of subsections (d)(3) and (d)(4) of § 365 of the Code . . . [but] 'remained good law in this Circuit as to other executory contracts . . . ' " *Wedtech*, 72 B.R. at 471 (quoting *Beher Industries Corp.*, 64 B.R. 890, 898 n.5 (Bankr. S.D.N.Y. 1986)).

²⁷ *Burger Boys*, 94 F.3d at 761.

obligations is not per se a precondition to an extension of the Assumption Period. It is similarly plausible to conclude, as the bankruptcy court did, that payment of post-petition rent—which section 365(d)(3) mandates—is the *sine qua non* to any extension of the Assumption Period.

The first conclusion employs the canon of statutory construction that a statutory provision should be applied according to its literal terms (its “plain meaning”) without resort to other statutory provisions or legislative history. The second conclusion employs the canon of statutory construction that interpretation of the Bankruptcy Code is a “holistic endeavor” requiring reference to related provisions of the broader statutory scheme of which it is a part. Clearly, with respect to the issue at bar, debtors fare better under the “plain meaning” approach to section 365(d)(4)—which references only “cause”—while landlords fare better under the “holistic” approach.

The issue raises complex questions of statutory construction and public policy, which, simply put, were overlooked by the trilogy of *Burger Boys* decisions. There is no “common sense” solution to this issue, because the statutory structure of section 365(d) of the Code and its legislative history are unclear, and there are significant and diametrically opposed interests at play. A workable solution requires a reconciliation by the courts (or preferably, Congress) of the relevant provisions of the Code with due regard to the policy concerns surrounding protections for landlords which formed the basis of the 1984 amendments to the Code.

III. ADMINISTRATION OF LEASES GENERALLY

To set the stage for discussing the narrow, but important, legal issue raised by the *Burger Boys* decision, we begin with a brief review of the Bankruptcy Code provisions which govern the administration of leases in bankruptcy proceedings. Section 365 of the Code provides that direction.

As part of the restructuring of its financial affairs, a debtor must determine whether to “assume” (reaffirm its obligations under), or “reject” (disavow its obligations under) each of

its unexpired nonresidential leases of property.²³ The Code provides that a debtor has until the hearing on the confirmation of a plan of reorganization to determine whether to assume or reject certain types of leases, as well as other executory contracts.²⁹ Until such leases and other executory contracts are assumed or rejected, such contractual arrangements continue "in effect and creditors are bound to honor [them]."²⁹

A pertinent exception to this rule involves the Assumption Period relevant to unexpired nonresidential real property leases; debtors are afforded sixty days from the commencement of the bankruptcy case (subject to extensions) to assume any unexpired lease of nonresidential real property. Unless a motion is filed³¹ to extend the Assumption Period prior to its conclusion (in some jurisdictions, an order must be entered prior to the termination of the Assumption Period extending the Assumption Period), the lease is deemed rejected as a matter of law and the debtor is obligated to "immediately surrender" the leased premises to its landlord.³²

Not surprisingly, in light of the overall purpose of chapter 11, the paramount concerns facing a debtor in determining whether to keep or dispose of a particular contract or lease are the financial value and strategic importance of that asset to the estate. Leases having a positive value to the estate will ordinarily be assumed, and either maintained for the restructured entity or sold to a third party if the asset does not fit into the debtor's long-term strategic plan.³³ Leases that are burdensome to the debtor's estate will almost always be rejected.³⁴

²⁸ See 11 U.S.C. § 365(a) (1994).

²⁹ See 11 U.S.C. § 365(d)(2) (1994); see also *Nostas Assoc. v. Costich (In re Klein Sleep Prods., Inc.)*, 78 F.3d 18, 29 (2d Cir. 1996); *Leslie Fay Companies, Inc. v. Corporate Property Assocs. 3 (In re Leslie Fay Companies, Inc.)*, 166 B.R. 802 (Bankr. S.D.N.Y. 1994); *Public Serv. Co. of New Hampshire v. New Hampshire Elec. Coop., Inc. (In re Public Serv. Co. of New Hampshire)*, 884 F.2d 11, 14 (1st Cir. 1989).

³⁰ *Public Serv. Co. of New Hampshire*, 884 F.2d at 14.

³¹ *Tigr Restaurant, Inc. v. Rouse S.I. Shopping Ctr., Inc.*, 79 B.R. 954, 956 (Bankr. E.D.N.Y. 1987); accord *Southwest Aircraft Serv., Inc. v. City of Long Beach (In re Southwest Aircraft Serv., Inc.)*, 831 F.2d 848, 853 (9th Cir. 1987); contra *In re Harwitz*, 167 B.R. 237 (Bankr. W.D. Okla. 1984).

³² 11 U.S.C. § 365(d)(4) (1994).

³³ *Klein Sleep*, 78 F.3d at 25.

³⁴ *Id.*

While the assumption/rejection decision can flow from a relatively straight forward economic analysis of the lease, that decision can have a significant impact on the dividends paid to creditors. Generally speaking, the Bankruptcy Code requires that (i) claims of equal legal rank are to be grouped in a class and paid equally,³⁵ and (ii) to the extent that the estate has insufficient assets to pay all allowed claims in a class in full, each claim receives a pro-rated distribution of any assets distributed to that class.³⁶

The rejection of a lease invokes two distinct provisions of the Code which, collectively, can cause a material shift in distributions to creditors by altering the amount and priority of the landlord's claim against the estate for damages resulting from the rejection. The amount and priority of a creditor's claim against the estate is generally fixed by applicable non-bankruptcy law, and where one exists, the terms of a contract.³⁷ The Code overlays a "cap" on a landlord's claim arising from the debtor's rejection of its real property lease. The purpose of this "cap" is to "prevent a landlord's single unsecured claim—which, depending on the length of the lease, may be enormous—to elbow aside other unsecured creditors" and swallow most of the unencumbered assets of a debtor that would otherwise be distributed rateably to the general creditor body.³⁸ More specifically, section 502(b)(6) of the Code provides that upon rejection of a real property lease, a landlord's rejection claim is limited to the lesser of one year's rent or fifteen percent of the remaining obligations under the lease (not to exceed a three-year term), plus any outstanding amounts due under the lease.³⁹

³⁵ See, e.g., 11 U.S.C. §§ 1122(a), 1123(a)(4) (1994).

³⁶ *Id.*

³⁷ See *In re Village Rathskeller, Inc.*, 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1992) (citing *Butner v. United States*, 440 U.S. 48, 54-55 (1979)).

³⁸ *Klein Sleep*, 78 F.3d at 28; H.R. REP. NO. 95-595, at 353 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6309; S. REP. NO. 95-989, at 63 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5849; *In re Leslie Fay*, 166 B.R. 294 (quoting *In re Bob's Sea Ray Boats, Inc.*, 143 B.R. 229, 231 (Bankr. D.N.D. 1992)).

³⁹ 11 U.S.C. § 502(b)(6) (1994). Section 502(b)(6) of the Bankruptcy Code disallows a landlord's lease rejection claim:

to the extent that— . . . such claim exceeds—(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—(i) the date of the filing of the petition; and (ii) the

The Code also dictates the priority of a landlord's lease rejection claim. Section 365(g)(1) of the Code provides that irrespective of the date on which a particular lease is rejected, upon such rejection, a legal fiction is created under which the debtor is said to have breached the lease immediately before the commencement of the bankruptcy case.⁴⁰ Because the rejection is deemed to occur pre-petition, any lease rejection claim is prioritized as an unsecured, nonpriority claim (along with other creditor claims which did, in fact, arise prior to the commencement of the bankruptcy case).⁴¹ As general unsecured claims are junior in priority to secured claims and administrative expense claims in the bankruptcy distribution scheme (only ahead of subordinated creditors and equity interests), this creditor group typically receives substantially less than a full distribution on account of their claims.

In contrast, if a debtor—in the prudent exercise of its business judgment⁴²—assumes a lease, the costs associated therewith become post-petition obligations of the debtor's estate (and the reorganized entity).⁴³ Once a lease is assumed, "it is said to be assumed *cum onere*; [t]he defaults are cured but the agreement becomes property of the estate in the same shape as it existed prior to bankruptcy, with all of its benefits and burdens."⁴⁴ After a lease is assumed, the law in the Second Circuit is that any claim for damages suffered by the landlord, including damages that may stem from a subsequent

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.

Id.

⁴⁰ *In re Riodizio, Inc.*, 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997); *accord In re Episode USA, Inc.*, 202 B.R. 691, 696 (Bankr. S.D.N.Y. 1996).

⁴¹ *Episode*, 202 B.R. at 696.

⁴² *See, e.g., Sharon Steel Corp. v. National Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39-40 (3d Cir. 1989) (in considering whether to authorize rejection of an unexpired lease, the bankruptcy court must determine whether the debtor has demonstrated, in its prudent business judgement, that rejection benefits the debtor's estate (citing *In re Stable Mews Assocs., Inc.*, 41 B.R. 594, 596 (Bankr. S.D.N.Y. 1984))); *accord Riodizio*, 204 B.R. at 424.

⁴³ *See In re Village Rathskeller, Inc.*, 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1992).

⁴⁴ *Id.* (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984)).

breach of the assumed contract, is afforded "administrative expense priority status" which is not subject to any statutory cap.⁴⁵

The importance in distinction between an administrative expense claim and an unsecured claim cannot be overstated. The distributive provisions of the Code provide that administrative claims are entitled to be paid first from unencumbered assets of the estate.⁴⁶ Unsecured claims are typically positioned at the end of the creditor distribution line and, accordingly, bear the greatest risk that they will receive less than 100 cents on the dollar. When all is said and done, unsecured creditors typically receive "little tiny Bankruptcy Dollars, which may be worth ten cents in U.S. dollars," while administrative claimants typically receive payment in full.⁴⁷

When this financial consequence is considered along with the Code's requirement that a debtor must provide for the cure of any existing default at the time that it assumes a lease,⁴⁸ it is axiomatic that a debtor has little, if any, financial incentive to make its assumption/rejection decision earlier than it absolutely must in a bankruptcy case.⁴⁹

Yet, while debtors may naturally prefer to put off the lease review process, in point of fact, debtors are often unable operationally to make assumption/rejection decisions during the initial Assumption Period. A predicate for making such decisions is the existence of a strategic plan for a debtor's emergence from chapter 11. In most larger reorganizations, the

⁴⁵ See *In re Klein Sleep Prods., Inc.*, 78 F.3d 18, 28-29 (2d Cir. 1996).

⁴⁶ See 11 U.S.C. § 507(a)(1) (1994); accord *Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.)*, 26 F.3d 481 (4th Cir. 1994).

⁴⁷ Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 253 (1989).

⁴⁸ More specifically, section 365(b)(1) of the Bankruptcy Code mandates that at the time of such an assumption: (i) the debtor cure any outstanding defaults (or provide adequate assurances that those defaults will be cured), (ii) compensate any third party for pecuniary losses resulting from those defaults (or provide adequate assurances that such compensation will be promptly given), and (iii) provide adequate assurance of future performance under the contract. 11 U.S.C. § 365(b)(1) (1994).

⁴⁹ Indeed, it has become commonplace in large retail chapter 11 cases for the debtor to obtain an order extending the Assumption Period through confirmation of a chapter 11 plan subject to the rights of landlords to seek by compulsion a shorter Assumption Period. See, e.g., *In re Gunter Hotel Associates*, 96 B.R. 696 (Bankr. W.D. Tex. 1988). One could question whether such practice runs afoul of Congress' intent in enacting section 365(d)(4).

debtor's initial concern is to stabilize the day-to-day operations of its business. Ordinarily, the debtor cannot review its leases and determine which fit into its long-term business plan until the debtor has developed such a plan. A debtor typically does not focus on its business plan until it has stemmed the immediate cause of its restructuring, restored relations with trade vendors, negotiated (or otherwise obtained court approval of) a stable source of cash flow and begun a detailed review of its operations. Thus, in most cases, unless a lease is the debtor's sole or primary asset, the debtor is in no position to make a strategic decision concerning its lease within the first sixty days of the reorganization.⁵⁰

In recognition of the potential for a debtor to be unable to make the assumption or rejection decision post haste, the Bankruptcy Code provides that the debtor may seek as much additional time to make the assumption/rejection decision as the bankruptcy court, for cause, permits.⁵¹ Because "cause" is not defined in the Code nor in the legislative history to section 365, a nonexhaustive list of "judge-made" factors has evolved to fill in the statutory void. As the Second Circuit discussed in *Burger Boys*, those factors include, among others:

- (1) whether the debtor is paying its post-petition rent;
- (2) whether the debtor's continued occupation could damage the landlord beyond the compensation available under the Bankruptcy Code;
- (3) whether the lease is the debtor's primary asset;
- (4) whether the debtor has had sufficient time to formulate a plan of reorganization;
- (5) the complexity of the debtor's chapter 11 case;
- (6) the number of leases that the debtor must evaluate;
- (7) the need for a judicial determination of whether a lease exists.⁵²

⁵⁰ See, e.g., *In re Wedtech Corp.*, 72 B.R. 464, 472 (Bankr. S.D.N.Y. 1987).

⁵¹ The decision to grant or deny a motion for an extension of time to assume or reject an unexpired nonresidential real property lease is generally within the sound discretion of the bankruptcy court. See *Burger Boys*, 94 F.3d at 760-61.

⁵² See, e.g., *Burger Boys*, 94 F.3d at 761; *Theatre Holding*, 681 F.2d at 105-06; *Wedtech*, 72 B.R. at 471. However, as discussed *supra* at note 24, one could question whether the *Theatre Holding* factors, which the *Burger Boys* court relied upon, have been legislatively overruled through congressional enactment of sections 365(d)(3) and (d)(4).

In *Burger Boys*, the Second Circuit concluded, as it had previously in *Theatre Holding*, that the "payment of rent" factor was just that—one factor—among many to be considered in determining the appropriate length of the Assumption Period. However, what the Second Circuit failed to consider was that subsequent to its decision in *Theatre Holding* (which spawned these factors), Congress codified section 365(d)(3) of the Code to expressly require the timely payment of post-petition rent during the pendency of the Assumption Period. In so doing, one could plausibly argue that Congress legislatively took the "payment of rent" factor of *Theatre Holding* and made it into a precondition. Given the change in the law since *Theatre Holding*, the continued viability of the *Theatre Holding* factors has been called into question.⁵³ It is to this inquiry that we now turn.

IV. THE INTERPLAY OF SECTIONS 365(D)(3) AND 365(D)(4) OF THE BANKRUPTCY CODE

To answer the question of whether the timely payment of post-petition rent is the prerequisite to—as opposed to one of many factors to be considered in—determining whether "cause" exists for an extension of the Assumption Period, we begin, as the United States Supreme Court has instructed, with the words of the governing statute.⁵⁴ Fundamental principles of statutory construction mandate that where a statute is clear and unambiguous on its face, the inquiry ends there and the statute is so interpreted.⁵⁵ However, where a statute's meaning is ambiguous in isolation and in light of its neighboring

⁵³ Cf. *In re Hooker Invs., Inc.*, 145 B.R. 138, 146 (Bankr. S.D.N.Y. 1992) (asserting that the doctrine of stare decisis, which is of fundamental importance to the rule of law, requires a federal court located in the Second Circuit "to follow a decision of the Second Circuit only when the effect of a decision has not been nullified in some fashion . . . or been questioned in subsequent decisions by the Second Circuit itself, or has not been rendered irrelevant by changes in the positive law.").

⁵⁴ See *Dewsnup v. Timm*, 502 U.S. 410, 419-20 (1992); *In re Palm Coast, Matanza Shores Ltd. Partnership*, 101 F.3d 253, 257 (2d Cir. 1996) (statutory construction necessarily begins with the language of the statute); accord *Berger v. Heckler*, 771 F.2d 1556, 1570 (2d Cir. 1985).

⁵⁵ *In re Yochum*, 89 F.3d 661, 666 (9th Cir. 1996); *In re Columbia Gas Sys., Inc.*, 33 F.3d 294, 300 (3d Cir. 1994).

provisions, a review of the legislative history surrounding these statutes is needed in order to discern congressional intent for the statute.⁵⁶ Where that inquiry is unavailing, courts are directed to look to the practice which existed prior to enactment of the statute, and assume that Congress intended to leave intact such practice absent some clear legislative declaration to depart from such practice.⁵⁷

Turning to the Code section at issue in *Burger Boys*, section 365(d)(4) of the Bankruptcy Code provides in pertinent part:

[i]f the trustee does not assume or reject an unexpired lease of non-residential real property under which the debtor is a lessee within 60 days after the date of the order for relief, *or within such additional time as the court, for cause, within such 60-day period, fixes*, then such lease is deemed rejected and the trustee shall immediately surrender such nonresidential real property to the lessor.⁵⁸

Because the relevant language of section 365(d)(4) simply references "cause," a "plain reading" of section 365(d)(4) lead the Second Circuit in *Burger Boys* to conclude that the timely payment of rent was not a precondition to an extension of the Assumption Period, but merely one factor to be considered. The court reasoned:

[a]lthough § 365(b)(1) may require that a debtor, before it assumes a lease, become current on or provide adequate assurance of its payment of past-due lease obligations . . . , we see nothing in § 365(d)(4) that requires a debtor to be current [in its post-petition rent payments] before the Bankruptcy Court grants a motion for an extension of time.⁵⁹

One need not disagree with the Second Circuit's decision in *Burger Boys* to let stand the district court's ruling on this point to quarrel with the analytical approach it employed in arriving at its conclusion. The analysis espoused by the Second Circuit in *Burger Boys* is appropriate for a statutory provision which is clear on its face and not subject to alternative interpretation. Here, however, we believe that section 365(d) of the

⁵⁶ *Patterson v. Shumate*, 504 U.S. 753, 761 (1992).

⁵⁷ *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 563 (1990) (court should not read the Bankruptcy Code to erase post-petition practice absent a clear indication that Congress intended such departure).

⁵⁸ 11 U.S.C. § 365(d)(4) (1994) (emphasis added).

⁵⁹ *Burger Boys*, 94 F.3d at 761.

Bankruptcy Code is an integrated statutory scheme which has been designed (and redesigned) to balance important, and, at times, competing interests. Where, as in this instance, a provision's language is ambiguous or part of a broader statutory scheme, courts "are not free to legislate but instead [are obligated to] look to the supporting legislative history, and, if necessary, to [prior] practice."⁶⁰ The Second Circuit in *Burger Boys* ignored this canon of construction.

Contrary to the Second Circuit's *Burger Boys*' reasoning, section 365(d)(4) of the Code is not clear and unambiguous on its face and therefore cannot be analyzed in isolation to discern its meaning.⁶¹ The existence of an ill-defined benchmark, "cause," in section 365(d)(4), necessarily renders this provision vague and unintelligible in isolation.⁶² Because section 365(d)(4) of the Code does not afford clear guidance as to what constitutes "cause," resort to legislative history is appropriate.⁶³ Said differently, section 365(d)(4) of the Code must be viewed in light of the remainder of the statutory scheme (and, in particular, section 365(d)(3)) because only through such a "holistic" approach can the words of the statute be interpreted in a manner consistent with Congress' intent in enacting it; namely, the protection of landlord rights in chapter 11 cases.⁶⁴

At the outset, it is important to remember that section 365(d)(4) (like its companion section 365(d)(3)) was enacted as part of the 1984 amendment to the Code. Prior to the 1984

⁶⁰ *Hooker*, 162 B.R. at 426 (citing *In re* 680 Fifth Ave. Assoc., 209 B.R. 314 (Bankr. S.D.N.Y. 1997)); accord *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) ("[T]his Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.").

⁶¹ See *In re Palm Coast, Matanza Shores Ltd. Partnership*, 101 F.3d 253, 257 (2d Cir. 1996) ("Where the scope of a statutory provision is not made crystal clear by the language of the provision, it is appropriate to turn to the legislative history of the statute.") (quoting *Berger v. Heckler*, 771 F.2d 1556, 1571 (2d Cir. 1985)); see also *Dewsnup*, 502 U.S. 410; *U.S. v. Nordic Village, Inc.*, 503 U.S. 30, 35-36 (1992); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253 (1992).

⁶² See, e.g., *Chapman Inv. Assocs. v. American Healthcare Management*, 94 B.R. 420, 421 (N.D. Tex. 1989) (stating that, "the meaning of the words of section 365(d)(4) are not clear").

⁶³ *Theatre Holding Corp. v. Mauro*, 681 F.2d 102, 104 (2d Cir. 1982).

⁶⁴ *United States v. Timbers*, 484 U.S. 365, 371 (1988).

amendments, chapter 11 debtors typically had a "reasonable" period of time to determine whether to assume or reject unexpired leases of real property.⁶⁵ During this open-ended "reasonable" period, which often extended for months on end, there was no statutory obligation for a debtor to timely pay its post-petition rent and disputes arose not only with respect to the timing of payments, but also with respect to the amount of rent owing. As one court recounted, "[p]rior to the 1984 enactment of § 365(d)(3), the payment of post-petition lease obligations prior to assumption or rejection was governed by 11 U.S.C. 503(b)(1)."⁶⁶ There were often debates concerning whether the debtor was liable for the rent reserved under the lease or some other amount. If the landlord could not live with this open-ended Assumption Period, the landlord carried the burden of forcing a debtor to make its assumption/rejection decision on a particular lease sooner than at a confirmation hearing.⁶⁷ As history demonstrates, this statutory framework did not work.

In 1984, Congress—in an effort to provide landlords with greater protection in chapter 11 cases—enacted sections 365(d)(3) and (d)(4) of the Code. The legislative history to the 1984 amendments makes clear that the underlying purpose of congressional enactment of sections 365(d)(3) and (d)(4) of the Code was to "remedy serious problems caused [to] shopping centers and their solvent tenants by the administration of the [B]ankruptcy [C]ode."⁶⁸ In addition to the issues just described, other problems included the detrimental effect that long-term vacancy or partial operation of space caused to "customer traffic," and, in turn, business opportunities in shopping malls, and the detrimental effect on the landlord and neighboring tenants of the debtor's failure to timely pay rent.⁶⁹

⁶⁵ *Id.*; see also *Theatre Holding*, 681 F.2d at 104.

⁶⁶ See *Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934, 936 (Bankr. S.D.N.Y. 1997).

⁶⁷ *In re Beker Indus. Corp.*, 64 B.R. 890, 896 (Bankr. S.D.N.Y. 1986).

⁶⁸ See 130 CONG. REC. S8,894 (daily ed. June 29, 1984) (remarks of Sen. Hatch); accord *In re Orient River Inves., Inc.*, 112 B.R. 126, 133 (Bankr. E.D. Pa. 1990) ("The 1984 Bankruptcy Code amendments . . . were added to strengthen the position of landlords.").

⁶⁹ 130 CONG. REC. S8,894-95 (daily ed. June 29, 1984) (remarks of Sen. Hatch).

As the Congressional Record explains:

The first problem which this bill would remedy is the long-term vacancy or partial operation of space by a bankrupt tenant. Although in a chapter 7 case the bankruptcy code presently requires that the trustee decide whether to assume or reject an unexpired lease within 60 days after the bankruptcy petition is filed, there is no deadline for this decision in a chapter 11 case. Because of the unprecedented number of bankruptcy cases and the consequent delays in the Bankruptcy Courts, tenant space has been vacated for extended periods of time before the Bankruptcy Court forced the trustee to decide whether to assume or reject the lease. During this time, the other tenants of the shopping center are hurt because of the reduced customer traffic in the shopping center. Tenants and landlords in other nonresidential structures have encountered similar problems.

The bill would lessen the problems caused by extended vacancies and partial operation of tenant space by requiring that the trustee decide whether to assume or reject nonresidential real property lease within 60 days after the order for relief in a case under any chapter. This time period could be extended by the court for cause, such as in exceptional cases involving large numbers of leases. One of the minor changes in this subtitle was to limit it to nonresidential real property leases. If the lease is not assumed or rejected within this 60-day period, or any additional period granted by the court, the lease is deemed rejected and the trustee must immediately surrender the property to the lessor.

A second and related problem is that during the time the debtor has vacated space but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments due under the lease. . . . In this situation, the landlord is forced to provide current services—the use of its property, utilities, security, and other services—without current payment. No other creditor is put in this position. In addition, the other tenants often must increase their common area charge payments to compensate for the trustee's failure to make the required payments for the debtor.

The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance requirement will insure that debtor-tenants pay their rent, common area, and other charges on time pending the trustee's assumption or rejection of the lease. For cause, the court can extend the time for performance of obligations due during the first 60 days after the order for relief, but not beyond the end of such 60-day period. At the end of this period, the amounts due during the first 60 days would be required to be paid, and thereafter, all obligations must be performed on time. This permissible 60-day grace period is intended to give the trustee time to determine what lease obligations the debtor has and to locate the cash to make the required

payments in exceptionally large or complicated cases. . . .⁷⁰

In short, in 1984 Congress created an initially infinite yet flexible Assumption Period (thus doing away with the concept of a "reasonable period") and made clear that the debtor was required to timely pay the amount of rent reserved under the lease until the assumption/rejection decision had been made. Noticeably absent from the legislative history to section 365(d) is any discussion of the appropriate penalty for a debtor's failure to timely comply with its post-petition obligations under a lease of nonresidential real property. Nor does the legislative history to section 365(d) express a congressional intent to link the extension of the Assumption Period to the timely payment of rent, although the legislative history does imply such a link by prominently discussing the financial hardships caused by these two "related issues" and the congressional desire to lessen the problems which commonly befell landlords. Yet, while Congress plainly desired to ensure that debtors paid their rent during their continued occupancy of the leased space, it failed to lay out what consequences would befall the debtor who failed to comply with these obligations.⁷¹

V. EARLY DECISIONAL LAW INTERPRETING THE 1984 AMENDMENTS

Early post-1984 amendment decisional law interpreting the changes to section 365(d) of the Bankruptcy Code apparently favored the bright line view that a debtor's timely payment of post-petition rent was a prerequisite to the court's consideration of a request for an extension of the Assumption Period.

In *In re Tandem Group, Inc.*,⁷² for example, the chapter 11 debtor—which manufactured wood office furniture and seating—sought an extension of the Assumption Period with respect to a lease which was its primary asset. The debtor had not paid any post-petition rent, and not surprisingly, the landlord opposed the requested extension. While finding that the debtor had demonstrated "cause" sufficient to be granted an

⁷⁰ *Id.*

⁷¹ See *infra* pp. 458-60 and note 77.

⁷² 60 B.R. 125 (Bankr. C.D. Cal. 1986).

extension of the 365(d)(4) time, the *Tandem* court concluded such an extension would be expressly conditioned upon the debtor's becoming current in its post-petition obligations. Citing *In re Condominium Administrative Services, Inc.*⁷³ and the legislative history to the 1984 amendments to the Code, the *Tandem* court concluded that "to preserve the ability to assume the lease, the debtor, or trustee, must perform all lease obligations during the sixty-day period and during any court-authorized extension [of the 365(d)(4) period]."⁷⁴ Absent such performance, no extension of the Assumption Period would be granted. Thus, while not expressly holding that section 365(d)(4) says as much on its face, the *Tandem* court found by reasoning that the payment of post-petition rent was the *sine qua non* to the court's granting of an extension of the Assumption Period. Other lower courts, by similarly analogous reasoning, have reached the same conclusion.⁷⁵

VI. SOUTHWEST AIRCRAFT AND ITS PROGENY

Other courts have refused to espouse this "bright line" interpretation of sections 365(d)(3) and (d)(4). In *In re Southwest Aircraft Services, Inc.*,⁷⁶ the debtor sought an extension of the Assumption Period. However, the debtor had failed to pay a significant amount of post-petition rent. At the hearing on the debtor's extension motion, the debtor tendered its landlord checks for all outstanding post-petition rent, which the landlord refused. One issue, among others, was the effect of the debtor's nonpayment of post-petition rent on the ability of the court to grant an extension of the Assumption Period.

⁷³ 55 B.R. 792 (Bankr. M.D. Fla. 1985)

⁷⁴ See *Tandem Group*, 60 B.R. at 125, 127.

⁷⁵ See *In re Mr. Gatti's, Inc.*, 164 B.R. 929, 933 n.2 (Bankr. W.D. Tex. 1994) ("[p]resumably, the failure of a debtor to comply [with section 365(d)(3)] would cause a motion to extend time [to assume or reject] to also be denied."); see also *In re Muir Training Techs., Inc.*, 120 B.R. 154, 158, (Bankr. S.D. Cal. 1990) ("the express language of § 365(d)(3), its legislative history and the case law interpreting this section require a debtor or trustee to satisfy their [sic] lease obligations during the 60 day assumption/rejection period and any court authorized extension"); *Corporate Prop. Inves. v. Chandel Enters., Inc.*, (*In re Chandel Enterprises, Inc.*), 64 B.R. 607, 610 (Bankr. C.D. Cal. 1986) (timely payments under the lease are required by section 365(d)(3) during the 60 day period and any extension thereof).

⁷⁶ 831 F.2d 848 (9th Cir. 1987).

Initially the *Southwest* court noted that, unlike its companion provision (section 365(d)(4)), section 365(d)(3) "does not expressly state what consequences follow from a debtor's violation of its terms."⁷⁷ The court found the *Tandem* "bright line" interpretation of sections 365(d)(3) and (d)(4), which the landlord espoused, to be "draconian" in nature, and instead concluded that the payment of rent was but one factor to be considered in the overall "cause" inquiry. Specifically, the *Southwest* court held that:

[w]e believe that Congress intended the bankruptcy courts to have the discretion to consider all of the particular facts and circumstances involved in each bankruptcy case and to decide whether the consequence of a violation of subsection (d)(3) should be forfeiture of the unassumed lease, some other penalty, or no penalty at all. Accordingly, we hold that the failure to make payments under subsection (d)(3) constitutes simply one element to be considered, along with all the other relevant factors, in determining whether cause exists under subsection (d)(4) to extend the 60-day period for assumption or rejection.⁷⁸

Several lower courts have reached the same conclusion. In *In re Wedtech Corp.* (which was cited with approval in *Southwest* and by the Second Circuit in *Burger Boys*), the debtor moved for an extension of the Assumption Period with respect to two nonresidential real property leases.⁷⁹ The landlord objected because the debtor had failed to pay significant post-petition rent. The *Wedtech* court applied four of the *Theatre Holding* factors in its extension determination: (1) whether the debtor had made post-petition payments for the use of the property; (2) whether the lease was the debtor's primary asset, such that the decision to assume or reject would be central to any chapter 11 plan; (3) whether the debtor had sufficient time to intelligently make an assumption/rejection decision; and (4) whether such an extension would damage the landlord

⁷⁷ Section 365(d)(4) provides that if the court does not extend the Assumption Period, or if the lease has not yet been assumed or rejected prior to the expiration of the Assumption Period, the lease is automatically deemed rejected as a matter of law.

⁷⁸ *Southwest*, 831 F.2d at 854. The court also held that the *Condominium* holding was made "without citation of authority except for a wholly unsupported reference to 'legislative history'." *Id.*

⁷⁹ *In re Wedtech Corp.*, 72 B.R. 464, 466 (Bankr. S.D.N.Y. 1987); see also *In re Westview 74th Street Drug Corp.*, 59 B.R. 747, 752 (Bankr. S.D.N.Y. 1986).

beyond the compensation available under the Bankruptcy Code.⁸⁰ After analyzing these *Theatre Holding* factors and additional factors utilized by other courts, the *Wedtech* court held that the payment of post-petition rent was not itself a prerequisite to seeking an extension of the Assumption Period. In reaching this conclusion, the *Wedtech* court declined to adopt the position that the payment of rent was a prerequisite to a finding of "cause," even though it recognized that the "payment" factor should be afforded greater weight in the court's decision than any of the other factors.

Similarly, in *In re Babylon Ltd. Partnership*,⁸¹ the debtor operated a nightclub in Manhattan pursuant to a seven year lease which was indisputably its principal asset. Shortly after filing for chapter 11 relief, the debtor moved for an extension of the Assumption Period. The landlord objected, arguing, inter alia, that the debtor's failure to timely make post-petition rent payments, coupled with the debtor's inability to fund its rental obligations solely from its revenues, mandated that the court deny the debtor's requested extension of the Assumption Period. Like the *Wedtech* court, the *Babylon* court looked to *Theatre Holding* for guidance, and in so doing, concluded that the timely payment of post-petition rent was but one of many factors the court should consider in making a section 365(d)(4) extension decision.⁸² Unlike the *Wedtech* court, however, the *Babylon* court went on to grant the requested extension of the Assumption Period, conditioned upon the "timely payment of [post-petition] rent."

VII. RECONCILING THE DIFFERING VIEWS

The statutory framework which governs and, in certain instances, modifies, the contractual rights of debtors and landlords in bankruptcy proceedings (section 365(d)) is silent on the consequences that flow from a debtor's failure to timely perform its post-petition obligations under an unexpired lease of nonresidential real property. Outside the bankruptcy context, the rights of the landlord and tenant are clearly defined, with

⁸⁰ See *Wedtech Corp.*, 72 B.R. at 471-72.

⁸¹ *In re Babylon Ltd. Partnership*, 76 B.R. 270 (Bankr. S.D.N.Y. 1987).

⁸² See *id.* at 274.

eviction and abatement generally representing the two judicial extremes of possible results flowing from the tenant's nonpayment of rent. The invocation of bankruptcy proceedings overlays upon the typical landlord-tenant dispute the protection of the interests of creditors and other interested parties in preserving the valuable assets of a debtor (i.e., its lease), even if the debtor is delinquent in doing all that can be done to preserve these assets. The schisms that result from the intersection of these competing interests are not new, as Congress recognized in attempting to address the situation through the 1984 amendments to the Code.

While the legislative history makes it clear that in enacting sections 365(d)(3) and (d)(4), Congress intended to provide better protection for landlords' economic interests in bankruptcy proceedings, section 365(d) has been interpreted by the Second Circuit in *Burger Boys* in a manner which effectively nullifies the intended economic protections of the 1984 amendments by authorizing extensions of the Assumption Period in the absence of timely rent payments by the debtor. Indeed, a plain reading of the *Burger Boys* decision suggests that a debtor can be eight months behind in its post-petition rent and still not be per se precluded from obtaining the benefit of an extension of the Assumption Period. Permitting the debtor to drag out the Assumption Period without at least providing the landlord with the economic benefit of its bargain certainly cannot be what Congress intended in enacting the 1984 amendments and, most likely, not what the Second Circuit intended either. Fortunately, there is a middle ground and a workable solution which is discernable from the statute, the legislative history and the trilogy of *Burger Boys* decisions.

As an initial matter, it is important to note that while the analysis employed by the Second Circuit in *Burger Boys* is subject to question, the result is not. It cannot be seriously disputed that *Burger Boys*' nonpayment of eight months of post-petition rent seems wrong and fails the "smell" test. Nonetheless, applying principles of statutory construction demonstrates that deeming the lease rejected as a matter of law for the debtor's nonpayment of rent, which was the result the bankruptcy court in *Burger Boys* reached, was not the proper remedy for the debtor's breach of section 365(d)(3) either.

Section 365(d)(3) states that the debtor must make timely payments of rent; it does *not* state that a failure to do so is fatal to the debtor's interest in the lease or its ability to demonstrate "cause" under section 365(d)(4) for an extension of the Assumption Period.⁸³ The legislative history contains no discussions of the effect of a debtor's nonpayment of rent on its ability to obtain extensions of the Assumption Period. Indeed, prior to 1984, the case law was clear that a debtor's failure to pay post-petition rent did not per se result in a forfeiture of the lease, although the debtor's time to assume or reject a lease could be shortened where the post-petition rent was not timely paid. Accordingly, based upon principles of statutory construction, there is no basis upon which to conclude that the penalties for a debtor's failure to timely fulfill its post-petition obligations are either (i) the automatic denial of an extension of the Assumption Period, or (ii) an immediate forfeiture of the lease.

While we agree that it is wrong to employ the "bright line," "no payment, no extension" test that the *Tandem Group*, *Babylon*, and *Burger Boys* bankruptcy courts did, we similarly acknowledge that adopting the test employed by the Second Circuit in *Burger Boys* (itself a restatement of the *Theatre Holding* factors) does not work either, since this framework does not give effect to the fundamental changes to the Code Congress implemented by the enactment of the 1984 amendments. To prevent the gamesmanship and costly litigation that were the subject of the *Burger Boys* case, we believe that bankruptcy courts (or ideally, Congress) must delineate and enforce strict criteria for an extension of the Assumption Period which reflect the underlying purposes of section 365 of the Code and the 1984 amendments.⁸⁴ Stated differently, the framework set

⁸³ See *In re Westview 74th Street Drug Corp.*, 59 B.R. at 752. The *Westview* court noted:

[t]hat § 365(d)(3) contains no . . . forfeiture provision is beyond dispute. Certainly, Congress knew how to achieve a forfeiture had it intended one, for § 365(d)(4) deems a lease rejected upon failure to assume or reject it within 60 days or such extended period as the court fixes and directs the trustee to immediately surrender the leases of nonresidential property to the lessor, without the necessity of any eviction proceedings under state law. But equally beyond dispute is the failure of § 365(d)(3) to proscribe any result for violation of its mandate.

Id.

⁸⁴ See *id.* at 754-755 (recognizing that the "aims" of section 365 of the Code is

out by the Second Circuit in *Theatre Holding*, which the court used as authority for its decision in *Burger Boys*, must be updated.

Ironically, the district court and Second Circuit decisions in *Burger Boys* demonstrate, *sub-silentio*, a solution which protects the interests of debtors, landlords and other interested parties, while giving a cohesive meaning to each of the provisions of section 365(d). In the *Burger Boys* case, a point of equilibrium was achieved when the debtor, eight months in arrears of its post-petition obligations, was denied any further extensions of the Assumption Period but afforded the necessary time period in which to move to assume or reject the lease. This practical result avoided the automatic forfeiture of a valuable estate asset which, if lost, would have prejudiced the interests of the debtor's other creditors. At the same time, the result protected the landlord's rights by denying the debtor more time to make the assumption/rejection decision. Said differently, the result recognized that the privilege of an extension of the Assumption Period cannot be bestowed upon a debtor that is both harming the landlord economically (through its nonpayment of rent) and keeping the landlord in the dark with respect to its long-term strategic plan for the lease at issue.

While the district court's approach in the *Burger Boys* case establishes a balance of the competing interests that will likely be appropriate in most cases, this solution should not be applied as an inflexible or "bright line" rule for determining the appropriateness of an extension of the Assumption Period.⁸⁵ Notwithstanding the general appeal of this approach, we be-

to protect (but not enhance) the interests of landlords upon the bankruptcy of a tenant).

⁸⁵ See *id.* at 753, citing 2 King, COLLIER ON BANKRUPTCY ¶ 365-03[2] at 365-31 (15th ed. 1985):

Termination of the period in which to assume or reject . . . does not work a forfeiture, for although the debtor may be forced to make a quick decision, it is not prevented from assuming the lease. Most assuredly, the debtor's failure to keep current on its post-petition obligations to its landlord is a factor which should weigh heavily in favor of limiting the debtor's right to maintain the lease in limbo, but the existence of such defaults should not effect an automatic termination of the leasehold interest.

lieve that a bankruptcy court has the authority, in the extraordinary case, to approve alternatives which protect the rights of landlords while avoiding the forfeiture of potentially valuable assets which courts of equity (like the bankruptcy courts) so abhor.⁸⁶ For example, there is no reason why a bankruptcy court, faced with an extension motion filed by a debtor who is delinquent in making post-petition rent payments, cannot condition a further extension—and thus a finding of “cause”—on the debtor’s becoming current on its post-petition obligations.⁸⁷ We do not see this result as “draconian,” but rather the practical application of a statute seemingly designed primarily towards ensuring that landlords get paid the contractual amounts due them during the pendency of the chapter 11 case.

Where there is a bona fide dispute concerning the existence of the underlying lease or the amount of post-petition rent, if any, which is owing, the bankruptcy court has the ability to fashion a remedy which considers extenuating circumstances presented and which adequately protects the interests of both the debtor and its landlord. For example, if the debtor disputes the amount of obligation owing, the bankruptcy court can simply require the debtor to escrow with the court the amount of post-petition rent in dispute until the amount of the debtor’s obligations under the lease is properly adjudicated. This option may also be appropriate where there is evidence of post-petition malfeasance on the part of the landlord. In this way, even though the landlord has no present right to the escrowed funds (which would earn interest at prevailing market rates), the landlord would be assured of its ability to collect the outstanding rent from the debtor if the court ultimately upholds the landlord’s legal position. In the meantime, the court retains the ability to protect the parties from any unintended economic prejudice that may arise on a case by case basis.⁸⁸ It is crucial to remember, however, that

⁸⁶ See *Westview 74th Street Drug Corp.*, 59 B.R. at 753-54.

⁸⁷ *In re Family Showtime Theatres, Inc.*, 58 B.R. 679, 684 (Bankr. E.D.N.Y. 1986).

⁸⁸ Interestingly, the decisions of the Second Circuit and the district court in *Burger Boys* touch upon—but do not explore—the effect of the bankruptcy court’s decision deferring to the state court the underlying lease disputes. The debtor’s right to assume the lease presumed, in the first instance, a finding by the state

court of the continued existence of the lease. The district court directed the debtor to make its assumption/rejection determination without the state court issues being fully resolved. This "business judgment" determination made prior to a judicial finding of the continued viability of the lease brings squarely into focus the Second Circuit's prior decisions in *Orion Pictures Corp. v. Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095 (2d Cir. 1993), and *Hart Envtl. Management Corp. v. Sanshoe Worldwide Corp.* (*In re Sanshoe Worldwide Corp.*), 993 F.2d 300 (2d Cir. 1993).

In *Sanshoe*, the Second Circuit focused on the bankruptcy court's obligation to resolve the disputed status of a lease in connection with the debtor's motion to assume that lease. The debtor in *Sanshoe* leased space and subleased a portion of it. Prior to the chapter 11 filing date, the state court had issued a warrant of eviction. The landlord subsequently accepted rent, and never executed upon the warrant. Post-petition, the debtor sought authority to assume and assign the lease and sublease. The sublessee objected, arguing that the issuance of the warrant of eviction had the effect of terminating the prime lease and sublease. The bankruptcy court permitted the debtor to assume and assign whatever interest it held in the lease without first determining the continued existence of that lease.

On appeal, both the district and circuit courts disagreed with the bankruptcy court's approach. Each concluded that section 365(e)(3) requires the bankruptcy court to make a "threshold" inquiry into the continued existence of a lease prior to permitting the debtor to assume the same.

Not four months later in *Orion*, the Second Circuit reversed the bankruptcy court for doing precisely that which *Sanshoe* had directed. In *Orion*, the debtor attempted to assume a pre-petition licensing and distribution contract which the other party thereto (Showtime) claimed the debtor had breached. The debtor filed its assumption motion and commenced an adversary proceeding against Showtime, asserting anticipatory breach. The debtor sought money damages, specific performance and authority to assume the agreement.

The bankruptcy court held a trial on the breach issue in connection with the assumption motion; finding no breach by the debtor, the bankruptcy court authorized assumption. The district court affirmed, but the Second Circuit reversed. *Orion*, 4 F.3d at 1095. The Second Circuit found that a motion to assume under section 365 is a summary proceeding involving the "business judgment" decision of whether assumption benefits or burdens the estate. Given the summary nature of this proceeding, the Second Circuit continued, section 365 does not authorize the bankruptcy court to resolve questions involving the validity of agreements in the context of assumption motions, especially since doing so could "usurp litigants' Seventh Amendment jury-trial rights." *Id.* Instead, the Second Circuit suggested that the bankruptcy court should don blinders and consider only whether assumption makes "business sense." *Id.* at 1099.

Interestingly, *Orion* did not cite *Sanshoe*, notwithstanding that Second Circuit Judge Oakes sat on both the *Orion* and *Sanshoe* panels. Subsequent lower court decisions have either noted the seeming inconsistency in the Second Circuit's *Orion* and *Sanshoe* decisions, see, e.g., *In re Best Prods. Co.*, 168 B.R. 35, 68 (Bankr. S.D.N.Y. 1994) ("*Orion* silently departed from *Sanshoe*"), or attempted to reconcile these decisions, see *In re* 611 Sixth Avenue Corp., 191 B.R. 295, 301 (Bankr. S.D.N.Y. 1996). However, to date, the Second Circuit has not reconciled these seemingly divergent views. Thus, practitioners in this Circuit are left in the precarious situation of often times having to move to assume a lease before the legal issue of the continued viability of the lease is resolved.

in either event, a debtor's failure to cure its post-petition defaults should not cause an immediate forfeiture of its lease, although it should ordinarily preclude an extension of the Assumption Period. Thus, if at any point in the chapter 11 process, the debtor stops paying post-petition rent, the court should normally deny a further extension of the Assumption Period and direct a debtor to decide sooner than it otherwise would whether to assume or reject the lease.

The bankruptcy court could also create a hybrid of these solutions and find "cause" for an extension of the Assumption Period without the direct payment of post-petition rent. For example, where a debtor is suffering at the outset of the case from a temporary cash flow drain, a bankruptcy court has the authority to defer a debtor's obligation to timely perform its post-petition obligation for the duration of the initial Assumption Period.⁸⁹ At the conclusion of the initial Assumption Period, the debtor is bound to cure any post-petition arrears. However, at least for the first sixty days of the case, the debtor could avoid making rent payments. This might afford the debtor the "breathing spell" it requires to focus on its business and long-term viability. At the same time, however, the landlord is assured of receiving its rent, even if it comes sixty days later.⁹⁰

While such a declaratory judgment action may be commenced so as to run on a parallel track with the assumption motion, the fact remains that a trial on the continued viability of the lease may be protracted and litigated in a different court than the assumption motion and may take longer to resolve. In addition, the result under *Orion* makes little sense. If the goal of chapter 11 is the expeditious rehabilitation of a business, it makes little sense for a debtor to develop a business plan (and chapter 11 plan of reorganization) around a lease which may be the cornerstone of its business and assume the lease, only to have the lease later "swiped out" from under its feet (and its chapter 11 plan scrapped as a result) under a judicial finding that the lease had previously expired under governing state law. Debtors need to know with certainty and expediency their rights under their leases. However, until the Second Circuit reconciles *Orion* and *Sanshoe*, its attempt to preserve litigants' jury-trial rights may also lead to the collapse of a debtor's emergence efforts.

⁸⁹ 11 U.S.C. § 365(d)(3) (1994).

⁹⁰ While section 365(d)(3) provides on its face that the debtor can defer its obligations only during the initial Assumption Period, there appears to be no business or policy reason to limit a bankruptcy court's authority to grant such relief only during the initial sixty days of the bankruptcy proceeding. Indeed, limiting a court's ability to grant debtors a temporary reprieve from paying its rent to only the initial Assumption Period would tend to doom its value since a debtor would

CONCLUSION

The rehabilitative process contemplated by chapter 11 of the Bankruptcy Code provides a troubled entity with a "snug harbor"⁹¹ in which to restructure its affairs free from the mounting threats of a chaotic dismemberment at the hands of its disenchanted creditors. The ante for a debtor to partake in this supervised and equitable process is that additional prejudice should not be foisted upon those parties that continue to do business with the debtor while it is restructuring. In the context of non-residential leases of real property, Congress recognized the importance to the restructuring process of a balanced landlord-debtor relationship and codified sections 365(d)(3) and (d)(4) of the Code in 1984. Because an orderly landlord-debtor relationship is often a key to a debtor's reorganization (and long-term) prospects, there is, quite simply no substitute for the payment of post-petition rent while the lease is being reviewed during the Assumption Period.

While neither section 365(d)(3) or (d)(4) of the Code link a debtor's ability to obtain an extension of the Assumption Period to the timely payment of post-petition rent, to conclude otherwise calls into question the point of equilibrium Congress attempted to establish through enactment of the 1984 amendments. The flaw in the Second Circuit's decision in *Burger Boys* was that it limited its analysis to a review of the text of section 365(d)(4) of the Code. Section 365(d)(4) of the Code cannot be read in isolation. Focusing solely on the language of section 365(d)(4), as the Second Circuit did in *Burger Boys*, may lead practitioners to the wrong conclusion that debtors need no longer comply with section 365(d)(3) before they seek extensions of the Assumption Period. This conclusion is not supported by either the language of section 365(d)(4) of the Code or the legislative history supporting it.

To give proper meaning to the statute and to effect the result we believe Congress intended, courts should interpret sections 365(d)(3) and (d)(4) in a manner that makes clear that

not ordinarily have reason to seek authority to defer payment of post-petition rent prior to the conclusion of the initial Assumption Period.

⁹¹ See *Zeisler & Zeisler, P.C. v. Prudential Ins. Co. of America (In re JLM, Inc.)*, 210 B.R. 19, 21 (2d Cir. BAP 1997).

the timely payment of post-petition rent is a crucial factor in the bankruptcy court's consideration of whether "cause" exists to extend the Assumption Period. If the debtor fails to comply with section 365(d)(3) of the Code's requirement, the lease is not rejected as a matter of law. However, the debtor should ordinarily lack the ability to convince the bankruptcy court to grant further extensions of the Assumption Period. Thus, the debtor will be forced to make a prompt assumption/rejection decision. While from a landlord's perspective, this result is not as appealing as a forfeiture of the lease, this alternative does create a ceiling on the landlord's continued economic risk. If the debtor moves to assume the lease, the debtor will have to cure all existing defaults (both pre- and post-petition) at the time of assumption and provide adequate assurances that, on an ongoing basis, the debtor will be able to make its rent payments.⁹² If the debtor rejects the lease, the landlord's unpaid post-petition rent claim will be paid as an administrative expense claim of the estate (assuming the estate is not administratively insolvent), while the landlord's "rejection" claim will be an unsecured claim capped by section 502(b)(6) of the Bankruptcy Code. At bottom, however, the bankruptcy court should endeavor to fashion a remedy which protects the economic rights of the landlord, the debtor, and the debtor's remaining creditor body.

⁹² 11 U.S.C. § 365(b)(1) (1994).