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**Post-Petition Rent Obligations: Use and Occupancy v. Due Date**By **Leslie A. Berkoff and Sandra M. Ishaq**

Confused about when a real property landlord or equipment lessor can commence charging post-petition rental payments? Does a debtor's obligation under Section 365(d)(3) of the Bankruptcy Code, (hereinafter, the "Code") to timely perform all obligations arising after the order for relief (or under Section 365(d)(10), 60 days after the order of relief), mean those obligations that "arise" by virtue of actual post-petition use of the property as opposed to obligations that arise by virtue of the "due date" of the rental payment by contract or invoice?

The two competing theories advanced in determining what obligations should be deemed a post-petition obligation under Section 365(d)(3) of the Code are: 1) the proration rule (majority approach); and 2) the billing date or performance date rule (minority approach). To date, three Circuits have addressed these theories as applied to non-residential real property leases. See *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3<sup>rd</sup> Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6<sup>th</sup> Cir. 2000); *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125 (7<sup>th</sup> Cir. 1998). To date, no Circuit has

*continued on page 4***Recovering Attorneys' Fees As an Administrative Expense**By **Anthony L. Lamm**

In counseling clients on whether to structure a transaction as a lease or a loan, there are several financial considerations. The first is the potential that the client's customer could file for bankruptcy, and its impact upon recovering rent payments as a priority administrative expense. In that case, attorneys' fees are a factor as well. The Bankruptcy Code provisions that govern the rights and remedies of an equipment lessor in comparison to the rights and remedies of a secured lender differ significantly — they may be considered more favorable to an equipment lessor than a secured lender for the reasons discussed later in this article, although certain provisions of the Code that address the remedies of a secured lender are applied to an equipment lessor as well. Section 365(d)(10) of the Bankruptcy Code provides that:

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

The language of this statute and its Congressional history have been interpreted and relied upon by bankruptcy courts in many circuits of the country. The courts have used the statute to grant an equipment lessor an automatic administrative expense for unpaid post-petition lease payments where the lessee remains in possession of the leased equipment on or after the 60th day from filing a bankruptcy petition until eventually assuming or rejecting the lease. This expense has been granted without the usual proofs required under Section 503(b)(1)(A) (to show actual, necessary costs of preserving the estate). *In re: Furley's Transport, Inc.*, 263 B.R. 733 (Bankr. D. Md. 2001); *In re: Russell Cave Co.*, 247 B.R. 656, 659 (Bankr. E.D.Ky.

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addressed this issue with respect to equipment leases. Discussed below is the treatment by other courts of this issue with regard to equipment lessors.

### SECTION 365(D)(3) OF THE BANKRUPTCY CODE

Section 365(d)(3) of the Code was enacted to grant the lessor of non-residential real property inherent priority status by requiring the debtor to make full and timely payment of post-petition rent. Section 365(d)(3) of the Code states, in pertinent part, that: The trustee shall timely perform all the obligations of the debtor ... arising from and after the order for relief under an unexpired lease of non-residential real property, until such lease is assumed or rejected, notwithstanding Section 503(b)(1) of this title. 11 U.S.C. Section 365(d)(3). The purpose behind the enactment of Section 365(d)(3) of the Code was to fairly protect the non-residential real property lessor who was considered one of the most disadvantaged creditors of the bankruptcy estate. See *In re Furr's Supermarkets, Inc.*, 283 B.R. 60, 67 (10<sup>th</sup> BAP Cir. 2002) (discussing in detail the legislative history of Section 365(d)(3) of the Code); see also *Handy Andy*, 144 F.3d at 1128. During the interim period between the commencement of the bankruptcy case and the rejection or assumption of the lease, the landlord was estopped from evicting the debtor because of the automatic stay, while the debtor was utilizing the premises for free. See *Furr's Supermarkets*, 283 B.R. at 67; see also *Handy Andy*, 144 F.3d at 1128.

In 1984 "Congress enacted §365(d)(3) to ensure that landlords would not be disadvantaged by providing post-petition services to the debtor [without receiving payment in return]." *In re Koenig Sporting Goods*,

*Inc.*, 229 B.R. 388, 393 (BAP 6<sup>th</sup> Cir. 1999). "The legislative history for [Section 365(d)(3) of the Code] indicates that its purpose is to 'prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-a-vis the estate.'" *In re Cannonsburg Envtl. Assocs., Ltd.*, 72 F.3d 1260, 1266 (6<sup>th</sup> Cir. 1996) (quoting H.R. Rep. No. 595, 95<sup>th</sup> Cong., 2d Sess. 348, reprinted in 1978 U.S.C.C.A.N. 5963, 6304).

Although there is no debate that the debtor's requirement to "timely perform" its lease obligations exists, the conflict addressed herein relates to the issue of whether Congress intended "arising from" to refer to all amounts that come due after the petition date or only those amounts that are allocable to the post-petition/pre-rejection period. See *Koenig Sporting Goods*, 229 B.R. at 390.

### THE TWO APPROACHES

It is under this background that courts have had to interpret what Congress intended in enacting Section 365(d)(3) of the Code and what the term "arises from and after the order for relief" truly is intended to mean. Under the proration rule, which constitutes the majority approach among the courts, the invoice date or contractual "due date" is irrelevant. Rather, the pre and post-petition rental charges are bifurcated and the debtor is only liable for those charges that accrued post-petition. (The monthly amount is thus turned into a per diem charge.) "The 'proration rule' provides that only those amounts that accrued during the time the debtor or trustee was in possession of the property 'arise after the order for relief' and should be assessed against the estate." *Furr's Supermarkets*, 283 B.R. at 62. The court in *In re Comdisco, Inc.* stated: "The obligations to pay taxes [and presumably other lease charges] arises at the time of occupancy, not when the lease says the landlord is entitled to bill and be paid for those charges ... the court of appeals held that §365(d)(3) requires the payment of only that portion of pass through expenses that relate to the period between the dates of the order for relief and the rejection of the lease, even if the lease by its terms requires

the debtor/tenant to pay expenses relating to an earlier time." 272 B.R. 671, 674 (Bankr. N.D. Ill. 2002).

For example, if the debtor filed for bankruptcy relief on July 11 and by contract the lease payment was due July 1, the debtor would be liable for rental payments for the remaining post-petition month of July (21 days prorated at the monthly rental rate provided for under the lease) and for every single day thereafter until the date the lease is rejected. In *Handy Andy*, the court explained "[w]hat it [the debtor] wanted was the continued occupancy of the leased property until it rejected the lease. To get this benefit it had to pay the full rent under the lease for every day that it continued to occupy the property ... " 144 F.3d at 1127. In *Furr's Supermarkets*, the debtor was required to make quarterly rent payments pursuant to its commercial lease. 283 B.R. at 60 (wherein the court adopted the proration approach and required the debtor to pay all rental obligations that accrued after the relevant period).

The performance date rule, otherwise known as the "billing date approach," provides that the debtor's obligations under a lease "arise" when the debtor is invoiced regardless of whether such bill includes pre-petition charges just so long as the billing date falls between the post-petition and prerejection/assumption period. *Koenig Sporting Goods*, 229 B.R. at 390. For example, if the bankruptcy filing date is July 11 and the billing date is July 19, the debtor would be obligated to pay the entire bill for July even though such amount may include amounts that accrued pre-petition. However, if the billing date fell on July 10, the eve of the debtor's bankruptcy filing, the debtor would be relieved from paying the entire July 10 bill, enjoying the luxury of utilizing and possessing the property without having to pay for it for that period.

In adopting this minority approach (the billing date rule), the Third Circuit in *In re Montgomery Ward Holding Corp.* relied on the *Koenig* decision stating "[w]e are not alone in holding that an obligation arises under a lease for-the

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purposes of §365(d)(3) when the legally enforceable duty to perform arises under the lease.” 268 F.3d 205, 211 (3<sup>rd</sup> Cir. 2001). The *Montgomery* court takes the position that Section 365(d)(3) of the Code should be given a plain text reading and it construed “obligation” to mean the full obligation as it comes due under the lease post-petition irrespective of whether the “obligation” includes pre-petition amounts. *See Id.* at 208-210. The court further explained: “The clear and express intent of §365(d)(3) is to require the trustee to perform the lease in accordance with its terms. To be consistent with this intent, any interpretation must look to the terms of the lease to determine both the nature of the ‘obligation’ and when it ‘arises.’ If one accepts this premise, it is difficult to find a textual basis for a proration approach.” *See Id.* at 209; *see also In re F&M Distrib., Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995) (holding that since the tax payment became due after the petition date, the debtor must pay the entire tax bill).

### THE PRORATION RULE PROMOTES GREATER UNIFORMITY

As previously discussed, Congress enacted Section 365(d)(3) of the Code to give commercial lessors inherent priority status for accrued post-petition obligations only. *See Handy Andy*, 144 F.3d at 1127. This intent would seem to require that the majority rule of proration should be the prevailing rule, because the proration rule holds a debtor should be obligated to pay only those rental amounts that accrue post-petition specifically carving out any amounts that are pre-petition. *See Id.* at 1127-28. This majority rule balances the harm and the obligations between the two parties most effectively. Under this rule a debtor pays only for the post-petition use of the property in question, limiting his or her obligations to those types of claims Congress intended to afford a priority to under Section 503(b) of the Code, while at the same time providing lessors with full and timely payments at the original rental rate provided under the

lease during the post-petition period consistent with the intent and purpose of Section 365(d)(3) of the Code, which was to compensate them for post-petition use of said property.

Under the billing date approach a more haphazard result is achieved, effectively promoting less equality and failing to follow the legislative intent of the Code. In certain instances, the lessor would achieve a windfall (*ie*, payment of an invoice which comes due post-petition for obligations that were incurred pre-petition), and in other instances the debtor could achieve a windfall, by filing just after the lease payment due date and being able to avoid paying rent for the first month it utilizes the property in bankruptcy. *See Koenig Sporting Goods*, 229 B.R. at 393 (noting that the application of the billing date approach will result in a windfall either to the debtor or the les-

### ***Under this rule a debtor pays only for the post-petition use of the property in question***

sor at the expense of other creditors, the debtor and/or the estate). *Compare Koenig Sporting Goods*, 203 F.3d at 988 (wherein the debtor rejected one of its commercial leases on December 2, 1997 and vacated the premises on that same day. By applying the billing date approach the lessor was able to collect a full month's rent for that last month even though the debtor did not utilize the property for the whole month), with *In re The ? Off Card Shop, Inc.*, 2001 WL 1822419 (Bankr. E.D. Mich. 2001) (wherein rent under the lease was due in advance on June 1, 2000 and because the debtor filed for bankruptcy on June 2, 2000, the debtor was not obligated to pay the June 2000 rent even though the debtor utilized the property for the majority of that month); *see also Furr's Supermarkets*, 283 B.R. at 60 (wherein application of the billing date approach would have resulted in no payments post-petition until the following quarterly invoice date).

Nothing in the Code or common law supports such a proposition nor did Congress ever intend on granting

any creditor or debtor such a windfall. *See id.* at 393-394; *see also Handy Andy*, 144 F.3d at 1128 (discussing in detail the legislative history of Section 365(d)(3) of the Code). Actually, this goes against the very purpose and function of not only legislative intent of Section 365(d) of the Code but also the Bankruptcy Code in its entirety. *See Id.*; *see also In re Ernst Home Ctr., Inc.*, 209 B.R. 955, 964 (Bankr. W.D. Wash. 1997).

### THE ANALYSIS AS APPLIED TO PERSONAL PROPERTY LEASES

In 1994, the Bankruptcy Reform Act added Section 365(d)(10) to the Code with the intent to provide personal property lessors in Chapter 11 cases rights similar to commercial real property lessors with respect to timely performance of rental payments subject to certain limitations. *See In re Muma Servs. Inc.*, 279 B.R. 478, 487 (Bankr. D. Del. 2002); *In re Furley's Transp., Inc.*, 263 B.R. 733, 740 (Bankr. D.MD. 2001) (discussing the legislative history and intent of Section 365(d)(10) of the Code as compared to its counterpart Section 365(d)(3) of the Code); *see also Ernest Home Ctr.*, 209 B.R. at 965. “Section 365(d)(10), like its non-residential real property counterpart, Section 365(d)(3), grants lessors the extraordinary benefit of an automatic administrative expense, without the usual proofs required under Section 503(b)(1)(A).” *Furley's Transp.*, 263 B.R. at 740.

With one exception, the language of Section 365(d)(10) of the Code is essentially identical to that of Section 365(d)(3) of the Code and provides, in pertinent part, that: “The trustee shall timely perform all of the obligations of the debtor ... first arising from or after 60 days after the order for relief in a case under Chapter 11 of this title under an unexpired lease of personal property ... until such lease is assumed or rejected notwithstanding Section 503(b)(1) of this title.” Section 365(d)(10) of the Code. Thus, with respect to personal property leases in Chapter 11 bankruptcy cases only, the debtor is granted a 60-day breathing period from the filing date before it is obligated to resume making payments

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under a lease. (Nonetheless, a lessor can seek priority administrative expense status pursuant to Section 503(b)(1) of the Code for the post-petition amounts that accrue but remain unpaid during the first 60-day period following the petition date.)

Although no circuit court has yet addressed this issue in connection with personal property leases, given the similarities between Section 365(d)(3) and Section 365(d)(10) of the Code and their legislative histories, there is no reason to believe that Section 365(d)(10) of the Code would not be given the same exact analysis as Section 365(d)(3) of the Code with respect to calculating a debtor's post-petition obligations for use of leased property. It is only a matter of time before courts begin applying this analysis to their interpretation of Section 365(d)(10) of the Code. See *Muma Servs.*, 279 B.R. at 487 (wherein the court held that Section 365(d)(10) of the Code requires the

debtor to fully and timely pay any billing statement that comes due after the 60th day of the bankruptcy case and prior to rejection/assumption of the lease and adopted the billing approach); see also *Furley's Transp.*, 263 B.R. at 740; *Ernest Home Ctr.*, 209 B.R. at 965 (discussing the similarities between the statutory language and

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legislative intent behind Sections 365(d)(3) and (d)(10) of the Code.) As the *Muma* court states "[g]iven the similarities between section 365(d)(3) and section 365(d)(10), we conclude that the Third Circuit would construe section 365(d)(10) in the same manner." *Muma Servs.*, 279 B.R. at 487.

## CONCLUSION

In conclusion, both Section 365(d)(3) and Section 365(d)(10) of the Code were similarly enacted to grant lessors an inherent priority status by requiring the debtor to make full and timely payment of post-petition rent. These sections both effectively shift the responsibility to the debtor to make the required payments under a lease without the lessor having to make a motion. Thus, it would seem that courts eventually will be applying similar rules in analyzing the post-petition obligations due under equipment leases, just as they have in real property (as noted above, the trend has already begun). We would contend that on the whole, those who advocate for application of the proration rule are sure to receive a fair and equitable result in the majority of the cases as opposed to the occasional windfall promoted by the billing date approach. Which approach courts will uniformly begin to adopt and apply to equipment leases, remains to be seen.



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