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# Rejection of Nonresidential Leases of Real Property in Bankruptcy: What Happens to the Mortgagee's Security Interest?

William E. Winfield\*

## I. INTRODUCTION

One of the most powerful tools accorded to debtors in possession or to trustees in bankruptcy is the power to assume or reject executory contracts or unexpired leases. Section 365 of the Bankruptcy Code,<sup>1</sup> which carries over similar provisions from the former Bankruptcy Act,<sup>2</sup> gives debtors in possession, or the debtor's trustee, the power to "assume or reject any executory contract or unexpired lease of the debtor."<sup>3</sup>

In 1984, Congress substantially rewrote section 365. The major focus of these changes was to address dissatisfaction with the fact that unexpired leases, primarily in shopping centers, remained unresolved for long periods of time.<sup>4</sup> Congress partly addressed these concerns

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Some of the research used for this article was done in connection with representation of a secured creditor with a security interest in a rejected lease. However, the author has not been compensated for the preparation of this article. The views reflected herein are those of the author alone and are not necessarily the views of Nordman, Cormany, Hair & Compton. Nordman, Cormany, Hair & Compton and the author have represented parties on various sides of the issues discussed herein. See Douglas, *Law Reviews and Full Disclosure*, 40 WASH. L. REV. 227, 232 (1965).

1. 11 U.S.C. § 365 (1988).

2. Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978).

3. 11 U.S.C. § 365(a) (1988); see Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 468 (1964) (noting that "[t]he power of rejection is a valuable weapon . . . in the armory of the trustee"); see also In re Booth, 19 Bankr. 53, 58 (Bankr. D. Utah 1982).

4. See R. AARON, BANKRUPTCY LAW FUNDAMENTALS § 9.05[1], at 9-64.4 (1989).

by creating a new category of leases—the nonresidential real property lease<sup>5</sup>—and imposing a sixty-day deadline for assuming or rejecting nonresidential real property leases.<sup>6</sup> Failure to expressly assume or reject within sixty days results in automatic “rejection” of the lease.<sup>7</sup>

Although the Code,<sup>8</sup> the Act,<sup>9</sup> and many commentators<sup>10</sup> describe the effect of “rejection” as a breach, case law has not uniformly adopted this description as a definition.<sup>11</sup> As one commentator pointed out, courts have described the power to reject as a release,<sup>12</sup> repeal,<sup>13</sup> reconsideration,<sup>14</sup> discharge,<sup>15</sup> revocation,<sup>16</sup> repudiation,<sup>17</sup> alteration,<sup>18</sup> voiding,<sup>19</sup> cancellation,<sup>20</sup> or avoidance.<sup>21</sup>

Indeed, while substantial case law and commentary have been dedicated to (1) the time and procedure for rejecting or assuming leases,<sup>22</sup> (2) which leases can be assumed,<sup>23</sup> and (3) the respective rights of lessors and lessees,<sup>24</sup> relatively little has been written on the

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5. 11 U.S.C. § 365(d)(4) (1988).

6. *Id.*

7. *Id.*

8. *Id.* § 502(g) (1988).

9. In 1938, the Chandler Act amended the Bankruptcy Act, adding sections 70b and 63c. Section 63c provided: “Notwithstanding any State law to the contrary, the rejection of an executory contract or unexpired lease, as provided in this Act, shall constitute a breach of such contract or lease as of the date of filing of the petition.” Epstein, *Executory Contracts in Leases*, in ALI-ABA, THE WILLIAMSBURG CONFERENCE ON BANKRUPTCY: CRITIQUE OF THE FIRST DECADE UNDER THE BANKRUPTCY CODE AND AGENDA FOR REFORM 74-75 (1988).

10. See, e.g., G. TREISTER, J. TROST, L. FORMAN, K. KLEE & R. LEVIN, FUNDAMENTALS OF BANKRUPTCY LAW § 5.04(f), at 251-53 (2d ed. 1988).

11. See Epstein, *supra* note 9, at 80-81.

12. Andrew, *Executory Contracts in Bankruptcy: Understanding “Rejection,”* 59 U. COLO. L. REV. 845, 847 (1988) (citing *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 528 (1984)).

13. *Id.* (citing *In re Stable Mews Assocs.*, 41 Bankr. 594, 596 (Bankr. S.D.N.Y. 1984)).

14. *Id.* (citing *In re Cleve*, 3 Bankr. Ct. Dec. (CRR) 1217, 1220 (Bankr. S.D. Cal. 1977)).

15. *Id.* (citing *In re KMMCO, Inc.*, 40 Bankr. 976, 977 (E.D. Mich. 1984)).

16. *Id.* (citing *KMMCO, Inc.*, 40 Bankr. at 978)).

17. *Id.* (citing *In re Chicago, Rock Island & Pac. R.R.*, 604 F.2d 1002, 1003-04 (7th Cir. 1979)).

18. *Id.* (citing *In re TransAmerican Natural Gas Corp.*, 79 Bankr. 663, 666 (Bankr. S.D. Tex. 1987)).

19. *Id.* (citing *In re Silver*, 26 Bankr. 526, 530 (Bankr. E.D. Pa. 1983) (noting that “any executory contract to which a debtor in bankruptcy is a party is a voidable contract by virtue of section 365(a) . . .”).

20. *Id.* (citing *In re Allain*, 59 Bankr. 107, 108 (Bankr. W.D. La. 1986)).

21. *Id.* (citing *In re Cherry*, 78 Bankr. 65, 69 (Bankr. E.D. Pa. 1987)).

22. See, e.g., *Assumption of Nonresidential Real Property Leases: Section 365(d)(4)*, 4 BANKR. DEV. J. 79 (1987).

23. See, e.g., *Executory Contracts and Unexpired Leases: Section 365*, 3 BANKR. DEV. J. 217 (1986).

24. See, e.g., *Executory Contracts and Unexpired Leases: Right to Adequate Protection Prior to Assumption or Rejection*, 4 BANKR. DEV. J. 421 (1987).

effect of lease rejection on the interests of leasehold mortgagees. This issue frequently arises in commercial leases in which the lessor or lessee (or both) grants a security interest in its interest in the lease to a lender or mortgagee, and one of the parties to the lease (*i.e.*, the lessor or lessee) files bankruptcy and rejects the lease.

Four general factual situations exist in which lease rejection under section 365 could affect a mortgagee's security interest: (1) rejection by a lessor where the lessor has granted a security interest in the lease; (2) rejection by a lessor where the lessee has granted a security interest in the lease; (3) rejection by a lessee where the lessee has granted a security interest in the lease; and (4) rejection by a lessee where the lessor has granted a security interest in the lease.

An interpretation that rejection is a "termination" could wipe out the security of a lender-creditor, while an interpretation that rejection is a "breach" could accelerate the debt, leaving the security intact. The Bankruptcy Code has built-in protections for lessees and lessors of rejected leases,<sup>25</sup> but no statutory provision presently protects secured creditors. The few published cases addressing the effect of lease rejection on mortgagees are deeply divided.<sup>26</sup> This article will analyze cases dealing with the effect of lease rejection on mortgagees under section 365, discuss drafting considerations to protect a mortgagee's interest from the perils of rejection, and suggest a resolution to the conflicting case law on the subject.

## II. EFFECT OF LEASE REJECTION UNDER SECTION 365 OF THE BANKRUPTCY CODE

Section 365(a) of the Bankruptcy Code provides that, with some specific exceptions, "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."<sup>27</sup> Section 365(d)(4) provides that when the debtor is the lessee, the trustee (or the debtor in possession) must assume or reject an unexpired lease of nonresidential real property within sixty days after the date of the petition's filing or the "lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor."<sup>28</sup> Sections 365(g) and 502(g) state that the rejection is to be treated as a prepetition breach.<sup>29</sup>

25. See 11 U.S.C. § 365(d), (g), (h) (1988).

26. See Epstein, *supra* note 9, at 80-81; see also *infra* notes 194-95.

27. 11 U.S.C. § 365(a) (1988).

28. *Id.* § 365(d)(4).

29. See *id.* §§ 365(g), 502(g).

The literal language of section 365(h), on the other hand, provides that a lessee may treat a lease rejected by a lessor-debtor as terminated "where the disaffirmance by the trustee amounts to such a breach as would entitle the lessee . . . to treat such lease . . . as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements the lessee . . . has made with other parties . . . ."30 Section 365(h) also provides that a lessee under a lease rejected by a lessor-debtor alternatively "may remain in possession of the leasehold . . . for the balance of such term and for any renewal or extension of such term that is enforceable by such lease . . . under nonbankruptcy law."<sup>31</sup> The language of all these sections could provide the basis for arguing that rejection is tantamount to either a breach or termination.

In *Bank of Marin v. England*,<sup>32</sup> Justice Douglas noted that literal application of section 70 of the former Bankruptcy Act—the predecessor of section 365 of the Bankruptcy Code—could compel inconsistent and inequitable results. Holding that the terms of the statute did not compel such a result, Justice Douglas stated for the Court: "Yet we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."<sup>33</sup> Section 365 of the new Bankruptcy Code is sufficiently complex that consideration of congressional intent is warranted to avoid inequitable and inconsistent conclusions based upon a narrow examination of the statute's language.<sup>34</sup> Also, when considering cases on the effect of lease rejection, it is important to note the context of each case and the equitable principles affecting the decision.

A recent article on executory contracts offers valuable insight into the meaning of rejection.<sup>35</sup> Rejection of a contract in bankruptcy is not a "revocation or repudiation or cancellation," but "simply a bankruptcy estate's decision not to assume, because the contract or lease does not represent a favorable or appropriate investment of the estate's resources."<sup>36</sup> Thus, the substantive rights of the parties to the contract or lease are not changed. Rejection means only that the bankruptcy estate will not become a party to the contract or lease,<sup>37</sup> and it "leaves the non-debtor in the same position as all others who

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30. *Id.* § 365(h)(1).

31. *Id.*

32. 385 U.S. 99 (1966).

33. *Id.* at 103.

34. See *In re Upland/Euclid, Ltd.*, 56 Bankr. 250, 259 (Bankr. 9th Cir. 1985) (Volinn, J., dissenting).

35. Andrew, *supra* note 12.

36. *Id.* at 848.

37. *Id.*

have dealt with the debtor . . . ."<sup>38</sup> The debtor is presumed to have "breached," providing the basis for a claim.<sup>39</sup> This understanding would obviate much litigation over the respective rights of parties and would help reconcile the apparent conflict found in cases interpreting the effect of rejection.

### III. EFFECT OF LEASE REJECTION BY THE LESSOR-DEBTOR

Numerous bankruptcy court decisions and commentaries discuss the effect of rejection of a lease by a lessor-debtor under section 365 of the Bankruptcy Code.<sup>40</sup> Most of these decisions deal with the impact of rejection on the innocent lessee.

A debtor assuming or rejecting a lease must assume or reject the entire lease. The debtor may not modify the lease or assume in part and reject in part.<sup>41</sup> It is well established that rejection of a lease by a lessor-debtor under section 365 does not affect the lessee's interest in the lease.<sup>42</sup> Under section 365(h)(1), a lessee can choose to treat a lease rejected by a lessor-debtor as terminated, or the lessee may remain in possession for the term of the lease and any renewals or extensions available under the terms of the lease.<sup>43</sup> In either case, the lessee can seek damages for breach of the lease resulting from rejection.

38. *Id.* at 931.

39. *Id.*

40. See, e.g., *In re LHD Realty Corp.*, 20 Bankr. 717, 719 (Bankr. S.D. Ind. 1982) (holding that rejection by the lessor-debtor did not terminate the lease so as to divest the lessee of his estate in the property); Epstein, *supra* note 9.

41. See *In re TSW Stores of Nanuet*, 34 Bankr. 299, 304 (Bankr. S.D.N.Y. 1983). In *TSW Stores*, the court noted that the trustee or debtor in possession must take a contract cum onere, or subject to all terms and conditions. *Id.* (citing *Thompson v. Texas Mexican Ry. Co.*, 328 U.S. 134, 141 (1946)).

42. See *In re Upland/Euclid, Ltd.*, 56 Bankr. 250, 252 (Bankr. 9th Cir. 1985) (noting that where lessor-debtor rejects a real property lease and lessee chooses to remain in possession, the debtor may stop the flow of funds and services, *but the debtor cannot take away the lessee's possessory interest in the leased property* and the debtor has no right to alter the rent stated in the lease); *In re Stable Mews Assocs.*, 35 Bankr. 603, 605 (Bankr. S.D.N.Y. 1983) (holding that a landlord-debtor cannot reject a lease for sole purpose of increasing rent to existing tenants, and that rent owed by tenant to landlord-debtor should remain as stated in the lease); *LHD Realty*, 20 Bankr. at 719 (holding that congressional intent was to "afford the debtor the benefit of rejecting an undesirable lease while at the same time protecting the property rights of the lessee" and that rejection does not divest the lessee of its interest in the property); *In re 1438 Meridian Place, N.W., Inc.*, 11 Bankr. 352, 352-53 (Bankr. D.D.C. 1981) (holding that rejection of the lease by the lessor-debtor in possession extinguished the lessor's obligation but did not bind lessees to surrender possession, and that a lessee's substantive rights of possession could not be determined without a plenary hearing on the issues).

43. 11 U.S.C. § 365(h)(1) (1988).

tion. The import of these cases is that rejection of a lease by a lessor-debtor under section 365 does not result in the eviction of the lessee.

Courts also have held that rejection of a lease by a lessor-debtor under section 365 merely places the lessee in a position to seek state law remedies.<sup>44</sup> The argument can be made that, just as summary rejection of the lease under section 365 does not affect a lessee's possessory interest in the leasehold, rejection of a lease under section 365 does not diminish the rights of secured parties. A secured party retains rights under the rejected contract,<sup>45</sup> and rejection of a lease under section 365 does not cancel contractual obligations between the parties.<sup>46</sup> In the absence of enforceable contractual provisions to the contrary, a lessee-nondebtor still would have the option under section 365(h)(2) to treat the lease as terminated, which could eliminate the secured party's rights in the lease.

If a lessor's rejection of a lease does not destroy the property interest of a lessee in the leasehold unless the lessee elects to terminate, a question arises as to whether the rejection of a lease by a lessor-debtor should destroy the security interest of a creditor in the leasehold. Commentators interpreting section 365 have argued that the rejection of a lease under section 365 and the concomitant balancing between a lessor-debtor's rights and a tenant's rights "should not frustrate the reasonable commercial expectations of the mortgagee . . . . [T]he most cogent legal reasoning and venerable principles of equity vindicate the mortgagee's priority . . . ."<sup>47</sup>

Two scenarios should be considered to highlight the potential inequity that can inure to mortgagees from a mechanical reading of section 365; they involve the lessee's mortgagee and the lessor-debtor's mortgagee. There are no cases on point dealing with the rights of either the lessee's mortgagee or the lessor-debtor's mortgagee. In either case, the lessee, not the lessor-debtor, owes a debt to the lessee's mortgagee. The lessee's mortgagee can still look to the lessee

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44. See *In re Adams*, 65 Bankr. 646, 649 (Bankr. E.D. Pa. 1986) (holding that rejection of a lease under section 365(d)(4), even if followed by a granting of relief from the automatic stay, merely places the creditor in a position to obtain possession of the premises under state law); see also *In re Garfinkle*, 577 F.2d 901, 904 (5th Cir. 1978) (noting that rejection of an unexpired lease does not preclude collection of payments for fair rental value of use and occupancy, and that if the tenant is injured by rejection of lease, the tenant becomes a creditor of the bankruptcy estate).

45. See *In re Pendleton*, 40 Bankr. 306, 311 (Bankr. W.D. Ky. 1984) (finding that rejection of an executory contract for sales of milk by the debtor in possession did not abrogate the secured creditor's assigned right in proceeds from milk sales).

46. See *In re Schnabel*, 612 F.2d 315, 317 (7th Cir. 1980) (holding that a tenant is still obligated to pay fair rental value of use and occupancy of leased premises); see also *LHD Realty*, 20 Bankr. at 719 (noting that rejection of a lease simply cancels the covenants requiring the debtor's future performance).

47. Alces, *Unexpired Leases in Bankruptcy: Rights of the Affected Mortgagee*, 35 U. FLA. L. REV. 656, 681 (1983).

for payment of its debt and for additional security. The lessee's mortgagee also may have contract rights<sup>48</sup> from its loan agreement which may allow the mortgagee some input in, or control of, the lessee's election to treat the lease as terminated or to remain in possession. In addition, the lessee's mortgagee may have a contract right to take possession of the leasehold and gain an interest in the damage claim against the lessor-debtor for breach of the lease.

If the lessee does not elect to treat the lease as terminated, the lessee's mortgagee's security interest in the lease should continue. It would be inequitable to allow the lessor-debtor to convert the lessee's mortgagee's secured claim into an unsecured claim by rejection of the lease.

The lessor-debtor's mortgagee's position also depends on whether the lessee elects to treat the lease as terminated or to remain in possession. Although there are no cases on point, the lessor-debtor's mortgagee's security interest in the lease might be considered the same as the lessee's right to possession, and thus might survive the rejection by the lessor-debtor.

Under this scenario, if the lessor-debtor rejected the lease and the lessee elected to treat the lease as terminated, the lessor's mortgagee's security interest in the lease would be extinguished. If the lessee elected to remain in possession, the lessor-debtor's mortgagee would have a security interest in the rents if the lease survived rejection by the lessor-debtor. It is not clear whether the lessor-debtor's mortgagee would have any priority regarding the rents if the court determined that the lease and, thus, its security interest were extinguished by the rejection. It also would be inequitable to allow the lessor-debtor to convert the lessor-debtor's mortgagee's secured claim into an unsecured claim by rejection of the lease when the lessee elects to remain in possession and does not treat the lease as terminated.

#### IV. EFFECT OF LEASE REJECTION BY THE LESSEE-DEBTOR

In the case of lease rejection by a lessee-debtor, one must consider the rights of the lessor, the lessor's mortgagee secured by the lease, and the lessee-debtor's mortgagee. Although no published cases presently exist dealing with the rights of the lessor's mortgagee, the lessor's mortgagee may have a security interest in the lessor's claim against the lessee-debtor if the lessor's mortgagee's contract so pro-

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48. See *infra* notes 72-99 and accompanying text.



vides.<sup>49</sup> The rights of the lessor and the lessee-debtor's mortgagee are discussed in the following cases.

#### A. *Garfinkle*

The first reported case interpreting the effect of lease rejection by a lessee-debtor on the rights of mortgagees was a case interpreting section 70 of the Bankruptcy Act—the predecessor to section 365 of the Bankruptcy Code.<sup>50</sup> In *In re Garfinkle*,<sup>51</sup> the court expressly considered the effect of lease rejection by a lessee-debtor and a lessor-debtor on the rights of the lessee-debtor's mortgagee. The trustee was a “split-personality” trustee in that the debtor was both the lessor and lessee under the subject lease and had a debt secured by the lessee's interest in the lease.<sup>52</sup> The court noted that the authorities agree that “rejection by the trustee of a bankrupt lessee, does not in and of itself terminate the lease.”<sup>53</sup>

The *Garfinkle* court held that the same rule applies to protect the rights of mortgagees. The court “agree[d] that the Trustee's rejection of the lease for Barbara Garfinkle, lessee, did not destroy the leasehold estate. That action *merely placed the leasehold outside the bankruptcy administration* without destroying the underlying estate and, therefore, the mortgage of Morris Landsburgh [lessee's mortgage].”<sup>54</sup> Subsequent cases have adopted this language,<sup>55</sup> as well as the equitable approach of *Garfinkle*.<sup>56</sup>

The *Garfinkle* court further stated that “[p]roperly used, the terms assumption and rejection refer to the bankruptcy trustee's decision to administer or refuse to administer assets of the bankrupt.”<sup>57</sup> The same rationale could logically pertain to application of section 365 in the case of mortgagees.

In *Garfinkle*, the trustee acting for the lessor-debtor also attempted to terminate the lease through the exercise of a default clause.<sup>58</sup> The court considered the mortgagee's argument that it was inequitable to allow the trustee acting for the lessor-debtor to take

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49. See *id.* for a discussion of contract drafting considerations.

50. See *supra* note 9.

51. 577 F.2d 901 (5th Cir. 1978).

52. *Id.* at 903.

53. *Id.* at 904.

54. *Id.* (emphasis added).

55. See, e.g., *In re Delta Motor Hotel of Syracuse*, 10 Bankr. 585, 601 (Bankr. N.D.N.Y. 1981) (applied equitable principles for the benefit of creditors and the public interest).

56. See, e.g., *In re Curio Shoppes, Inc.*, 55 Bankr. 148, 153-55 (Bankr. D. Conn. 1985) (holding that resort to equity was proper to prevent forfeiture of lease when literal enforcement of statute would frustrate purposes of reorganization); see also Epstein, *supra* note 9, at 81 (discussing cases that follow and decline to follow *Garfinkle*).

57. *Garfinkle*, 577 F.2d at 905.

58. *Id.* at 904.

advantage of a situation created by the lessee-debtor.<sup>59</sup> The court also considered the counterargument that the mortgagee should not be placed in a better position just "because the lessor and lessee [were] the same person."<sup>60</sup>

The court observed that the mortgagee had the opportunity to protect himself by including a "pick-up lease" clause in the lease agreement.<sup>61</sup> As the *Garfinkle* court noted, creditors of the bankruptcy estate usually are better served by the continued existence of a leasehold mortgage, especially if the lessee's mortgagee is willing to contribute money to the bankruptcy estate as he does by picking up the lease.<sup>62</sup> The court stated that "[i]n a bankruptcy context the justification for the continued existence of the leasehold mortgage is stronger if the mortgagee is willing to 'put something in the pot' for the rest of the creditors."<sup>63</sup>

Since resolution of the issue regarding exercise of the default clause in *Garfinkle* involved a factual determination concerning the equities, the case was remanded for further proceedings.<sup>64</sup>

### B. *Hawaii Dimensions*

One of the first Code cases to squarely address the issue of the effect of lease rejection by a lessee-debtor on mortgagees was *In re Hawaii Dimensions*.<sup>65</sup> Although its analysis is sparse, *Hawaii Dimensions* specifically addresses the effect of lease rejection by a lessee-debtor.

*Hawaii Dimensions* involved a Chapter 11 lessee-debtor who rejected a commercial lease a few days before closing its doors and converting to Chapter 7. The lessee-debtor owed \$100,000 in rent to the lessor. The debtor also owed a debt secured by the lease to Commercial Finance, Ltd., a debtor in a separate Chapter 11 proceeding. Commercial Finance opposed the court's order allowing rejection of the lease.<sup>66</sup> Bankruptcy Judge Jon J. Chinen was left to decide, in essence, who would receive the security—the landlord or the secured creditor. Judge Chinen noted that "Commercial [the lessee's mortga-

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59. *Id.*

60. *Id.* at 905.

61. *Id.*

62. *Id.* at 905-06.

63. *Id.* at 906.

64. *Id.*

65. 39 Bankr. 606 (Bankr. D. Haw. 1984), *aff'd*, 47 Bankr. 425 (D. Haw. 1985).

66. *Id.* at 606-07.

gee] had protective measures available to it by way of the mortgage protection clause in its lease, which it did not exercise.”<sup>67</sup> Judge Chinen ruled in favor of the landlord, summarily concluding that:

Where the debtor-lessee in possession rejects the lease, it is clear that the debtor no longer desires to remain in possession but rather desires the cancellation or termination of the lease. The “protection” then afforded the other party to the lease, the nondebtor lessor, as stated in § 502(b)(7) is to claim “damages resulting from the termination of a lease of real property . . . .”

The interrelationship of § 365(h) and § 502(b)(7), the former referring to rejection and the latter to termination, further reveal the intent of Congress that the effect of a debtor lessee's rejection is the termination of the landlord-tenant relationship. The fact that Congress did not include a statutory provision to the contrary is further support for the proposition that rejection of a lease constitutes termination.

Although courts have dealt with various aspects of rejection of a lease, few, if any have discussed the effect. Those which have, are in accord that rejection constitutes termination. In *In re O.P.M. Leasing Services, Ltd.*, . . . although the court was dealing with a setoff issue, the court clearly treated the rejection as termination of the lease.<sup>68</sup>

The “interrelationship of § 365(h) and § 502(b)” does not support Judge Chinen's conclusion for two reasons. First, section 365(h), which allows a rejected lease to be treated as terminated, does not apply to the facts of *Hawaii Dimensions* because it applies only to lessor-debtors, and *Hawaii Dimensions* did not involve a lessor-debtor. Second, even if *Hawaii Dimensions* did involve a lessor-debtor, Judge Chinen's conclusion conflicts with both the legislative history for the 1984 amendment to section 365, which suggests that a mortgagee's interest is not terminated,<sup>69</sup> and the pre-Code case law that protects mortgagees even in the absence of mortgage protection clauses.<sup>70</sup>

The *In re O.P.M. Leasing Services*<sup>71</sup> case cited in *Hawaii Dimensions* did not involve the rights of a mortgagee. Rather, *O.P.M. Leasing* dealt with the issue of setoffs and concluded that post-petition rent for a lease rejected under section 365 could not be set off against another post-petition obligation because a lease rejection under section 365 is deemed terminated immediately prior to the filing of the bankruptcy petition.<sup>72</sup> “A close reading of *O.P.M. Leasing* . . . indicates that Judge Lifland was referring to the damage claims arising from the deemed breach of lease under [section] 365(g)(1) and not the actual termination of the lease.”<sup>73</sup>

Commercial Finance, the lessee-debtor's mortgagee, appealed the

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67. *Id.* at 608.

68. *Id.* (emphasis added) (citation omitted).

69. See *infra* note 180.

70. See *supra* note 51 and *infra* note 181.

71. 30 Bankr. 642 (Bankr. S.D.N.Y. 1983).

72. *Id.* at 650-51.

73. *In re Storage Technology Corp.*, 53 Bankr. 471, 474 (Bankr. D. Colo. 1985).

trial court's decision in *Hawaii Dimensions*.<sup>74</sup> On appeal, the district court upheld the bankruptcy court's decision.<sup>75</sup> District Court Judge Samuel King compared the effect of lease rejection by a lessee to lease rejection by a lessor, in which the lessee has the option to remain in possession, and concluded that the result of rejection is termination of the lease.<sup>76</sup> Judge King did not consider the underlying legal rationale for preserving the lessee's possessory interests, as discussed in *In re 1438 Meridian Place, N.W., Inc.*<sup>77</sup>

Judge King distinguished *Garfinkle* because it was an Act case, and because it was a case in which the only effect of rejection was termination of the mortgage—as opposed to providing a benefit to the estate and allowing a lessor to regain possession.<sup>78</sup> It is significant that the district court's decision to uphold *Hawaii Dimensions* was apparently based in part on equitable considerations.

### C. *Southwest Aircraft*

A subsequent case sometimes cited<sup>79</sup> for the proposition that rejection terminates the lease is the opinion by Judge Russell in *In re Southwest Aircraft Services*,<sup>80</sup> even though it did not involve or address the issue of a secured creditor's interest in the leasehold. In *Southwest Aircraft*, the lessee-debtor filed a motion to extend the time to assume or reject a lease under section 365(d)(4). The issue was whether section 365 permits the court to extend the time for a debtor in possession to assume or reject a lease under section 365(d)(4), where the motion was filed within sixty days but not heard until after sixty days. Judge Russell ruled that a hearing *and* decision must occur within sixty days or the lease will be deemed rejected.<sup>81</sup>

The debtor filed a motion for reconsideration, arguing that rejection of the lease resulted in an abandonment of property to the debtor, rather than a termination of the lease. Judge Russell rejected this argument and ruled that "it is clear Congress intended

74. *In re Hawaii Dimensions*, 47 Bankr. 425 (D. Haw. 1985).

75. *Id.* at 428.

76. *Id.* at 427-28.

77. 11 Bankr. 352 (Bankr. D.D.C. 1981).

78. *Hawaii Dimensions*, 47 Bankr. at 428.

79. See *In re Bernard*, 69 Bankr. 13, 15 (Bankr. D. Haw. 1986).

80. 53 Bankr. 805 (Bankr. C.D. Cal. 1985), *aff'd*, 66 Bankr. 121 (Bankr. 9th Cir. 1986), *rev'd*, 831 F.2d 848 (9th Cir. 1987).

81. *Id.* at 809.

that rejecting a lease terminates the lease.”<sup>82</sup> In support of this ruling, Judge Russell referred to just two cases—*Hawaii Dimensions* and *In re Mead*.<sup>83</sup>

*Southwest Aircraft* did not address the impact of lease rejections on holders of a security interest, nor did it consider the *Garfinkle* decision. The totality of *Southwest Aircraft*'s analysis of lease rejection is contained in the above-quoted sentence and its citation of the two supporting cases.<sup>84</sup> *In re Mead*<sup>85</sup> did not involve the impact of lease rejection on a security interest. In fact, *Mead* does not analyze the issue of termination of a lease, as opposed to rejection, and does not even consider the effect of a lease rejection. The case merely states: “The court must deem the lease rejected and terminated by operation of law. The landlord’s application for termination of the lease will be granted.”<sup>86</sup>

After the trial court decision in *Southwest Aircraft*, the debtors appealed to the Bankruptcy Appellate Panel for the Ninth Circuit, which upheld Judge Russell’s ruling that (1) the decision regarding acceptance or rejection of the lease must be made within the sixty-day time limit, and (2) rejection of a lease under section 365(d)(4) results in termination of a lease.<sup>87</sup> Without analysis or citations, the panel summarily concluded: “To us, ‘rejection’ normally implies termination of the debtor’s interest. The statute is even more explicit here, however, because it adds that if the lease is deemed rejected ‘the trustee shall immediately surrender such nonresidential real property to the lessor.’ ”<sup>88</sup>

The Bankruptcy Appellate Panel’s decision was overruled by the Ninth Circuit, which held that (1) the bankruptcy court retained authority to consider a debtor’s motion even though the sixty-day period had expired, and (2) the debtor’s failure to make proper rental payments during the sixty-day period did not require the bankruptcy court to deem the lease rejected.<sup>89</sup> Because the Ninth Circuit did not consider the effect of a lease rejection under section 365, *Southwest Aircraft* has come to stand, in part, for the proposition that rejection of a lease is tantamount to termination, even though the holdings on the issue are dicta.

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82. *Id.* at 810.

83. *Id.*

84. See *supra* notes 82-83 and accompanying text.

85. 28 Bankr. 1000 (E.D. Pa. 1983).

86. *Id.* at 1002.

87. *In re Southwest Aircraft Services*, 66 Bankr. 121, 123 (Bankr. 9th Cir. 1986), *rev’d*, 831 F.2d 848 (9th Cir. 1987).

88. *Id.* (quoting 11 U.S.C. § 365(d)(4) (Supp. IV 1986)).

89. *In re Southwest Aircraft Services*, 831 F.2d 848, 854 (9th Cir. 1987).

#### D. *Storage Technology*

The *Hawaii Dimensions* case was questioned in *In re Storage Technology Corp.*<sup>90</sup> Sobrato Development Companies (Sobrato) was the lessor-owner of commercial real property located in California. Storage Technology Corporation (STC) was the debtor and lessee under a master lease with Sobrato. STC subleased to National Semiconductor Corporation (NSC). STC subsequently filed for bankruptcy. STC and Sobrato made a formal settlement agreement, which was approved by the court after notice to all creditors, providing that STC would assume the subleases with NSC and assign them to Sobrato, and then reject the master lease leaving NSC in direct contractual privity with Sobrato. In exchange, Sobrato agreed to reduce its claim against STC.<sup>91</sup>

NSC filed a motion for summary judgment, arguing that (1) rejection of the master lease terminated the subleases; (2) rejection of the master lease would create a merger terminating the subleases under California law; and (3) the settlement between STC and SDC was "an improper partial assumption and partial rejection of the master lease."<sup>92</sup>

The court determined that the threshold issue was the effect of rejection of the master lease as contemplated by the original settlement. After a thorough analysis of *Hawaii Dimensions*, *O.P.M. Leasing*, and *Garfinkle*, the court followed the *Garfinkle* decision and stated: "[T]he apparently conflicting cases regarding the effect of rejection of a lease can be reconciled with one word: equity. In both *Garfinkle* and *Hawaii Dimensions*, the potential for inequitable results appears to have a large impact on the ultimate result reached."<sup>93</sup>

The *Storage Technology* court went on to hold that a legal distinction exists between the terms "breach" and "termination":

Under the law of the [S]tate of California, and virtually every other state, a breach of a real property lease is not synonymous with termination of the lease. . . .

The drafters of § 365 apparently knew the difference between breach and termination. Where the legal concept of termination is appropriate that term is used. . . .

A review of the overall structure of § 365 also indicates that the words "breach" and "termination" were intended to have different meanings. Under

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90. 53 Bankr. 471 (Bankr. D. Colo. 1985).

91. *Id.* at 472.

92. *Id.* at 473.

93. *Id.* at 474.

subsection (a) the trustee, subject to court approval, may *reject* any lease or executory contract. The trustee's unqualified right to reject leases and executory contracts is limited by subsections (h) and (i) which limit the trustee's right to *terminate* all such leases or contracts.<sup>94</sup>

The *Storage Technology* court also noted that the authors of *Collier on Bankruptcy* recognized the same distinction when stating:

The touchstone of a claim under the 1978 legislation is termination of a lease of real property rather than claims for anticipatory breach of contracts, damages for injury resulting from rejections, or damages under a covenant continued in such lease. Whether, in fact, a lease has terminated is a matter to be determined by the court, for not all events result in termination within the meaning of section 502(b)(6).<sup>95</sup>

In light of the foregoing, the court in *Storage Technology* concluded "that rejection of a lease does not have the conclusive effect of terminating the lease. At a minimum, a nondebtor lessor has the option of treating a lease which has been rejected as not having been terminated."<sup>96</sup>

#### E. *Picnic 'N Chicken*

The next case to deal with this issue was *In re Picnic 'N Chicken*.<sup>97</sup> In *Picnic 'N Chicken*, the lessee-debtor rejected a commercial lease. The debtor was the fee owner of the land and the lessee of the building and improvements on the land. The debtor had sold the buildings and improvements to Blue Barn Associates and had leased them back as part of a sale/leaseback arrangement. The purchaser did not lease the land from the debtor, but the lease for the building and improvements provided that in the event of a default by the debtor, the debtor would lease the land to the purchaser on a triple-net basis for the unexpired term of the building lease. The debtor rejected the building lease, arguing that it was no longer bound to lease the land to the owner of the building as the lease was terminated by its rejection. Blue Barn argued that rejection did not relieve the debtor from its obligation to lease the land to it, that the sale/leaseback transaction was really a loan/security transaction, and that it should have an equitable lien on the land.<sup>98</sup> Bankruptcy Judge Louise DeCarl Malugen held that:

[A] rejection under § 365(g) is a breach of lease. California law provides that a breach of a lease is not synonymous with the termination of that lease. Where a California lease so provides, California Civil Code § 1951.4 permits a lessor to treat the lease as continuing in effect even though its lessee has breached the lease and abandoned the property. Therefore, under California law there is clearly a distinction drawn between a breach of the lease and the termination of it.

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94. *Id.* at 474-75 (emphasis in original) (citations omitted).

95. *Id.* at 475 (quoting COLLIER ON BANKRUPTCY ¶ 502.02, at 502-60 (15th ed. 1984)).

96. *Id.*

97. 58 Bankr. 523 (Bankr. S.D. Cal. 1986).

98. *Id.* at 524-25.

Likewise, it appears that the drafters of § 365 were aware of the difference between a "breach" and a "termination." For example, in § 365(h)(1) and (i)(1), although the trustee has a right to reject lease and executory contracts, the lessees, time share interest purchasers and real property purchasers in possession are accorded the option of treating the rejected agreements as terminated or remaining in possession. Therefore, at least with respect to those sections, it is clear that the drafters were aware that a rejection of a lease or executory contract did not result necessarily in the termination of that agreement.<sup>99</sup>

Judge Malugen noted the paucity of cases on the issue and stated that "the better-reasoned decisions hold that rejection by the debtor does not necessarily terminate a lease agreement for all purposes."<sup>100</sup> Judge Malugen further noted that "[a]lthough the [c]ourt's decision [in *Garfinkle*] was one construing the effect of rejection under § 70(b) of the Bankruptcy Act . . . it does not appear that the [c]ourt's analysis would have been significantly different under the present § 365."<sup>101</sup>

After considering the *Hawaii Dimensions* case, Judge Malugen adopted the ruling of *Storage Technology*, which reconciled the opposite conclusions of *Hawaii Dimensions* and *Garfinkle* by resort to equity.<sup>102</sup> Judge Malugen held that rejection of the lease for the building did not terminate it and the clause requiring the debtor to lease the land to the building owner was enforceable.<sup>103</sup> Judge Malugen also concluded that the sale/leaseback agreement was a disguised financing agreement and that the lessor was a secured creditor and should be treated as such.<sup>104</sup>

Two subsequent cases, *Societe Nationale Algerienne Pour La Recherche v. Distrigas Corp.*<sup>105</sup> and in *In re Blackburn*,<sup>106</sup> have followed the reasoning in *Picnic 'N Chicken*.

#### F. Bernard

In 1986, Judge Chinen again addressed the effect of lease rejection.

99. *Id.* at 525-26 (citation omitted).

100. *Id.* at 526 (citing *In re Garfinkle*, 577 F.2d 901 (5th Cir. 1978)).

101. *Id.*

102. *Id.*; see *supra* note 93 and accompanying text.

103. *Picnic 'N Chicken*, 58 Bankr. at 526, 530.

104. *Id.* at 527, 530.

105. 80 Bankr. 606, 608-09 (D. Mass. 1987) (noting that the narrow and precise construction of statutory language requires adoption of the *Picnic 'N Chicken* and *Storage Technology* position that lease rejection results in a breach rather than termination as suggested by *Hawaii Dimensions*).

106. 88 Bankr. 273, 276 (Bankr. S.D. Cal. 1988) (holding that rejection of a lease under section 365 does not result in termination of the lease).



In *In re Bernard*,<sup>107</sup> Judge Chinen signed an order indicating that a nonresidential sublease had been “rejected [by the lessee-debtor] and terminated.”<sup>108</sup> First Interstate Bank, which had a security interest in the lease as the lessee-debtor’s creditors, and the Mortgage Bankers Association of Hawaii filed a motion to amend Judge Chinen’s order, contending that the rights of the leasehold mortgagee and other third parties prevented a merger and termination of the leasehold.<sup>109</sup>

Judge Chinen rejected the arguments of the mortgage bankers and stated:

If it is determined that a lease is still in existence and subject to the leasehold mortgage even after the lease is deemed rejected, the lessor will continue to be frustrated in obtaining income from his commercial property. Unless the mortgage is paid, the mortgagee may foreclose on its mortgage and deprive the new lessee of the premises. Under such circumstances, the lessor may have difficulties finding a new tenant. This means that the lessor will be further frustrated and the purpose of [s]ection 365(d)(4) will not be achieved. Such result is contrary to the intent of Congress.<sup>110</sup>

Judge Chinen then cited the language of section 365(d)(4) requiring surrender of property to the lessor as evidence of congressional intent that a rejection of a lease is synonymous with termination of the lease.<sup>111</sup> Judge Chinen’s concern that the mortgage could make it difficult for the lessor to find a new tenant would be appropriate only if the leasehold mortgagee was arguing that its leasehold mortgage should continue to exist after the lessee’s obligations were extinguished. If the lessee’s obligations were not extinguished, the lessee or mortgagee would be required to pay the rent to the lessor and to find a new tenant.

Judge Chinen acknowledged that the only authority then existing to support his proposition was his own decision in *Hawaii Dimensions* and the *Southwest Aircraft* case, which had cited *Hawaii Dimensions*.<sup>112</sup> Then, curiously, Judge Chinen held that *Southwest Aircraft*, which had cited *Hawaii Dimensions* and *Mead*, had not relied upon those cases in reaching this ruling, but had relied instead upon the provision in section 365(d)(4) for immediate surrender of the premises to the lessor upon rejection of the lease.<sup>113</sup>

Apparently recognizing the existence of logical inconsistencies and inequities to mortgagees, Judge Chinen then suggested what the remedies for mortgagees should be:

Section 554(b) is a new section and affords the protective provision for a party in interest to protect its interest in the lease. If a mortgagee believes

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107. 69 Bankr. 13 (Bankr. D. Haw. 1986).

108. *Id.* at 13-14.

109. *Id.* at 14.

110. *Id.* at 14-15.

111. *Id.* at 15; see also *supra* note 28 and accompanying text.

112. *Bernard*, 69 Bankr. at 15.

113. *Id.*

that the debtor-lessee is unable or unwilling to assume the lease, that the lease is burdensome to the estate or that it is of inconsequential value and benefit to the estate, then the mortgagee should immediately request that the court order the trustee (debtor-in-possession) to abandon the leased premises. Once the leased premises is abandoned, § 365(d)(4) is no longer applicable to said leased premises.<sup>114</sup>

Judge Chinen's suggestion of abandonment of the lease under section 554 would result in a reversion to the debtor. The secured creditor then would be required to foreclose on the property. The only difference between abandonment under section 554 as proposed by *Bernard* and rejection as proposed by *Storage Technology* is that, presumably, a secured creditor would not need to wait sixty days before seeking to have the lease abandoned. Adherence to this suggestion would provide creditors with another avenue to litigate their interests during the first days of a bankruptcy. Moreover, the burden required to have a lease abandoned may be easier to meet than that necessary for a motion for relief from stay under section 362. However, Judge Chinen's summary procedure for rejecting contracts and terminating property interests is inconsistent with case law requiring a plenary hearing before any taking of property rights.<sup>115</sup>

Judge Chinen's opinion in *Bernard* evidences a mechanical application of the language in section 365 in order to reach an equitable result. Judge Chinen's mechanical application makes analysis of section 365 more complicated than it should be. The confusion in applying section 365 arises not only from the fact that the term "rejection" is evocative of other unrelated concepts, such as rescission, termination, and cancellation, but also from the confusion over just exactly who is doing the "rejecting." In order to properly apply section 365, one must understand that the party doing the rejecting is not the debtor per se, but rather the debtor in possession (or trustee) acting on behalf of the debtor's bankruptcy estate, a separate legal entity.

### G. *CM Systems*

In July 1988, the District Court for the Middle District of Florida, in *In re CM Systems*,<sup>116</sup> upheld a bankruptcy court's decision that a lessor's security interest in personal property collateral was not extinguished by a lessee's lease rejection. The debtor in *CM Systems*

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114. *Id.*

115. See, e.g., *In re 1438 Meridian Place, N.W., Inc.*, 11 Bankr. 352, 352-53 (Bankr. D.D.C. 1981).

116. 87 Bankr. 707 (Bankr. M.D. Fla. 1988).

leased three caterpillar off-highway trucks from the lessor. As part of the lease transaction, the debtor granted the lessor a security interest in any and all equipment "now or hereafter belonging to [the] debtor."<sup>117</sup> This security interest was properly perfected. Thereafter, the debtor acquired a Pettibone loader and the lessor's security interest attached to the loader. The debtor subsequently filed bankruptcy under Chapter 11 and rejected the equipment lease for the trucks. The trustee argued that any existing security interest was extinguished when the lease was rejected.<sup>118</sup> The court rejected the trustee's argument, holding that "it is clear that the rejection of a lease does not change a lessor's status from secured to unsecured."<sup>119</sup> Nevertheless, because the creditor's security interest was not actually in the lease, *CM Systems* arguably does not provide direct support for either the *Storage Technology* position or the *Hawaii Dimensions* view.

#### H. Giles

One of the most recent published decisions on the issue of lease rejection and its impact on secured creditors is *In re Giles Associates*.<sup>120</sup> In *Giles*, the debtor owned one half of an office building and leased the other half from the City of San Antonio. National Bank of Commerce (NBC) had a first trust deed on the half of the building owned by the debtor, as well as a lien on the debtor's leasehold from the city. After the debtor filed bankruptcy, NBC tendered several rental payments to the City which were accepted. Neither the debtor nor NBC took any action to assume the lease between the lessee-debtor and the City within the sixty-day period set forth by section 365(d)(4).<sup>121</sup>

The lessor, the City of San Antonio, then filed a motion to have the lease deemed rejected. NBC (the leasehold mortgagee) opposed the motion, arguing that rejection of the lease did not result in the termination of the leasehold in accordance with *Storage Technology*.<sup>122</sup> Simply stated, the competing equities in *Giles* were (1) the City's desire to relet the premises to another tenant, and (2) NBC's desire to protect its interest in the secondary collateral securing its loan.

R. Glen Ayers, Jr., Chief Judge of the Bankruptcy Court for the Western District of Texas, found it easy to reject the reasoning of *Storage Technology* "and other similar opinions cited by the bank,"<sup>123</sup>

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117. *Id.* at 708.

118. *Id.*

119. *Id.*

120. 92 Bankr. 695 (Bankr. W.D. Tex. 1988).

121. *Id.* at 696.

122. *Id.*

123. *Id.*

and to instead adopt the rationale, set forth in cases such as *Bernard*, that automatic rejection of a lease under section 365(d)(4) terminates the lease as to all parties, including creditors.<sup>124</sup> According to Judge Ayers, the issues were "really very simple and straightforward."<sup>125</sup> Although Judge Ayers considered the argument in *Storage Technology* that rejection of a lease under section 365(d)(4) is merely a breach of a lease, he firmly rejected that position: "This analysis would make some sense if the Bankruptcy Code at § 365(d)(4) and the legislative history of that section were not so very clear."<sup>126</sup>

Judge Ayers further stated: "[T]he statute is clear. Failure to act results in first rejection and next in an absolute obligation to surrender the premises . . . ."<sup>127</sup> Judge Ayers continued:

To say, as Judge Gueck [in *Storage Technology*], that the failure to act is merely a "breach" is not consistent with either that statute or its history. Why not? Because § 365(d)(4) deems that the trustee or debtor has, by failing to act, breached the lease and that the breach is so serious that immediate surrender is mandatory. The breach plus the surrender obligation can only be seen as termination of any of the trustee's or debtor's rights in the leasehold. Otherwise, the face of the statute and its history are meaningless.<sup>128</sup>

Judge Ayers did not discuss *Picnic 'N Chicken*<sup>129</sup> or *Societe Nationale*.<sup>130</sup> His analysis, like the analysis in *Hawaii Dimensions* and *Bernard*, fails to reconcile his position with the cases that hold the leasehold is not terminated by rejection.<sup>131</sup>

Judge Ayers next rejected the rationale of *Storage Technology* concerning the use of the terms "breach" and "rejection," opining that "Congress could have and should have used consistent terms, but Congressional inconsistency creates no presumptions."<sup>132</sup> He further stated that it was a "stretch" to conclude that the drafters of section 365 knew the difference between breach and termination.<sup>133</sup> Thus, Judge Ayers' opinion fails to accord deference to congressional intent which would lead one to assume, at a minimum, that the drafters

124. *Id.*

125. *Id.*

126. *Id.* at 697.

127. *Id.*

128. *Id.* at 697-98.

129. See *supra* notes 97-104 and accompanying text.

130. See *supra* note 105 and accompanying text.

131. See, e.g., *In re Adams*, 65 Bankr. 646, 648-49 (Bankr. E.D. Pa. 1986) (refusing to follow *Southwest Aircraft*); *In re 1438 Meridian Place, N.W., Inc.*, 11 Bankr. 352, 352 (Bankr. D.D.C. 1981) (noting that "[i]t is also well established that a rejection of a lease does not in any way affect a tenant's leasehold estate").

132. *Giles*, 92 Bankr. at 698.

133. *Id.*

knew that a distinction existed between the words "breach" and "termination."

Finally, Judge Ayers discounted the equity analysis of *Storage Technology*. To him, the equity done in *Storage Technology* was "not permissible" and in conflict with his understanding of the meaning of section 365(d)(4): "Act within sixty days or loose [sic] possession."<sup>134</sup> Judge Ayers' opinion interprets the statute in a mechanical fashion, like that criticized by Justice Douglas in *Bank of Marin v. England*,<sup>135</sup> without acknowledging the appropriate consideration of equity.

### I. *Gillis*

In another recent case from Hawaii, Judge Chinen again ruled that rejection of a lease extinguished a security interest. In *In re Gillis*,<sup>136</sup> the debtor was a lessee of commercial real property which the debtor subleased to tenants. The debtor had encumbered the leasehold in favor of a bank to secure repayment of two loans. The sixty-day period to assume or reject under section 365(d)(4) passed without assumption, and the court ruled that the lease was thus automatically deemed rejected.<sup>137</sup> The court further held (1) that the effect of rejection was to terminate the lease, effective on the date the debtor filed the bankruptcy petition;<sup>138</sup> (2) that "[w]hen the lease was terminated [i.e., as of the petition date], the bank's security interest was completely extinguished since there was no remaining leasehold interest to which the security interest could attach";<sup>139</sup> and (3) that, unlike leases under the Bankruptcy Act, a lease under the Bankruptcy Code becomes part of the bankruptcy estate at the time of filing, even before assumption.<sup>140</sup>

The *Gillis* court also held that rents collected from tenants after the petition was filed, but prior to the end of the sixty-day period of section 365(d)(4), are the property of the bankruptcy estate, and that "[t]he effective termination of [the lessee's] rights in the [l]ease as of the date of the filing of [the] petition does not divest the bankruptcy estate of [the lessee's] interest in the post-petition rents."<sup>141</sup> Therefore, the bank, which had collected and held such rents, was required to turn the rents over to the trustee.<sup>142</sup> However, the court found

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134. *Id.*

135. 385 U.S. 99, 103 (1966); see *supra* notes 32-33 and accompanying text.

136. 92 Bankr. 461 (Bankr. D. Haw. 1988).

137. *Id.* at 463, 465.

138. *Id.*

139. *Id.*

140. *Id.* at 467.

141. *Id.*

142. *Id.* at 468. The bank also was required to pay interest to the debtor on the sums withheld because the bank had improperly accepted and retained the post-peti-

that rents collected *after* the sixty-day period of section 365(d)(4) are not the property of the bankruptcy estate.<sup>143</sup>

In support of its ruling that the effect of lease rejection is to terminate the lease as of the date the bankruptcy petition was filed, the court again cited *Southwest Aircraft*.<sup>144</sup> The court also cited section 365(g) and *In re Lovitt*.<sup>145</sup> In *Gillis*, the court continually cites section 365(g) as if it supports the court's view on the effect of lease rejection, notwithstanding that section 365(g) specifically states that the rejection of an unexpired lease "constitutes a breach."<sup>146</sup> The court's citation of *Lovitt* is also inconsistent because, as the court points out in the same opinion, *Lovitt* was decided under the Bankruptcy Act.<sup>147</sup> The court stated:

The court in *Lovitt* held that, because rejection of an executory contract is retroactive to the date the bankruptcy petition is filed, such a contract never became a part of the estate. But this particular aspect of the *Lovitt* decision cannot be treated as precedent in the present case since 11 U.S.C. § 541 provides that property of the estate includes all property in which debtor has an interest. *Lovitt* was decided under the former bankruptcy Act, which limited that which was considered property of the estate. The bankruptcy act has been substantially amended under the Code.<sup>148</sup>

For the same reasons, *Lovitt* does not support the court's holding that the effect of rejection is to terminate the lease effective on the date of the bankruptcy petition.

To support its holding that the bank's security interest was completely extinguished by rejection of the lease, the court stated "the Bank cannot hold a security interest in property in which the debtor has no interest,"<sup>149</sup> and quoted the following passage: "[A] mortgage ceases to have consequence as an interest in land whenever the mortgagor's interest in the premises ends, as where a mortgagor—leasee [sic] surrenders the leased premises to his landlord."<sup>150</sup> The court also cited its own opinion in *Bernard*: "[A]llowing [the] leasehold mortgage to exist after rejection of the lease would frustrate the purpose of section 365(d)(4)."<sup>151</sup>

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tion rents in violation of the automatic stay and had failed to seek relief from the stay. *Id.* at 471.

143. *Id.* at 469.

144. *Id.* at 465.

145. 757 F.2d 1035 (9th Cir. 1985); see *Gillis*, 92 Bankr. at 465.

146. See 11 U.S.C. § 365(g) (1988).

147. *Gillis*, 92 Bankr. at 466.

148. *Id.* (citing *Lovitt*, 757 F.2d at 1041).

149. *Id.* at 465.

150. *Id.* at 465-66 (quoting 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY ¶ 461 (1987)).

151. *Id.* at 466 (citing *In re Bernard*, 69 Bankr. 13, 14-15 (Bankr. D. Haw. 1986)).

Judge Chinen did not explain, either in *Gillis* or *Bernard*, how the continued existence of a leasehold mortgage would frustrate the purpose of section 365, or which specific purpose would be frustrated. In *Gillis*, Judge Chinen cited *Ango Restaurant Corp. v. Sunrise Hotel Corp.*<sup>152</sup> for the proposition that “where the leasehold is terminated, [the] secured party with assignment of [the] lease is precluded from asserting any right in [the] leasehold.”<sup>153</sup> Judge Chinen concluded that “[u]pon the date that the [l]ease was effectively terminated, any right, title or interest held by the Bank in the [l]ease was fully and permanently extinguished.”<sup>154</sup> However, the *Ango Restaurant* decision involved a landlord who consented to an assignment of the lease by the lessee and then attempted to collect money owed by the original lessee from the lessee’s assignee.<sup>155</sup> In *Gillis*, the court never pointed out that the security interest in *Ango Restaurant* is a security interest held by the landlord, who had consented to the assignment.

In discussing its holding that under the Code a lease is part of the estate at the time of filing, the *Gillis* court distinguished the *Lovitt* decision and offered, as the sole support of its decision, a line of cases holding that the debtor has no interest in rejected leases. In reviewing the language, the court stated that “under the Bankruptcy Code, as opposed to the prior Act, a lease becomes a part of the bankruptcy estate at the time of filing, and need not be expressly assumed by the trustee.”<sup>156</sup> Without discussing conflicting case law or statutory language, the court boldly (and revealingly) asserted: “Thus, for example, the Bank is regarded as a general unsecured creditor since *its security interest is deemed to have evaporated* at the time [the debtor] filed [the] bankruptcy petition.”<sup>157</sup>

The *Gillis* decision and its notion of evaporation of security interests give pause to jurists as well as secured creditors. In *Gillis*, the court seems to have started with a desired result, and then, without acknowledging the application of equity, indulged in an exercise of justification instead of objective analysis. The result is that a provision intended by Congress to express a simple concept has been further obscured.

### J. Sea Harvest

A recent case by the Ninth Circuit Court of Appeals might be cited for the proposition that rejection is tantamount to termination. In

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152. 98 Misc. 2d 597, 414 N.Y.S.2d 265 (Sup. Ct. 1979).

153. *Gillis*, 92 Bankr. at 466.

154. *Id.*

155. *Ango Restaurant*, 98 Misc. 2d at 597-98, 414 N.Y.S.2d at 266-67.

156. *Gillis*, 92 Bankr. at 467 (citing 11 U.S.C. § 541 (Supp. IV 1986)).

157. *Id.* at 468 (emphasis added).

*Sea Harvest Corp. v. Riviera Land Co.*,<sup>158</sup> a Chapter 11 debtor in possession was the lessee of nonresidential property. The bankruptcy court held that because the debtor in possession failed to properly assume the lease, the lease was rejected.<sup>159</sup> The district court upheld the bankruptcy court's decision.<sup>160</sup> On appeal to the Ninth Circuit, Judge Clifford Wallace noted that under section 365(d)(4), when a lease is deemed rejected, the trustee or debtor in possession must "immediately surrender" the leased property to the lessor.<sup>161</sup> Judge Wallace then held that the surrender of the leasehold had the "effect of terminating the enterprise that operates there."<sup>162</sup>

The narrow holding in *Sea Harvest* does not clearly support either the termination or breach positions concerning the leasehold security interests for two reasons. First, the case did not involve a leasehold security interest; and second, the court specifically held that "the enterprise that operates there," and not the lease, was terminated.<sup>163</sup>

#### K. Austin

In *In re Austin*,<sup>164</sup> the court considered a lessee-debtor's motion to assume a lease which had been deemed rejected by operation of law.<sup>165</sup> The lease was not in default,<sup>166</sup> and the lessor "accepted rental payments from the [lessee-debtor] from the time the [lessee-debtor] filed for protection under Title 11 and for more than two years after it had knowledge of the bankruptcy petitions."<sup>167</sup> Citing *Giles* as authority, the lessor sought to have the court deem the lease rejected and thus the debtor's interest terminated. The court acknowledged *Giles*<sup>168</sup> and the cases holding that after the expiration of the sixty-day period the lessee-debtor may not assume an unexpired lease,<sup>169</sup> but stated that "[b]inding precedent on this court

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158. 868 F.2d 1077 (9th Cir. 1989).

159. *Id.* at 1078.

160. *Id.*

161. *Id.* at 1080 (quoting 11 U.S.C. § 365(d)(4) (1988)).

162. *Id.* at 1080-81.

163. *Id.*

164. 102 Bankr. 897 (Bankr. S.D. Ga. 1989).

165. *Id.* at 898.

166. *Id.* at 901.

167. *Id.* at 900.

168. *See supra* notes 120-35 and accompanying text.

169. *Austin*, 102 Bankr. at 899-900; *see In re Dial-A-Tire, Inc.*, 78 Bankr. 13 (Bankr. W.D.N.Y. (1987) (holding that where the debtor was both lessee and sublessor of non-residential real property and failed to assume the lease and sublease within 60 days of filing, both the lease and sublease were deemed rejected, "leaving the bankruptcy estate with no meaningful interest in the ultimate disposition of the Premises"); *In re*



has held that section 70(b) of the former Bankruptcy Act, which was very similar to 365(d)(4), was designed for the benefit of the lessor and could be waived by the lessor . . . . Section 365(d)(4) was also designed for the benefit of the lessor and has the same effect as former section 70(b)."<sup>170</sup> The court noted that "[t]he right of a lessor to have a lease deemed rejected by operation of law may be waived under appropriate circumstances, and the lessor may be estopped from efforts to dispossess a lessee-debtor if a waiver has occurred."<sup>171</sup>

## V. ANALYSIS OF DIFFERENT FACTUAL SITUATIONS AND DRAFTING CONSIDERATIONS FOR MORTGAGEES

Four categories of general factual situations exist in which lease rejection under section 365 could impact a security interest: (1) a lessor-mortgagor whose lessee files bankruptcy; (2) a lessor-mortgagor who files bankruptcy; (3) a lessee-mortgagor whose lessor files bankruptcy; and (4) a lessee-mortgagor who files bankruptcy. The effect of lease rejection on each scenario is discussed below under either the breach theory or the termination theory for determining the effect of rejection. Key negotiation points and contractual clauses are also suggested.

### A. *Lessor-Mortgagor, Lessee-Debtor*

A lessor with a long-term tenant may borrow money secured by the stream of income or rent. If the lessee files bankruptcy and rejects the lease, the mortgagee's security interest would be jeopardized, whether the lease rejection is regarded as terminating the lease or merely breaching the lease.

If the lease is regarded as terminated, the lessor-mortgagor would be left without the stream of rent and the lessor's mortgagee would be left without the stream of rent as security for its loan. The secured party would be in a stronger position, of course, if it also has a perfected security interest in the lessor's real property interest.

If lease rejection is merely a breach of the lease, the secured party would be in a slightly better position because the secured party may have a security interest in the damages for the breach under sections 365(g) and 502(g), particularly if the mortgagee has bargained for this right. Language should be included in the loan documents and the lease assigning to a leasehold mortgagee the damage claim of the les-

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Las Margaritas, Inc., 54 Bankr. 98 (Bankr. D. Nev. 1985) (holding that when a Chapter 11 lessee-debtor did not assume a nonresidential real property lease within 60 days of filing, the lease was deemed rejected and the lessee-debtor had no right to assume it later).

170. *Austin*, 102 Bankr. at 900 (citations omitted).

171. *Id.* at 901.

sor-mortgagor arising out of the rejection of the lease.<sup>172</sup>

### B. Lessor-Mortgagor Who Files Bankruptcy

A lessor who has granted a security interest in the leasehold may file bankruptcy and, by election, choose to reject that lease.<sup>173</sup>

The courts that view rejection as terminating the leasehold presumably would rule that the leasehold under these facts "evaporates" upon rejection.<sup>174</sup> However, under section 365(h), the lessee still has an option to remain in possession and pay rent at the contract rate. In this scenario, the view that lease rejection is synonymous with termination or evaporation seems to make little sense. The lessee is still in possession and, under section 365(h), is still required to make rent

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172. See L. CHERKIS, COLLIER REAL ESTATE TRANSACTIONS AND THE BANKRUPTCY CODE ¶ 2.01[5], at 2-19 (1989). Cherkis suggests the following language:

Mortgagor hereby unconditionally assigns, transfers and sets over to Mortgagee all of Mortgagor's claims and rights to the payment of damages arising from any rejection by [lessee] of the lease under the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"). Mortgagee shall have the right to proceed in its own name or in the name of Mortgagor in respect of any claim, suit, action or proceeding relating to the rejection of the lease, including, without limitation, the right to file and prosecute, to the exclusion of Mortgagor, any proofs of claim, complaints, motions, applications, notices and other documents, in any case in respect of [lessee] under the Bankruptcy Code. This assignment constitutes a present, irrevocable and unconditional assignment of the foregoing claims, rights and remedies, and shall continue in effect until all of the indebtedness and obligations secured by this mortgage shall have been satisfied and discharged in full. Any amounts received by Mortgagee as damages arising out of rejection of the lease as aforesaid shall be applied first to all costs and expenses of Mortgagee (including, without limitation, attorneys' fees) incurred in connection with the exercise of any of its rights or remedies under this paragraph . . . and then in accordance with paragraph . . . of this mortgage [application of proceeds clause].

*Id.*

173. A lessee-debtor cannot reject a nonresidential lease by inaction. Section 365(d)(1) provides that the trustee in a Chapter 7 case can reject an unexpired lease of residential real property, but it does not make such a provision for nonresidential real property. 11 U.S.C. § 365(d)(1) (1988). Section 365(d)(2) provides that a trustee or debtor in possession in a case under Chapter 11 or Chapter 13 may reject an unexpired lease for residential real property at any time before confirmation of a plan. *Id.* § 365(d)(2).

Section 365(d)(4) provides that the trustee under any chapter, or a debtor in possession under Chapter 11, must expressly assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days or such additional time as the court fixes or the lease will be deemed rejected. *Id.* § 365(d)(4).

Based on the explicit language of section 365(d)(4), it would appear that a lease can be rejected by inaction only if it is a nonresidential lease under which the debtor is the lessee.

174. See *In re Gillis*, 92 Bankr. 461 (Bankr. D. Haw. 1988). For a discussion of *Gillis*, see *supra* notes 136-57 and accompanying text.

payments to the lessor.<sup>175</sup>

Under this factual scenario, it makes more sense to regard the lease as breached by the lessor who has rejected the lease. Section 365(a) provides that "the trustee, subject to the court's approval, may accept or reject any executory contract or unexpired lease of the debtor" except as provided in section 365(d).<sup>176</sup> If the lessee elects to remain in possession and pay rent at the contract rate, it would be particularly inequitable to deny the leasehold mortgagee the right to the rent as security based on a unilateral act of the lessor in rejecting the contract.<sup>177</sup>

A mortgagee might deal with this situation in its contract by including language which provides for (1) an assignment of the lessor's right to reject under section 365(a); or (2) an assignment of the lessor's right to rents paid by the lessee as required under section 365(h); and/or (3) a clause setting a deadline for the lessor-debtor to assume or reject.

While the enforceability of an agreement waiving the right to reject the lease in a bankruptcy case would be doubtful, an agreement granting the mortgagee the option to assume a lease in lieu of rejection by the trustee or debtor in possession may be enforceable.<sup>178</sup>

A leasehold mortgagee can protect against the possibility that its leasehold security will be considered "evaporated" by claiming a security interest in the lessee's post-rejection tenancy arising not from the lease, but from the statutory "right of possession" created by sec-

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175. See 11 U.S.C. § 365(h)(1), (2) (1988). For a discussion of section 365(h), see *supra* notes 30-31, 43 and accompanying text.

176. 11 U.S.C. § 365(a) (1988).

177. Under similar facts, the court in *In re LHD Realty Corp.*, 20 Bankr. 717 (Bankr. S.D. Ind. 1982), treated the rejected lease as not terminating the leasehold estate. *Id.* at 719; see also *supra* notes 40, 42 and accompanying text.

178. See L. CHERKIS, *supra* note 172, ¶ 2.01[7], at 2-28 to -29. The following language grants the mortgagee the option to assume a lease in lieu of rejection of the lease by the trustee:

If there shall be filed by or against the Mortgagor a petition under the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"), and the Mortgagor, as [lessor] under the lease [defined], shall determine to reject the lease pursuant to Section 365(a) of the Bankruptcy Code, and the Mortgagor shall give the Mortgagee not less than ten days' prior notice of the date on which the Mortgagor shall apply to the bankruptcy court for authority to reject the lease. The Mortgagee shall have the right, but not the obligation, to serve upon the Mortgagor within such ten-day period a notice stating that (a) the Mortgagee demands that the Mortgagor assume and assign the lease to the Mortgagee pursuant to section 365 of the Bankruptcy Code and (b) the Mortgagee covenants to cure or provide adequate assurance of future performance under the lease. If the Mortgagee serves upon the Mortgagor the notice described in the preceding sentence, the Mortgagor shall not seek to reject the lease and shall comply with the demand provided for in clause (a) of the preceding sentence within 30 days after the notice shall have been given, subject to the performance by the Mortgagee of the covenant provided for in clause (b) of the preceding sentence.

*Id.* ¶ 2.01[7], at 2-29.

tion 365(h)(1).<sup>179</sup> The legislative history for the 1984 amendment, which added section 365(h)(1), states that the amendment "enables a sublessee or leasehold mortgagee to step in the position of the debtor's lessee in the event the lessee seeks to treat the trustee's rejection as a termination."<sup>180</sup> This statement of intent is consistent with pre-Code cases which, even in the absence of protective language in a leasehold mortgage, held that the leasehold mortgagee's position would be protected against impairment by a rejecting lessor-debtor and a lessee which elected to treat the lease as terminated.<sup>181</sup>

Section 365(d) does not place any time restriction for assumption or rejection of a nonresidential lease by a lessor-debtor. A mortgagee may be able to bargain for language in its loan and security document requiring the lessor, in the event of bankruptcy, to assume or reject the lease within a specified period.

### C. Lessee-Mortgagor, Lessor Files Bankruptcy

A lessee may borrow money secured by a long-term lease. If the lessor then files bankruptcy and rejects the lease, and the lessee elects to treat the rejection as terminating the leasehold, the leasehold mortgagee would be allowed under the legislative history of section 365(h)<sup>182</sup> to step into the position of the debtor's lessee. This, essentially, is what the courts allowed in *In re Penn Central Transportation Co.*<sup>183</sup> and *In re Garfinkle*.<sup>184</sup> The congressional history seems to recognize the inequity of treating the leasehold as terminated and, therefore, suggests that the leasehold mortgagee should be allowed to step in and assume. Based on the language of the legislative history, a clause requiring the lessee-mortgagor to obtain the leasehold mortgagee's consent before electing to treat the lease as terminated should be enforceable.<sup>185</sup> The leasehold mortgagee might

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179. 11 U.S.C. § 365(h)(1) (1988). Cherkis suggests the following clause for this purpose: "Mortgagor shall not without Mortgagee's prior written consent elect to treat the lease as terminated under Section 365(h)(1) of the Bankruptcy Code, U.S.C. § 365(h)(1). Any such election made without Mortgagee's prior written consent shall be void." L. CHERKIS, *supra* note 172, ¶ 2.01[5], at 2-18.

180. S. REP. NO. 65, 98th Cong., 1st Sess. 77 (1983).

181. See, e.g., *In re Garfinkle*, 577 F.2d 901 (5th Cir. 1978); *In re Penn Cent. Transp. Co.*, 458 F. Supp. 1346 (E.D. Pa. 1978); see also *supra* notes 51-64.

182. See *supra* note 180 and accompanying text.

183. 458 F. Supp. 1346 (E.D. Pa. 1978).

184. 577 F.2d 901 (5th Cir. 1978). For a discussion of *Garfinkle*, see *supra* notes 51-64 and accompanying text.

185. See L. CHERKIS *supra* note 172, ¶ 2.01[5], at 2-18. For the text of the clause suggested by Cherkis for this purpose, see *supra* note 179.

also consider inclusion of language in an attornment agreement with the lessor which would protect the leasehold mortgagee by specifically allowing the leasehold mortgagee to assume the lease.<sup>186</sup>

#### D. Lessee-Mortgagor, Lessee-Debtor

This factual scenario is potentially the most precarious for a leasehold mortgagee because, under section 365(d), a nonresidential lease could be rejected by the inaction of the debtor in possession or trustee.<sup>187</sup> A leasehold mortgagee, therefore, should include language in documents requiring immediate notice of any bankruptcy so that the leasehold mortgagee will be in a position to take quick action, if necessary.<sup>188</sup>

If the lessee-mortgagor debtor in this scenario rejects the lease, and the court interprets the effect of rejection to be termination or "evaporation" of the leasehold, the leasehold mortgagee would be completely deprived of its security. This occurred in *Hawaii Dimensions*,<sup>189</sup> *Giles*,<sup>190</sup> *Gillis*,<sup>191</sup> and *Bernard*.<sup>192</sup>

If the court treats rejection as a breach, the leasehold mortgagee would have the right, to the extent provided for by contract and allowed under state law, to retake the leasehold premises, pay the lessor, and sublease or sell the lease in order to obtain payment of his debt. The latter interpretation is the most equitable since it protects the leasehold mortgagee from the legal abhorrence of a forfeiture.<sup>193</sup> It is also consistent with the apparent recognition in the legislative history for section 365(h) of the need to protect leasehold mortgagees.<sup>194</sup>

Leasehold mortgagees in this factual scenario could protect their interests by including a provision granting the leasehold mortgagee

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186. A lessor might agree to the language only if the leasehold mortgagee agreed to assume the lease at market rent rather than at the contract rent, which may not be palatable to the leasehold mortgagee.

187. See *supra* note 28 and accompanying text.

188. This language could protect against situations in which creditors lose assets from the bankruptcy estate without realizing it. See *In re Kelly Lyn Franchise Co.*, 26 Bankr. 441, 447 n.9 (Bankr.), *aff'd*, 33 Bankr. 112 (M.D. Tenn. 1983); see also Andrew, *supra* note 12, at 880 n.143.

189. For a discussion of the *Hawaii Dimensions* case, see *supra* notes 65-78 and accompanying text.

190. For a discussion of the *Giles* case, see *supra* notes 120-34 and accompanying text.

191. For a discussion of the *Gillis* case, see *supra* notes 136-57 and accompanying text.

192. For a discussion of the *Bernard* case, see *supra* notes 107-15 and accompanying text.

193. See Annotation, *Commercial Leases: Application of Rule that Lease May be Cancelled Only for "Material" Breach*, 54 A.L.R. 4TH 595, 606 (1987).

194. See *supra* note 180 and accompanying text.

an option to assume the lease in lieu of rejection by the trustee.<sup>195</sup> A leasehold mortgagee also might consider the inclusion of language signaling the court that the rights of the leasehold mortgagee should be considered in the context of lease rejection.<sup>196</sup> Leasehold mortgagees could further protect their interests from the ambiguity of judicial interpretation of section 365(g) by including language to the effect that rejection by the lessee's trustee will not terminate the lease if the leasehold mortgagee assumes the lease and cures the outstanding defaults thereunder.<sup>197</sup> In the absence of such a provision in

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195. See L. CHERKIS, *supra* note 172, ¶ 2.01[7], at 2-28 to -29. The following language grants the mortgagee the option to assume a lease in lieu of rejection of the lease by the trustee:

If there shall be filed by or against the Mortgagor a petition under the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"), and the Mortgagor, as lessee under the lease [defined], shall determine to reject the lease pursuant to Section 365(a) of the Bankruptcy Code, and the Mortgagor shall give the Mortgagee not less than ten days' prior notice of the date on which the Mortgagor shall apply to the bankruptcy court for the authority to reject the lease. The Mortgagee shall have the right, but not the obligation, to serve upon the Mortgagor within such ten-day period a notice stating that (a) the Mortgagee demands that the Mortgagor assume and assign the lease to the Mortgagee pursuant to section 365 of the Bankruptcy Code and (b) the Mortgagee covenants to cure or provide adequate assurance of future performance under the lease. If the Mortgagee serves upon the Mortgagor the notice described in the preceding sentence, the Mortgagor shall not seek to reject the lease and shall comply with the demand provided for in clause (a) of the preceding sentence within 30 days after the notice shall have been given, subject to the performance by the Mortgagee of the covenant provided for in clause (b) of the preceding sentence.

*Id.* ¶ 2.01[7], at 2-29.

196. Cherkis suggests the following language:

Effective upon the entry of an order for relief in respect of the Mortgagor under the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"), the Mortgagor hereby assigns and transfers to the Mortgagee a non-exclusive right to apply to the Bankruptcy Court under Section 365(d)(4) of the Bankruptcy Code for an order extending the period during which the lease [defined] may be rejected or assumed.

*Id.* ¶ 2.01[8], at 2-30.

197. The following language is representative of the provisions providing that rejection will not terminate the lease if the mortgagee assumes the lease, and providing further for reassignment of the lease by the leasehold mortgagee to a new party:

If the lessee shall reject this lease pursuant to Section 365(a) of the Bankruptcy Code, 11 U.S.C. § 365(a), the lessor shall serve on the holder of the then existing leasehold mortgage written notice of such rejection, together with a statement of all sums at the time due under this lease (without giving effect to any acceleration), and of all other defaults under this lease then known to the lessor. The holder of the leasehold mortgage shall have the right, but not the obligation to serve on the lessor within ten days after service of the notice provided for in the preceding sentence, a notice that the leasehold mortgagee elects to (a) assume this lease and (b) cure all defaults outstanding thereunder (x) concurrently with such assumption as to defaults in the payment of money, and (y) within sixty days after the date of such as-

the lease, the leasehold mortgagee or collateral assignee has no standing under the lease or the Bankruptcy Code to cure lease defaults and to compel an actual assignment.<sup>198</sup>

Finally, as an alternative to, or in conjunction with, the language providing for the right of the leasehold mortgagee to assume the lease, security documents could include language providing that the lessor will enter into a new lease with the mortgagee upon rejection and satisfaction of certain conditions. As noted by one commentator, the disadvantage of such a clause would be the possibility that the mortgagee would be required to subordinate to other liens.<sup>199</sup>

## VI. CONCLUSION

The language of section 365 is subject to different interpretations on the effect of lease rejection—especially on leasehold mortgagees. Indeed, the few reported cases interpreting the effect of lease rejection on security interests in nonresidential real property reflect a sharp division.

Two lines of cases exist with respect to rejection by a lessee-debtor: one line holding that rejection constitutes termination of the lease and all rights associated therewith,<sup>200</sup> and the other holding that rejection constitutes a breach which does not result in complete termination of the lease for all purposes.<sup>201</sup> The complete termination line

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sumption as to other defaults except defaults of the type specified in Section 365(b)(2) of the Bankruptcy Code, 11 U.S.C. § 365(b)(2). If such holder of the leasehold mortgage serves the notice provided for in the preceding sentence, then, as between the lessor and such leasehold mortgagee (1) the rejection of the lease by the lessee shall not constitute a termination of this lease, (2) the leasehold mortgagee may assume the obligations of the lessee under this lease without any instrument or assignment or assignment from the lessee, (3) the leasehold mortgagee's rights under this lease shall be free and clear of all rights, claims and encumbrances of or in respect of the lessee, and (4) the leasehold mortgagee shall consummate the assumption of the lease and the payment of the amounts payable by it to the lessor pursuant to this section at closing to be held at the offices of the lessor at the address set forth at the head of this lease [insert other closing mechanism as desired] on the . . . business day after the leasehold mortgagee shall have served the notice hereinabove provided for. Upon an assignment of this lease by the leasehold mortgagee, the leasehold mortgagee shall be relieved of all obligations and liabilities arising from and after the date of such assignment.

*Id.* ¶ 2.01[8], at 2-31.

198. See *In re Cobham Enter., Inc.*, 62 Bankr. 191, 194-95 (Bankr. S.D.N.Y. 1986).

199. L. CHERKIS, *supra* note 172, ¶ 2.02[1], at 2-32 (citing Levitan, *Leasehold Mortgage Financing: Reliance on the "New Lease" Provision*, 15 REAL PROP. PROB. & TR. J. 413 (1980)).

200. See *In re Giles Assocs.*, 92 Bankr. 695 (Bankr. W.D. Tex. 1988); *In re Gillis*, 92 Bankr. 461 (Bankr. D. Haw. 1988); *In re Bernard*, 69 Bankr. 13 (Bankr. D. Haw. 1986); *In re Southwest Aircraft Services*, 53 Bankr. 805 (Bankr. C.D. Cal. 1985), *aff'd*, 66 Bankr. 121 (Bankr. 9th Cir. 1986), *rev'd*, 831 F.2d 848 (9th Cir. 1987); *In re Hawaii Dimensions*, 39 Bankr. 606 (Bankr. D. Haw. 1984), *aff'd*, 47 Bankr. 425 (D. Haw. 1985).

201. *In re Miller*, 103 Bankr. 353 (Bankr. D.D.C. 1989); *In re Austin*, 102 Bankr. 897 (Bankr. S.D. Ga. 1989); *In re Blackburn*, 88 Bankr. 273 (Bankr. S.D. Cal. 1988); *In re*

is based on the last clause of section 365(d)(4), which states that upon rejection by the lessee-debtor, "the trustee shall immediately surrender such nonresidential real property to the lessor."<sup>202</sup> The courts in this line equate rejection and the surrender of possession with complete termination of the lease.

On the other hand, the line of cases holding that rejection is a breach which is not equivalent to complete termination for all purposes is based on the fact that Congress, by using the terms rejection, breach, and termination in different parts of the Code, presumably knew the difference between the terms. These courts do not dispute that a lessee-debtor who rejects a lease must surrender possession to the lessor, but they generally are concerned with the continued application of other terms of the rejected lease. In all cases, equity should be acknowledged as an important consideration.

Ironically, the trial courts on both sides of the issue claim that the statutory language is clear. The only decision stating that the statutory language is not clear is the decision of the Ninth Circuit Court of Appeals in *Southwest Aircraft*, which did not even specifically deal with the issue.<sup>203</sup>

The conflict between the cases on this issue cannot be resolved by resort to mechanical statutory interpretation. As suggested by Justice Douglas,<sup>204</sup> few statutes applied in a mechanical fashion will yield uniform and equitable results. Michael Andrew's cogent commentary was correct in stating that a strikingly simple concept has been lost in confusion.<sup>205</sup> The cause of the confusion is twofold: (1) the wording of section 365 is unclear, and (2) the statute has, all too often, been mechanically applied to reach equitable results without acknowledging the equitable principles upon which the statute was based. Just as the conflict between the cases can be understood by understanding and acknowledging the role of equity, the resolution of the conflict is soluble by understanding, as suggested by Mr. Andrew, that rejection does not affect contract liabilities; rather, rejection or assumption merely refers to the trustee's election to assume

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CM Systems, 86 Bankr. 707 (Bankr. M.D. Fla. 1988); *Societe Nationale Algerienne Pour La Recherche v. Distrigas Corp.*, 80 Bankr. 606 (Bankr. D. Mass. 1987); *In re Picnic 'N Chicken*, 58 Bankr. 523 (Bankr. S.D. Cal. 1986); *In re Storage Technology Corp.*, 53 Bankr. 471 (Bankr. D. Colo. 1985).

202. 11 U.S.C. § 365(d)(4) (1988).

203. See *Southwest Aircraft*, 831 F.2d at 849-50.

204. See *supra* note 33 and accompanying text.

205. Andrew, *supra* note 12, at 848.



or not to assume the contract.<sup>206</sup>

Considerable support exists for Mr. Andrew's view. David Epstein discussed the "Andrew approach" to rejection in a recent article on executory contracts and leases.<sup>207</sup> Judge S. Martin Teel of the United States Bankruptcy Court for the District of Columbia also considered this approach to rejection and stated "upon rejection and resulting breach, the lease may no longer be an asset of the estate, but the lease itself is essentially undistributed, remaining intact with all of its benefits and burdens outside of bankruptcy."<sup>208</sup>

The Supreme Court, for its part, has not always led the way in reviving the plain meaning rule for interpretation of statutes. The Court followed the plain statutory language in ruling on an unsecured creditor's right to adequate protection,<sup>209</sup> but chose a different tack in ruling on rejection of collective bargaining agreements.<sup>210</sup> The Supreme Court should lead the way in interpretation of statutes based upon their plain meaning. When the plain meaning is not clear, either on the face of the statute or by resort to legislative history, courts should strive to ensure that legitimate process is preserved by acknowledging the role of equity in sound legal reasoning, rather than obscuring result-oriented reasoning with a cloak of logic and disciplined analysis. It is important for courts to lead the way in preserving intellectual honesty and legitimate process if the courts are to maintain the respect of society as the ultimate forum for resolution of disputes.<sup>211</sup>

The Bankruptcy Code has provisions to protect lessees and lessors from the inequitable results of lease rejection.<sup>212</sup> Correctly interpreted, the simple definition of lease rejection, as intended by the drafters, also would protect mortgagees. If the present conflicting decisions on the issue cannot be resolved by following what now appears to be an emerging majority position, Congress should amend the Code to protect mortgagees by clearly defining the effect of lease rejection on security interests in leases.

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206. *Id.*

207. See generally Epstein, *supra* note 9.

208. *In re Miller*, 103 Bankr. 353, 355 (Bankr. D.C. 1989).

209. *United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assoc.*, 108 S. Ct. 626, 634-35 (1988).

210. *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (1984).

211. See R. BORK, *THE TEMPTING OF AMERICA* 261-64 (1990).

212. The Bankruptcy Code also contains "separate statutory provisions for landlords, shopping centers . . . commodities, aircraft leasing, collective bargaining, retiree's [sic] benefits, timesharing . . . installment [sic] and sales contracts" and licensees of intellectual property. Epstein, *supra* note 9, at 147.