

SELECTED ISSUES IN ADMINISTRATIVE INSOLVENCY

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**PART I: ARE COMMERCIAL LANDLORDS  
ENTITLED TO SUPERPRIORITY ADMINISTRATIVE CLAIMS?**

Rent incurred by a debtor post-petition but pre-rejection are governed by 11 U.S.C. §365(d)(3). Section 365(d)(3) provides the framework for how estate representatives are to handle unexpired, non-residential leases. This section provides, in pertinent part, that

The trustee shall timely perform all the obligations of the debtor ... arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.

11 U.S.C. §365(d)(3). Disputes arise, however, when an estate representative fails to make timely payments due under a lease not yet assumed or rejected. Such disputes are rooted, at least in part, because §365(d)(3) “provides a right but no remedy” – i.e. there are no enforcement provisions dictating the consequences for non-payment. See In re Brennick, 178 B.R. 305, 308 (Bankr. D. Mass. 1995).

There are differing views on what rights commercial landlords have for any post-petition pre-rejection rent claims.

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Before discussing the dispute, however, there is some agreement as to the treatment of post-petition pre-rejection rents. It appears that Courts are in agreement that the phrase “notwithstanding section 503(b)(1) of this title” eliminates the requirement for an order expressly authorizing payment of an administrative rent claim and eliminates the requirement that administrative rent claims reflect an objective benefit to the estate. See In re Pyxsys Corp, 288 B.R. 309, 313 – 314 (Bankr. D. Mass. 2003) (collecting cases). Finally, courts are in general agreement that administrative rent claims are valued according to lease terms and not according to a reasonable value based upon benefit to the estate. See, e.g., Towers v. Chickering & Gregory (In re Pacific – Atlantic Trading Co.), 27 F.3d 401, 404 (9<sup>th</sup> Cir. 1994); In re Microvideo Learning Systems, Inc., 232 B.R. 602, 605 (Bankr. S.D.N.Y. 1999).

Now for the dispute – how should the actual payment for administrative rent claims be made? “The majority view is that since §365(d)(3) contains no explicit authority for the payment of administrative rent claims as a priority to the derogation of other claims against the insolvent estate, these claims are not entitled to superpriority status.” In re Ames Department Stores, Inc., 306 B.R. 43, 81 (Bankr. S.D.N.Y. 2004) (expenses payable under §365(d)(3) have administrative priority but not implied superpriorities which share *pari passu* with other unpaid administrative expenses when estate is administratively insolvent); Pyxsys, 288 B.R. at 314 (*citing Towers v. Chickering & Gregory*, 27 F.3d at 401; Pudgies’s Dev. of NY, Inc., 239 B.R. 688, 692 (Bankr. S.D.N.Y. 1999); In re J.T. Rapps, Inc., 225 B.R. 257, 260 (Bank. D. Mass 1998); In re MJ 500 Inc., 217 B.R. 93 (Bankr.

D. Mass. 1998); In re Bryant Universal Roofing, Inc., 218 B.R. 948 (Bankr. D. Ariz. 1998); In re Tel-Central Communications, Inc., 212 B.R. 342 (Bankr. W.D. Mo. 1997); In re Amber's Stores, 193 B.R. 819 (Bankr. N.D. Tex. 1996); In re Almac's Inc., 167 B.R. 4 (Bankr. D.R.I. 1994)). These courts reason that when Congress wanted to give a superpriority to certain claims, it did so. See 11 U.S.C. §§726(b), 364(c)(1) and 507(b). Similarly, awarding a superpriority payment status to administrative rent claims would disturb the distribution scheme contained in the Bankruptcy Code. See Pudgie's Dev. of NY, 239 B.R. at 692.

The minority view holds that §365(d)(3) gives a clear mandate to the debtor to “timely perform” its obligation to pay rent, so immediate payment of post-petition pre-rejection rents is the only appropriate remedy. See, e.g., Brennick, 178 B.R. at 305; In re McCabe, 212 B.R. 21 (Bankr. D. Mass. 1996). In re new Almacs, Inc., 196 B.R. 244 (Bankr. N.D.N.Y. 1996); In re Leisure Time Sports, Inc., 189 B.R. 511 (Bankr. S.D. Cal. 1995).

Within the minority view, there is an additional split of authority. Some courts authorize payment of administrative rent claims subject to later disgorgement in the event of administrative insolvency. See, e.g., Microvideo Systems, 232 B.R. 602; J.T. Rapps, 225 B.R. at 261; Tel Central Communications, 212 B.R. 342; In re Buyer's Club Markets, Inc., 115 B.R. 700 (Bankr. D. Colo. 1990). These courts view §365(d)(3) as mandating immediate payment, but not conferring any additional priority over other administrative claimants.

Other courts hold that the so-called “plain meaning” of the statute requires immediate payment of these superpriority claims, without regard to current or

future administrative insolvency. See, McCabe, 212 B.R. 21; In re Rare Coin Galleries of America, Inc., 72 B.R. 415 (D. Mass. 1987) (ordering immediate payment of administrative rent claim despite administrative insolvency); Brennick, 178 B.R. 305 (payment of administrative rent claim regardless of estate solvency); see also In re Montgomery Ward Holding Corp., 268 F.3d 205 (3<sup>rd</sup> Cir. 2001) (estate must perform under terms of lease when estate becomes legally obligated to perform); In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6<sup>th</sup> Cir. 2000)(same).

Finally, the First Circuit Bankruptcy Appellate Panel and a Massachusetts Bankruptcy Court have each required payment of administrative rent claims on a superpriority basis citing its own previously issued orders. In Krikor Dularian Trust v. Unified Management Corp. of Rhode Island, Inc (In re Peaberry's Ltd.), 205 B.R. 6, (B.A.P. 1<sup>st</sup> Cir. 1997), the First Circuit Bankruptcy Appellate Panel determined that it “need not reconcile or choose among divergent authorities addressing the relative priorities of the landlords’ pre- and post-petition rent claims and other administrative claims.” It concluded that “given the propriety of the assumption order and the absence of any timely challenge to its substance or regularity, the bankruptcy court was duty bound to enforce it according to its terms.” Id. at 8. Similarly, in In re Rich’s Department Stores, Inc., 209 B.R. 810 (Bankr. D. Mass. 1997), Judge Feeney concluded that, as in Peaberry’s, the Court permitted the debtor to conduct a going-out-of-business sale on the condition that it paid its lease obligations. The various directives were clear, and intended to avoid the circumstance described in the legislative history of the disputed Bankruptcy Code section – that the landlords serve as involuntary financiers of the debtor’s post-petition operations. In conclusion, the Court ordered the Chapter 7 trustee to abide by previous orders, and immediately pay post-petition and pre-rejection claims of the complaining landlords.

One additional issue has been hotly debated – once a debtor rejects a lease, how much of the post-petition pre-rejection rent can the landlord claim. Put another way, if the effective date of a debtor’s lease rejection is mid-month, is the landlord entitled to a full month’s rent or only entitled to a pro-rata share of the rent accrued. This issue was faced head on in In re Ames Department Stores, Inc., 306 B.R. 43 (Bankr. S.D.N.Y. 2004). In this case, the Court was charged with deciding numerous issues, not the least of which was whether the debtor had a duty to pay post-rejection period rent to two landlords under section 365(d)(3). The debtor had rejected two leases mid-month. Both lease agreements allowed for the advance payment of rent on the first of each month. The debtor, though, had failed to pay the final month’s rent prior to rejecting the leases. The landlords, under section 365(d)(3), sought payment as an administrative expense of the full monthly rent that was due and payable for the final month of the two leases, notwithstanding the mid-month rejection.

The Court, deeming the issue “post-rejection prorating,” noted that other courts considering the same matter were sharply divided.<sup>2</sup> Four cases decided by the Southern District of New York courts hold that the debtor-tenant is liable for obligations under section 365(d)(3) relating only to the period through the date of rejection. Or, stated another way, the section obligates the payment of only the post-petition rent that has been prorated to cover the portion allocable to the pre-rejection period. Id. at 64 (citing In re McCrory Corp., 210 B.R. 934, 939 (S.D.N.Y. 1997); In re Child World, Inc., 161 B.R. 571, 576 (S.D.N.Y. 1993); In re Swanton Corp., 58 B.R. 474, 475 (Bankr. S.D.N.Y. 1986); In re Ames Department Stores, Inc., 150 B.R. 107, 109 (Bankr. S.D.N.Y. 1993)(Goodman, J.)). Other jurisdictions do not adopt this prorating approach. See, e.g., Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting

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<sup>2</sup> The Ames Court noted that this issue must be distinguished from a similar issue dubbed “pre-petition prorating” which relates to whether section 365(d)(3) requires the payment of obligations that accrued pre-petition but became payable post-petition or whether such items require proration to separate pre- from post-petition components.

Goods, Inc., 203 F.3d 986 (6<sup>th</sup> Cir. 2000); HA-LO Industries, Inc. v. Centerpoint Properties Trust, 342 F.3d 794 (7<sup>th</sup> Cir. 2003); In re Comdisco, Inc., 272 B.R. 671 (Bankr. N.D.Ill. 2002).

The Ames Court fell in line with the majority of its district-mates, holding that §365(d)(3) required that the debtor pay only prorated portions of post-rejection lease obligations. Accordingly, a landlord is only entitled to an administrative claim for post-petition rent up to the date of rejection. Any additional amounts owed under the lease for that month became part of the pre-petition rejection damages claim. Id. at 80; See also In re NETtel Corp, Inc., 289 B.R. 486, 489 (Bankr. D.D.C. 2002). The Court so decided based on the language of the section, and based on Bankruptcy Code §§365(g) and 502(g). Those two sections have the undisputed effect of turning claims for an estate's failure to honor obligations after rejection into pre-petition claims, not administrative claims. In effect, these landlords were attempting to use § 365(d)(3) as a vehicle that drives down the same road as other provisions of the Code.

The Court also noted that there is nothing to suggest that Congress, in passing §365(d)(3), meant to overturn § 503(b)(1). That section allows for the prorating of debtor-tenant's rent to cover only the post-petition, pre-rejection period, regardless of the billing date. That section aims to prevent landlords from getting a windfall; from allowing landlords to recover for items of rent which are billed during the post-petition, pre-rejection period, but which represent payment for services rendered by the landlord outside that time period. That windfall would be to the detriment of other creditors. Moreover, §365(d)(3), the Court declared, must be construed so that it is not inconsistent with this "current payment" for "current services" purpose. Id. at 70 (internal citation omitted). Thus, post-rejection prorating is necessary in any instance in which a request for § 365(d)(3) payments is made after a lease has been rejected and that the landlords

were due unpaid rent only to the extent that it is allocable to the post-petition, pre-rejection period. Id. at 80.

## **PART II: RECENT ISSUES IN CARVE OUTS – THEY ARE ONLY AS GOOD AS THE DRAFTING**

When looking to protect professional fees in the event that a case becomes administratively insolvent, professionals often negotiate “carve outs” from the Debtor-In-Possession financing. As these next cases show, getting these provisions in place at the start of the case, well BEFORE administrative insolvency hits, is key.

In In re California Webbing Industries, 370 B.R. 480 (Bankr. D. Mass. 2007), the debtor filed a Chapter 11 petition and, thereafter, operated two related textile businesses as a debtor-in-possession. The case was financed by CIT Group/Commercial Services Inc. (“CIT”), which had a first-priority security interest in all of the debtor’s assets. CIT was owed \$21.5 million at the outset of the case. As part of an agreed upon reorganization strategy, the debtor sold one of its subdivisions, reducing its debt owed CIT to roughly \$17 million. The debtor looked to sell the remainder of its assets, and soon entered into a purchase agreement with a Philadelphia area bank. That sale fell through. At all times before the botched unloading of assets, it was believed that all creditors and administrative claimants would be paid in full, with some assets remaining in the debtor’s control. After the sale fell through, however, the debtor’s top management jumped ship, the reorganization was abandoned, and the case was converted to Chapter 7.

While the Chapter 11 case was still viable and healthy, the debtor applied for and received several short-term conditional cash collateral orders which permitted the debtor to keep operating its two textile businesses. Six of those orders were negotiated and agreed to by the debtor, CIT, and the Unsecured Creditors’ Committee. A seventh and final cash collateral

agreement (for a longer term than the previous agreements) was contested, and formed the predicate of this case.

None of the seven orders contained a carve-out provision for the payment of the administrative claims of professionals. However, a carve-out controversy arose in 2003 (two years after the case was converted to a Chapter 7) when the debtor's counsel filed a motion entitled "Motion and Memorandum of Law to Request Hearing on Administrative Claims of Professionals." This memo – "the Carve-Out Memo" – argues that, in hearing the contested cash collateral agreement, the Court drew up a carve-out provision or, in the alternative, CIT impliedly consented to such a provision.

The Bankruptcy Court found that a "carve-out" agreement had not been created, either by court order or by consent of the secured creditors. At the outset, the Court had the following to say: "[t]his dispute illustrates the hazards to Chapter 11 professionals who are blind-sided when a reorganization case that, by all accounts, appears destined for success, unexpectedly becomes an administratively insolvent Chapter 7 case." It went on to highlight the carve-out law. A carve-out agreement generally refers to "an agreement between a secured lender, on the one hand, and the trustee or debtor-in-possession, on the other, providing that a portion of the secured creditor's collateral may be used to pay administrative expenses." [Citations omitted]. There is no standard form of carve-out agreement, but the details of such must be consented to by the creditor responsible for paying the carved-up collateral or must be approved by the bankruptcy court. [Citations omitted].

The Bankruptcy Court concluded that there was neither consent nor judicial construction here. First, while CIT had consented to the debtor's use of cash collateral in six previous agreements, it did not consent, expressly or impliedly, to the carving-out from the cash collateral

the funds needed to pay administrative fees. CIT discussed such a carve-out provision only in general terms and in passing before the court at the contested hearing. And, while carve-out provisions might have been discussed prior to the negotiation of the final cash collateral agreement, that agreement contained no language to indicate that CIT had consented to such provision. The order expressly provided: “[n]othing contained herein or in the Budget shall be deemed an admission by CIT...that any creditor or creditors committee is entitled to surcharge or use in any way of the Cash Collateral, the Pre-Petition Collateral, or the Post-Petition Collateral.”

Second, the Bankruptcy Court found that a carve-out provision had not been created during the hearing on the contested cash collateral agreement. That hearing had been dedicated to determining how any fees could be paid by the debtor – the serious question was whether the debtor had *any* unencumbered funds from which to make payments. Indeed, when the question of how the fees owed to administrators could be paid arose at the end of the hearing, counsel for the Committee acknowledged that disgorgement of the administrative fees was the appropriate course in the event of administrative insolvency. A carve-out provision was mentioned by the hearing judge only in passing, and in recognition of the possibility that the parties might later agree to such a provision. No agreement was made.

Noting that to accept the debtor’s argument that CIT had expressly or impliedly consented to the carve-out agreement in this case might “chill future secured creditors’ willingness to participate in the reorganization process,” the Court denied the debtor’s carve-out motion. Absent the collateral carve-out there remained no funds to pay administrative expenses, so the Court denied as moot the professional’s attendant applications for payment of fees.

In Robotic Vision Systems, Inc. v. Costa (In re Robotic Systems), 367 B.R. 232 (Bankr. 1st Cir. 2007), the debtors, Robotic Vision Systems and Auto Image ID, filed Chapter 11 petitions, which were administratively consolidated. The debtors sought authority to use cash collateral, then subject to a liens of RVI Investors, Intel Corporation, and Pat Costa. The use of cash collateral was resolved by an agreement between all parties. This cash collateral order set approved a carve-out provision to pay certain estate professionals. That carve-out provision was amended and extended multiple times. When the Chapter 11 case was converted to Chapter 7, the conversion order expressly addressed the carve-out issue and mandated its preservation for the Chapter 11 professionals “who were the intended beneficiaries of such carve outs pursuant to the terms of the Cash Collateral Orders previously approved” by the bankruptcy court.

Subsequent to Chapter 7 conversion, Chapter 11 professionals filed final fee applications for payment from the carved-out collateral, or, to the extent that the carve-out was insufficient, allowance of Chapter 11 administrative expenses. The professionals agreed that the carve-out fund would be insufficient to pay all of the carve-out beneficiary fees. Pat Costa as a secured creditor filed specific objections as the reasonableness of several of the fee applications. Costa also filed an omnibus objection as to the validity of the carve-out and to “any payment to the applicants from carve-outs established under various cash collateral orders for Applicants’ benefit.” In essence, Costa argued that when the first secured creditor was paid in full from the sale of the debtors’ assets, the carve-out disappeared leaving the estate assets subject to Costa’s lien and the professionals left to share *pari passu* on whatever remained. Costa’s omnibus objection was overruled by the lower bankruptcy court, and he lodged his appeal with the First Circuit appellate panel.

In affirming the bankruptcy court, the appellate bankruptcy panel noted that this case presented a “jurisdictional jigsaw” that might hold “fascination for enthusiasts.” The panel, however, found that it could reject the appeal on the merits, without putting together the pieces.

In so dealing, the Court noted that carve-out agreements, and concessions for those agreements, are the “warp and woof of the reorganization process.” The instant carve-out agreement was one of “fairly common convention.” It noted also that, while bankruptcy courts have grappled with the problems presented by carve-out agreements, there is no broad body of consistent law. See In re U.S. Flow, 332 B.R. 792 (W.D. Mich. 2005) (holding that carve-out funds were insulated from the Code priority scheme, and as such were not “property of the estate” subject to pro rata distribution among all administrative claimants of an administratively insolvent estate); but see In re World Waste Services, Inc., 345 B.R. 810 (E.D. Mich. 2006) (holding that disgorgement is an appropriate remedy where necessary to ensure that some or all of a group of “similarly situated” administrative claimants receive like treatment). The First Circuit acknowledged the principle that equal priority creditors are to be treated equally, and passed on the opportunity to consider the extent, if any, that a carve-out provision may permissibly alter that principle.

The First Circuit panel ultimately held that Costa’s omnibus objection “came too late” and that it “smack[ed] of sour grapes.” The Court noted that Costa had expressly consented to and supported the carve-out provision when the collateral use agreement was written and when it was repeatedly amended and extended. Costa only objected to the provision after estate professionals had received payment and Costa himself had benefited from it. The Court opined that Costa probably would not have challenged the validity of the provision were he sure there would be sufficient funds on hands to answer all of his administrative claims. The panel held

that allowing Costa to successfully contradict his early position would provide him an “unfair advantage,” undercutting the “judicial integrity and efficacy” of the bankruptcy court. He was judicially estopped from taking advantage of the court as such.

Finally, some creative thinking has allowed an interesting twist to permit a tiered “administrative claimant” system to effectuate the policies of the bankruptcy code to ratably pay administrative claimants, while allowing a wind-down while still in Chapter 11. In *The Caldor Corporation* and affiliated cases (collectively, “Caldor” or “debtors”), the debtors’ estates were administratively insolvent. Caldor came up with a plan to wind-down their businesses while still in Chapter 11. The Caldor wind-down plan was intended to effect an orderly liquidation of Caldor’s businesses while maximizing recoveries on assets through GOB sales, expense and staff reductions and store and office closings for the benefit of creditors. Caldor proved and the bankruptcy court found, however, that no third party would provide services or extend credit to Caldor except on a super-priority basis. See *In re The Caldor Corp.*, 240 B.R. 180, 189 (Bankr. S.D.N.Y. 1999), aff’d *Pearl-Phil GMT (Far East) Ltd. v. The Caldor Corp. (In re Caldor Corp.)*, 266 B.R. 575 (S.D.N.Y. 2001). In order to permit the wind-down plan to go forward, the bankruptcy court entered an Order on January 22, 1999 (the “Wind-Down Order”), a copy of which is included with these materials. Pursuant to the Wind-Down Order, the bankruptcy court bifurcated administrative expense into two categories – claims arising from the petition date until the date of the Wind-Down Order entered (the “Operating Period”) and administrative claims arising after the Wind-Down Order entered (the “Wind-Down Period”). The Wind-Down Order “conferred super-priority administrative expense status upon Wind-Down Period claims and directed that they be paid in full, and prohibited Caldor from paying Operating Period claims. This prohibition of payment expressly includes payments to ‘vendors and suppliers for goods

and services provided during the Operating Period.” Caldor, 240 B.R. at 183; Wind-Down Order at p. 5. When the Wind-Down Order was later challenged, the bankruptcy court defended its decision first by pointing out that no one disputed that Caldor realized significantly more on its assets using the wind-down program than it would have realized if the cases had been converted to Chapter 7. Caldor, 240 B.R. at 184. The court also stated, “[w]e understand that we cannot accord claims priority treatment that is not otherwise provided for under the Bankruptcy Code. We have not done so in this case because our actions are grounded in §§105(a), 364(c)(1) and 1112(b) of the Bankruptcy Code.” Id. at 189. This creative solution was justified by “the unique exigencies of the case, Caldor’s dire need to obtain credit during the Wind-Down Period and the benefit to all Operating Period creditors from the implementation of the procedures in the Wind-Down Order....” Id.