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Enforceability of a Lease Termination Clause in Proceedings Under Bankruptcy Act, Chapter XI

ENFORCEABILITY OF A LEASE TERMINATION CLAUSE IN PROCEEDINGS UNDER BANKRUPTCY ACT, CHAPTER XI

Section 70b of the Bankruptcy Act allows an important remedy to the landlord of a bankrupt tenant. The provision states: "[A]n express covenant that . . . the bankruptcy of a specified party . . . shall terminate the lease or give the other party an election to terminate the same is enforceible."[1] When the estate of a bankrupt tenant is liquidated and distributed to creditors, such a clause in a business tenant's lease works no unusual hardship upon him.[2] Section 302, however, ensures that this landlord's remedy also will be available in proceedings under Chapter XI[3] of the Act, insofar "as [it is] not inconsistent or in conflict with the provisions of this chapter . . . ."[4] Although one purpose of both Chapter XI and Chapter X[5] is the financial rehabilitation of an insolvent debtor, rehabilitation may be impossible if the debtor's lease is terminated as permitted by section 70b. This possibility confronted the Court of Appeals for the Second Circuit in *Queens Boulevard Wine & Liquor Corp. v. Blum*.[6] Although the court attempted to restrict its opinion narrowly, its refusal to enforce a termination clause in the circumstances of the case represents an inappropriate expansion of the equitable powers of a bankruptcy court.

The debtor in *Queens* had entered into a seven-year lease in 1970 for the premises in which it operated a retail liquor store.[7] The lease was a standard form used in the state of New York and included a

1. 11 U.S.C. § 110(b) (1970). Section 70b also gives a trustee in bankruptcy the authority to reject executory contracts, including unexpired leases, within a limited time period. *Id.* Section 342 of the Act, 11 U.S.C. § 742 (1970), provides that the powers given a trustee by the Act may be exercised by a debtor in possession when no trustee or receiver is appointed.

2. J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 118, 173-74 (1956). Furthermore, unless the lease is carefully drafted, termination by the landlord can work to his own disadvantage because of possible loss of priority under section 63a(9), 11 U.S.C. § 103(a)(9). *See* 4A COLLIER'S ON BANKRUPTCY ¶ 70.44 (14th ed. rev. 1971) [hereinafter cited as COLLIER].

3. 11 U.S.C. §§ 701-799 (1970).

4. Section 302 makes all provisions of Chapters I to VII applicable in Chapter XI proceedings so long as they are consistent with the provisions of Chapter XI. 11 U.S.C. § 702 (1970). Section 70b is included in Chapter VII of the Bankruptcy Act, a chapter pertaining expressly to "bankruptcy" proceedings under Chapters I-VII. Despite the different objectives of bankruptcy proceedings and of reorganizations and arrangements, section 70b also is applicable in the latter proceedings. *See, e.g.*, Finn v. Meighan, 325 U.S. 300, 302-03 (1945) (reorganization); Geraghty v. Kiamie Fifth Ave. Corp., 210 F.2d 95 (2d Cir. 1954) (arrangement).

5. 11 U.S.C. §§ 501-676 (1970).

6. 503 F.2d 202 (2d Cir. 1974).

7. *Id.* at 203-04.

clause permitting termination for nonpayment of rent or upon the filing of a petition for adjustment of Queens' debts pursuant to Chapter XI of the Bankruptcy Act.[8] One month after filing such a petition, Queens had neither paid certain rent arrearages nor posted a bond for the rent in accordance with the bankruptcy referee's order. With a solvent prospective tenant for the premises available, the landlord served on Queens a notice of termination of the lease. Thereafter, having obtained the required bond, Queens offered to pay the three months rent in arrears, but the landlord rejected the tender and pressed to have the bankruptcy court's stay of eviction proceedings vacated.

When the landlord served the notice of termination on Queens, the debtor and its unsecured creditors still were attempting to formulate a satisfactory plan of arrangement. Because the location of the liquor store was an important asset of the business, the plan eventually devised was premised on Queen's continued occupancy of the store for the remaining term of the lease. Although the referee found that the landlord had not waived its option to terminate by having continued to press for rent and that it had exercised the option properly by the notice served on Queens, he ordered that Queens continue in possession and pay to the landlord a sum equal to the rent specified by the lease as compensation for use and occupancy. Confirmation of the plan of arrangement, however, was adjourned pending determination of petitions for review filed by both the landlord and Queens.[9]

Even though it upheld the district court decision not to permit the landlord to evict Queens, the Court of Appeals for the Second Circuit conceded: "Bankruptcy forfeiture provisions are necessary for

8. Article 16(b) of the lease provided: "If at the date fixed as the commencement of the term of this lease or if at any time during the term hereby demised . . . Tenant [shall] make an assignment for the benefit of creditors or petition for or enter into an arrangement this lease, at the option of Landlord, exercised within a reasonable time after notice of the happening of any one or more of such events, may be cancelled and terminated . . . ." 503 F.2d at 203 n.1.

An addendum to the lease provided: "Notwithstanding the provisions of Article '16' hereof, in the event no relief is requested in any of the bankruptcy proceedings set forth in Article '16' hereof to disaffirm this lease, or to reform the same . . . and provided, further, that all rent, additional rent and other charges due from Tenant under this lease are paid promptly when due, . . . this lease shall not be terminated as provided in Article '16' hereof, but shall continue in full force and effect." *Id.* n.2.

9. Queens petitioned to have the termination clause invalidated; the landlord, for review of the referee's order. 503 F.2d at 204.

the protection of landlords and generally are enforceable."[10] Termination clauses in leases generally have been construed strictly against the creditor-landlord, but enforced routinely,[11] even when the enforcement would vitiate an otherwise feasible plan to rehabilitate the debtor.[12] Because of the ambiguous legislative history[13] of section 70b and the provisions in sections 102[14] and 302[15] to the effect that sections governing "straight" bankruptcy should apply in proceedings under Chapters X and XI insofar as they were not inconsistent or in conflict with the provisions of those chapters, the Act left open the question whether section 70b applied when the debtor was not to be liquidated in bankruptcy proceedings. The issue was first raised in 1945 in *Finn v. Meighan*,[16] wherein the Supreme Court asserted that Congress had provided that section 70b was applicable in reorganization proceedings under Chapter X, and stated: "That being the policy adopted by Congress, our duty is to enforce it."[17]

Section 70b is no longer an absolute mandate that a termination clause be enforced, however; in 1962 the language of the section was amended to provide that such a clause "is enforceible."[18] By the change from mandatory to permissive terminology, Congress accommodated existing judicially created exceptions to the original provision.[19] Two categories of exceptions were noted by the court in

10. *Id.* at 207. Even after its decision in *Queens*, the court had little difficulty applying the general rule to uphold lease terminations when the debtor's extended failure to pay rent had created financial difficulties for the landlord and the debtor had failed to present a feasible plan for rehabilitation that had a reasonable chance for success. *See In re* D.H. Overmeyer, Co., No. 74-2326 (2d Cir., Feb. 5, 1975).

11. *See, e.g.*, Finn v. Meighan, 325 U.S. 300 (1945); B.J.M. Realty Corp. v. Ruggieri, 326 F.2d 281 (2d Cir. 1963); Model Dairy Co. v. Foltis-Fischer Inc., 67 F.2d 704 (2d Cir. 1933); Jandrew v. Bouche, 29 F.2d 346 (5th Cir. 1928); Empress Theatre Co. v. Horton, 266 F. 657 (8th Cir. 1920).

12. *See, e.g., In re* Technical Marine Maint. Co., 169 F.2d 548 (3d Cir. 1948).

13. When the Bankruptcy Act was amended substantially in 1938, the National Bankruptcy Conference originally proposed a provision excluding section 70b from applying to the other chapters, but the proposal was eliminated, apparently because it was too controversial. Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467 n.127 (1964).

14. 11 U.S.C. § 502 (1970).

15. *Id.* § 702.

16. 325 U.S. 300 (1945).

17. *Id.* at 302-03.

18. Act of September 25, 1962, Pub. L. No. 87-681, § 9, 76 Stat. 572, *amending* 11 U.S.C. § 110(b) (1958).

19. *See generally* S. REP. No. 1954, 87th Cong., 2d Sess. (1962). The Report did not comment specifically on this amendment, but stated that the general purpose of the bill was to

Queens: First, a landlord may waive the right to terminate or be estopped from asserting it if he evidences by his conduct an intent to affirm the lease;[20] second, bankruptcy courts may at times refuse enforcement[21] of a termination clause if it is unjust, and its effect is only to frustrate a reorganization.[22]

The district court in *Queens* had accepted the referee's finding that the landlord had not waived its right to terminate since the landlord had neither accepted rent under the lease after exercising the right to terminate,[23] nor delayed unreasonably in giving notice of termination. The circuit court reluctantly accepted the finding

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make a number of changes the need for which had become apparent in the course of periodic review of the operation of the Bankruptcy Act and which were considered noncontroversial.

20. 503 F.2d at 204. *See* Davidson v. Shivitz, 354 F.2d 946, 948 (2d Cir. 1966); B.J.M. Realty Corp. v. Ruggieri, 338 F.2d 653 (2d Cir. 1964).

21. Powers exercisable by a bankruptcy court generally may be exercised by a referee in bankruptcy because section 1(9) of the Act, 11 U.S.C. § 1(9) (1970), defines "court" to include the judge or the referee of the bankruptcy court.

22. 503 F.2d at 205. *See* Weaver v. Hutson, 459 F.2d 741 (4th Cir.), *cert. denied*, 409 U.S. 957 (1972); *In re* Fleetwood Motel Corp., 335 F.2d 857 (3d Cir. 1964).

The two cases basically represent the injection of the doctrine of "unconscionability" into the issue of whether termination clauses are enforceable in proceedings under Chapter X. As a matter of federal law, unconscionability is a valid defense in equity, and thus in the bankruptcy courts. *See* Campbell Soup Co. v. Wentz, 172 F.2d 80 (3d Cir. 1948); *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Pa. 1966). *But see* Manufacturers Fin. Co. v. McKey, 294 U.S. 442 (1935) (where the creditor asked for no distinctly equitable relief, court powerless to deny relief on equitable grounds).

When the question of unconscionability arises, "the basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." UNIFORM COMMERCIAL CODE § 2-302, Comment 1 (1972 version). *See also* RESTATEMENT OF CONTRACTS § 234, at 107-19 (Tent. Draft No. 5, 1970). Nevertheless, there is still controversy concerning the concept, and it has been argued that the essence of unconscionability is in the consequences of a contract. *See, e.g.*, Poulos, *A Review of Recent Law Review Articles on Unconscionability*, 45 AM. BANKR. L.J. 195, 198 (1971).

In neither *Weaver* nor *Fleetwood* did the courts review the development of the doctrine of unconscionability to determine whether the principle was applicable, although in both of these cases the lease provisions could have been found to be unconscionable under the test that seeks to determine whether the contracts were, in light of all the circumstances, reasonable commerical devices. *See In re* Elkins-Dell Mfg. Co., *supra* at 874. In both cases, the forfeitures of large amounts of the debtors' property in addition to the reversion of the lessors' land were considered the unreasonable elements. As the court discussed lucidly in *Elkins-Dell*, the issues of unconscionability and the policy of the Bankruptcy Act should not be confused, a warning that was not heeded in *Fleetwood*, *Weaver*, and *Queens*.

23. Mere acceptance of payments for "use and occupancy" from the debtor does not constitute acceptance of "rent." *In re* Wil-Low Cafeterias, Inc., 95 F.2d 306 (2d Cir.), *cert. denied*, 304 U.S. 567 (1938).

also, although noting that the landlord's conduct prior to giving notice of termination "strongly suggests that it was willing to accept payment of rent arrears, to forgive Queen's default and to continue under the lease."[24]

Besides the waiver exception to the general rule of enforceability of termination clauses, in at least two cases prior to *Queens*, bankruptcy courts in Chapter X proceedings have refused enforcement by drawing upon their powers of equity to avoid injustice and prevent the failure of a plan of rehabilitation.[25] Bankruptcy courts have equity powers derived from several sources, including section 2a(15) of the Bankruptcy Act,[26] and, more generally, section 1651 of the Judicial Code[27] and the traditional equity powers of a court of bankruptcy.[28] Some decisions[29] have emphasized, however, what is now

24. 503 F.2d at 205. There is a hazard in loosely extending the waiver exception in the manner hinted at in *Queens*; if the landlord could lose his right to terminate merely by his readiness to continue the lease if the tenant would pay the rent due, he may be stripped of a basis for bargaining with the tenant. One result could be that a landlord would not cooperate in the efforts to rehabilitate a debtor-tenant in proceedings under Chapter XI unless willing to waive the right to terminate. The superficial and unduly extended approach of some bankruptcy courts to the question of estoppel has been criticized sharply. *See* J. MACLACHLAN, *supra* note 2, at 51.

25. *See* note 22 *supra*.

26. Section 2a(15) of the Act provides:

> (a) The courts of the United States hereinbefore defined as courts of bankruptcy are created courts of bankruptcy and are invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this title, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—
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> . . .
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> (15) Make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this [Act] . . . .

11 U.S.C. § 11(a)(15) (1970).

27. The Judicial Code provides: "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C. § 1651(a) (1970).

28. *See, e.g.*, SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940); Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & Pac. Ry., 294 U.S. 648, 675-76 (1935); 8 COLLIER, *supra* note 2, ¶ 3.23. Judicial comments on the nature of a bankruptcy court's powers of equity have been numerous. *See, e.g.*, Cedar-Comp Materials Co. v. Bumb, 344 F.2d 256 (9th Cir. 1965); Fahs v. Martin, 224 F.2d 387 (5th Cir. 1955); United States v. Duggan, 210 F.2d 926 (8th Cir. 1954); Solomon v. Gerstel, 207 F.2d 601 (5th Cir. 1953); Evarts v. Eloy Gin Corp., 204 F.2d 712 (9th Cir.), *cert. denied*, 346 U.S. 876 (1953). The Supreme Court's discussion in Pepper v. Litton, 308 U.S. 295 (1939), has had the greatest effect on recent decisions. After emphasizing in *Pepper* that courts of bankruptcy are essentially courts of equity, the Court stated that bankruptcy courts have invoked these equitable powers "to the end that fraud will not prevail, that substance will not give way to form, that technical

the statutory limitation in section 2a(15), that a bankruptcy court is to exercise its equity power only "as may be necessary for the enforcement of the provisions of [the Bankruptcy Act] . . . ."[30] Because a bankruptcy court is a statutory court created and governed by the Bankruptcy Act, courts typically have reasoned that the specific provisions of the Act should prevail when they conflict with general principles of equity.[31] Despite the admonition of section 2b[32] that the powers of bankruptcy courts are not limited by the enumerated powers in section 2a, it nevertheless should be apparent that Congress did not intend that bankruptcy courts should be able to exceed jurisdictional limitations within the Act itself in pursuit of equitable goals.[33]

Two prior cases were used by the circuit court in *Queens* to support its refusal to enforce the termination clause. *Weaver v. Hutson*[34] and *In re Fleetwood Motel Corp.*[35] both concerned similar fact situations in Chapter X proceedings. In *Fleetwood* a termination clause in a 99-year lease of land provided for the lessor to take title to a motel constructed thereon in the event of bankruptcy of the tenant corporation. Annual rental for the land was forty thousand dollars, while the equity of the corporation (and thus of its shareholders) in the building exceeded five hundred thousand dol-

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considerations will not prevent substantial justice from being done." *Id.* at 305. This language has encouraged increasingly liberal applications of equitable principles in the bankruptcy courts. *See generally* Aug, *Recent Trends in the Application of Equitable Principles in Bankruptcy*, 43 REF. J. 109 (1969); Gleick, *The Equitable Power of Bankruptcy Courts to Subordinate Claims or to Disallow Claims Entirely on Equitable Grounds: A Discussion of Developments*, 33 REF. J. 69 (1959).

29. *See, e.g.*, American United Mut. Life Ins. Co. v. Avon Park, 311 U.S. 138, 145 (1940); *In re* Friedman, 232 F.2d 151 (2d Cir.), *cert. denied*, 352 U.S. 835 (1956); Solomon v. Gerstel, 207 F.2d 601 (5th Cir. 1953); *In re* Judith Gap Commercial Co., 5 F.2d 307 (9th Cir. 1925).

30. 11 U.S.C. § 11(a)(15) (1970).

31. *See, e.g.*, Luther v. United States, 225 F.2d 495 (10th Cir. 1954); Southern Bell Tel. & Tel. Co. v. Caldwell, 67 F.2d 802 (8th Cir. 1933).

32. Section 2(b) provides: "Nothing in this section contained shall be construed to deprive a court of bankruptcy of any power it would possess were certain specific powers not herein enumerated." 11 U.S.C. 11(b) (1970). *But see In re* Judith Gap Commercial Co., 5 F.2d 307 (9th Cir. 1925); 1 COLLIER, *supra* note 2, ¶ 2.80. Section 2b has been interpreted infrequently by the courts. In *Judith Gap* the court rejected an argument that the section confirmed broad equity powers in bankruptcy courts and asserted instead that bankruptcy proceedings, though equitable, must be administered in accord with the Bankruptcy Act.

33. *See, e.g.*, SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965); *In re* Texas Consumer Fin. Corp., 480 F.2d 1261 (5th Cir. 1973); Bank of Marin v. England, 352 F.2d 186 (9th Cir. 1965), *rev'd on other grounds*, 385 U.S. 99 (1966).

34. 459 F.2d 741 (4th Cir.), *cert. denied*, 409 U.S. 957 (1972).

35. 335 F.2d 857 (3d Cir. 1964).

lars. Relying upon the "inherent equity powers of a court of bankruptcy," the court held the termination clause unenforceable because the forfeiture would entail the loss of more than a half million dollars invested by the public and because no plan of reorganization could be formulated if forfeiture were permitted.[36] *Weaver* also involved a long-term lease of land on which a lessee corporation constructed a motel. At the commencement of the proceedings, the land was valued at one hundred fifty thousand dollars without improvements, while the debtor corporation's equity in the motel was approximately one million dollars. All rents had been paid to the lessor, and his financial interests were not in jeopardy. Citing *Fleetwood*, the court refused to enforce the termination clause when "the result of the forfeiture . . . would be the complete emasculation of the reorganization because the forfeiture would remove the entire res from the estate of the debtor."[37]

Two considerations supported the decisions in *Fleetwood* and *Weaver*: the unconscionability of the "windfalls" to the landlord resulting from forfeitures of substantial debtor property and the undesirability of emasculating reorganization plans. Despite its assertion that the rationale of both cases was applicable,[38] even the majority in *Queens* considered the landlord to be seeking only the return of his own property.[39] Furthermore, as Judge Hayes argued in his dissent,[40] the benefit that the lessor would secure by termination of the lease "is present in every case like this because the landlord would never terminate the lease unless he could relet at a higher rent."[41] Moreover, the fact that the court did not discuss the facts of the case as they might relate to the doctrine of unconscionability indicates that it did not consider the termination to be unconscionable.[42] Rather, it appears that the *Queens* decision at-

36. *Id.* at 862.
37. 459 F.2d at 744.
38. 503 F.2d at 206.
39. *Id.*
40. *Id.* at 207.
41. *Id.*
42. Among the factors that have been suggested as relevant in judging whether a security provision is unconscionable are the following: the financial position of the bankrupt at the time the agreement was entered into; the extent to which such agreements are customary; the extent to which the security interest given reflects anticipated risks; the extent to which the contract provision facilitated commerce by making credit available where it otherwise would not be or impeded commerce by precluding access to other sources of credit; and the effects of holding the provision unenforceable in bankruptcy on the future financing of similar business. *See In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 874 (E.D. Pa. 1966).

tempted to stand primarily on the second leg of *Fleetwood* and *Weaver*, that the termination clause was unenforceable because enforcement would prevent the financial rehabilitation of the debtor.

Viewed against the statutory scheme of the Bankruptcy Act, however, the attempt made to effectuate rehabilitation in *Queens* is an inappropriate extension of the equitable powers of bankruptcy courts in Chapter XI proceedings to accomplish an otherwise proscribed alteration of rights other than those of unsecured creditors. While both Chapters X and XI have a similar general purpose, the financial rehabilitation of the insolvent debtor, Chapter XI concerns arrangements only for settlement or satisfaction of unsecured claims;[43] other rights against the debtor may be adjusted in proceedings under Chapter X.[44] Whether a particular debtor should seek relief under Chapter X or XI is not always readily apparent since selection of the appropriate proceeding may depend upon a variety of business and public interest considerations.[45] More discernible, however, are the differences in powers conferred upon the courts by

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A landlord may be willing to lease premises to a marginal or speculative venture if, like a creditor, he can "repossess" his property without delay should the venture fail. If the landlord cannot terminate the lease upon the insolvency of the tenant, he is placed at a disadvantage relative to secured creditors. In considering a security arrangement the referee had labeled "unconscionable" and unenforceable, the court in *Elkins-Dell* stated:

> It would be a paradoxical course for the bankruptcy court, in the process of protecting bankrupts and unsecured creditors, to adopt a principle which dealt a *coup de grace* to other shaky businesses in need of financing but unable to get it except upon terms unacceptable to the court as it views the transaction *post facto*. It would be an egregious instance of "yielding to pity for the individual case at the cost of a more inclusive rescue . . . ."
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> To hold these contracts unenforceable on their face would probably be to impose a judicially invented but economically dysfunctional morality upon knowledgeable contracting parties. It might jeopardize the availability of receivables financing for those from whom factoring is the only practicable way of securing capital. It would be to add a risk of unenforceability to the other risks inherent in such financing.

Id. at 871-72 (citation omitted). *See also* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

43. SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965); SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940); *In re* Pioneer Sample Book Co., 374 F.2d 953 (3d Cir. 1967); Chafee County Fluorspar Corp. v. Athan, 169 F.2d 448 (10th Cir. 1948); Bankruptcy Act § 356, 11 U.S.C. § 756 (1970).

44. SEC v. United States Realty & Improvement Co., 310 U.S. 434, 452 (1940); 11 U.S.C. § 616(1) (1970).

45. SEC v. American Trailer Rentals Co., 379 U.S. 594, 613-15 (1965). There is, however, no discretion in selecting the appropriate proceeding; a Chapter XI proceeding must be dismissed if Chapter X should have been utilized. *Id.* at 619-20 n.18; SEC v. Canadaigua Enterprises Corp., 339 F.2d 14 (2d Cir. 1964).

each chapter to accomplish a rehabilitation once the appropriate proceeding has been selected.

Because section 356[46] of the Act provides for the alteration only of rights of unsecured creditors in Chapter XI proceedings, the equity powers of the court should be limited to the adjustment of general claims against the assets of the debtor.[47] While bankruptcy courts in a Chapter XI arrangement have the power under section 314[48] to stay the commencement or continuance of proceedings to enforce liens against specific property, they may not adjust, much less extinguish, rights other than the claims against the debtor's general assets.[49] Thus they should not be able to refuse enforcement to a landlord's contractual right of termination since that right is not merely a claim against general assets of the debtor. Since section 356 limits the interests which can be adjusted in a Chapter XI proceeding, the reliance of the *Queens* court upon *Weaver* and *Fleetwood* was misplaced;[50] those cases, concerning proceedings under Chapter X, were decided pursuant to a much broader stan-

46. 11 U.S.C. § 756 (1970). The section provides: "An arrangement within the meaning of this chapter shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration."

47. Despite the importance of the concept to Chapter XI, the Act nowhere defines the term "unsecured creditor." Professor Moo, however, provides a working definition: "those creditors who have not been granted special property rights or interests in some or all of the debtor's property. . . ." Moo, *The Secured Creditor in Bankruptcy*, 47 AM. BANKR. L.J. 23, 27 (1973). A "secured creditor" is defined by section 1(28) of the Act to include "a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this [Act] or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets . . . ." 11 U.S.C. § 1(28) (1970). For the purposes of a Chapter XI proceeding involving more than a mere extension of payment periods, section 307 defines "creditors" to include "the holders of all unsecured debts, demands, or claims of whatever character against a debtor. . . ." 11 U.S.C. § 707 (1970).

48. 11 U.S.C. § 714 (1970). *See* note 65 *infra* & accompanying text.

49. *See* Chaffee County Fluorspar Corp. v. Athan, 169 F.2d 448 (10th Cir. 1948); *In re* Camp Packing Co., 146 F. Supp. 935 (N.D.N.Y. 1956). For a critical discussion of the distinction between secured and unsecured creditors on the basis of their contractual rights, see Poulos, *Leading Case Commentary*, 46 AM. BANKR. L.J. 165 (1972).

50. The court in *Queens* stated: "Since Chapters X and XI both contemplate the continued viability of the debtor, the fact that *Weaver* and *Fleetwood* arose in the context of Chapter X proceedings does not diminish their relevance here." 503 F.2d at 205 n.6. There is ample support, however, for declining to distinguish *Weaver* and *Fleetwood* from *Queens* merely on the basis that the two Chapter X cases involved substantial amounts of public investment. The Supreme Court specifically rejected an attempt to make the presence of publicly held debt the sole determinant for selecting between proceeding under Chapter X or Chapter XI. *See* SEC v. American Trailer Rentals Co., 379 U.S. 594, 613 (1965).

dard, section 216,[51] which specifically gives the court greater control over all claims against the debtor, including the adjustment of claims held by both secured creditors and stockholders.

Schokbeton Industries, Inc. v. Schokbeton Products Corp.[52] illustrates the constraints placed upon the equitable powers of a court by Chapter XI. Acknowledging that the effect of its holding was to jeopardize seriously the debtor's chances for financial rehabilitation,[53] the Court of Appeals for the Fifth Circuit nevertheless dissolved an injunction that prevented the operation of a termination clause in a valuable exclusive licensing agreement.[54] Although section 70b would have permitted the debtor to reject the entire executory contract,[55] the court held that the debtor could not keep the contract in effect to retain its benefits, while at the same time seeking to prevent the licensor from exercising his own contractual right to end the agreement under the termination clause.[56] The effect of the decision is that a bankruptcy court which has statutory authority in a Chapter XI proceeding to allow the rejection of an entire contract still may not rely on equity powers to rewrite particular provisions so as to alter rights under the contract; this limitation contrasts sharply with the court's specific authority pursuant to section 356 to adjust the claims of unsecured creditors against the general assets of the debtor. Even when the party whose rights the court attempts to adjust engaged in conduct sufficiently reprehensible as to shock the conscience of the court, the Court of Appeals for the Fifth Circuit subsequently rejected the exercise of equity powers in a Chapter XI proceeding when claims other than those of unsecured creditors would be altered.[57]

Although the lease termination clause that the *Queens* court refused to enforce can be distinguished somewhat from that of the license agreement in *Schokbeton* on the basis of the barnacles of property law that adhere to the concept of a lease,[58] the termination

51. 11 U.S.C. § 616 (1970).

52. 466 F.2d 171 (5th Cir. 1972).

53. *Id.* at 177.

54. *Id.* at 178. The court admitted the possibility that a bankruptcy court might stay temporarily the enforcement of a contractual right, *id.* at 176-77, but it equated the indefinite postponement of the debtor's obligation to perform to the nullification of the licensor's contractual rights, *id.* at 176.

55. *See* note 1 *supra.*

56. *Id.* at 175, *citing inter alia* Hurley v. Atchison, T. & S.F. Ry., 213 U.S. 126 (1909).

57. *See In re* Texas Consumer Fin. Corp., 480 F.2d 1261 (5th Cir. 1973).

58. The lease is a legal concept unique to itself: "Much has been written about the nature

clause itself should be recognized as giving the landlord a right distinct from his right to receive rent under the lease. Clearly the latter obligation creates a claim on the part of the landlord against the debtor's general assets, and that claim may be adjusted by a bankruptcy court in a Chapter XI proceeding.[59] Nevertheless, it is just as clear that the landlord enjoys a status not unlike that of a secured creditor in certain regards;[60] his right to terminate gives him a right exercisable, not against the debtor's general assets as an unsecured creditor, but against a specific property interest of the debtor, the leasehold.[61] Although, in an analogous context, a secured creditor might waive its security by filing a claim against a debtor's general assets,[62] the court in *Queens* found, however reluctantly, that the landlord had not waived its rights under the termination clause of the lease.[63] As a consequence, the court's refusal to enforce the clause constituted more than a simple adjustment of an unsecured claim against the general assets. Whether viewed as a contract right like that in *Schokbeton* or as a right against specific property analogous to a security interest, the landlord's right to

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of a lease, whether a conveyance or, as in the civil law, a contract. The obvious answer is that it is both. . . . The lease operates to convey a possessory estate to the lessee. . . . But any modern lease also contains numerous contractual provisions. . . . If the warp is conveyance, the woof is contract and neither alone makes a whole cloth." 1 AMERICAN LAW OF PROPERTY § 3.11, at 202-03 (A.J. Casner ed. 1952).

59. *See* Bankruptcy Act § 353, 11 U.S.C. § 753 (1970).

60. As explained by one commentator:

> A lessor having a right to forfeit a lease in case of default is like a secured creditor. If it is advantageous to the estate to prevent a forfeiture of the lease, a payment of rent for that reason is not a preference, even in the absence of any distress or statutory landlord's lien. If, however, the landlord does not enter for condition broken, he is not regarded as having realized upon a security which must be valued under section 57h and deducted from his claim for rent in arrears. If the landlord elects to continue the lease and to prove in bankruptcy or arrangement proceedings, he may accordingly file a claim which may sometimes be put in a class by itself.

J. MACLACHLAN, *supra* note 2, at 397 (footnotes omitted). *See also* Festersen, *Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle*, 46 AM. BANKR. L.J. 311, 335 (1972); Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 484 (1964).

61. The similarity between the interests of lessors and secured creditors is illustrated by the fact that secured creditors may attempt to achieve the generally more protected status of lessor by drafting security agreements in the form of leases. *See generally* Del Duca, *Evolving Standards for Distinguishing a "Bona Fide Lease" from a "Lease Intended as Security"—Impact on Priorities*, 75 COM. L.J. 218 (1970).

62. *See* United States Nat'l Bank v. Chase Nat'l Bank, 331 U.S. 28 (1947).

63. *See* notes 23-24 *supra* & accompanying text.

terminate gives him a claim that cannot be extinguished by use of the court's equity powers without exceeding the limits imposed upon those powers by Chapter XI.

If adjustment of a lessor's right to terminate a leasehold is necessary for the rehabilitation of the debtor, reorganization under Chapter X is appropriate. While the choice between proceeding under Chapter XI or Chapter X is not discretionary, the standard for reorganization pursuant to the former is that an arrangement under the latter would be ineffective.[64] If rehabilitation would be impossible without extinguishing the landlord's right of termination, the requirements for a Chapter X reorganization would be met because the necessary relief could not be accomplished in accordance with the limitations imposed upon the court's equity powers by Chapter XI.

Relief for the financially strained small business may yet be available under Chapter XI, however, without the overextension of the bankruptcy court's equity powers illustrated by *Queens*. Section 314 of the Act[65] authorizes the court in a Chapter XI proceeding, upon a showing of cause, to stay the commencement or continuation of actions to enforce a lien against property. Moreover, courts on occasion have exercised equitable powers to stay the eviction of a debtor-tenant even after the landlord has established his right to immediate possession.[66] A stay so indefinite in duration as to constitute a practical extinguishment of the landlord's right to terminate the lease would be just as much an overextension of equitable powers as was the *Queens* court's refusal to enforce a termination clause.[67]

64. SEC v. American Trailer Rentals Co., 379 U.S. 594, 607 (1965).

65. 11 U.S.C. § 714 (1970). Similar relief is available also in Chapter X. *See* 11 U.S.C. §§ 513, 516(4), 548 (1970).

66. *See In re* Program Aids Co. Inc., 310 F. Supp. 198 (E.D.N.Y. 1969); *In re* Lane Foods, Inc., 213 F. Supp. 133 (S.D.N.Y. 1963). In *Program Aids* the referee attempted to keep the debtor-tenant in business for the benefit of creditors while also permitting the landlord to initiate a more profitable lease with a new tenant. The court did not find that the referee had exceeded the bounds of his equitable powers by his purportedly temporary refusal to honor the landlord's right to terminate the lease, but it suggested that the referee consider limiting the debtor's possession to no more than eight months from the date of filing the petition pursuant to Chapter XI. 310 F. Supp. at 198. In *Lane Foods* the court permitted an 80-day stay of the execution of a properly obtained eviction warrant, stating that the equitable powers of the court were sufficient to defer the landlord's right of reentry. 213 F. Supp. at 133. *See also In re* Walker, 93 F.2d 281, 283 (2d Cir. 1937).

67. *See* note 54 *supra*. One commentator has noted: "[S]ince the plan in Chapter XI can ultimately affect the rights of unsecured creditors only, the court cannot legally or in good conscience stay secured creditors indefinitely. There is no such component of conscience in

Properly circumscribed, however, a temporary stay can permit the debtor to remain in possession of valuable premises while he renegotiates his debts, obtains additional financing, or seeks an alternate location for his business;[68] it thus can facilitate rehabilitation of the debtor without resort to Chapter X reorganization.

Temporary restraint of the landlord's effort to reenter the premises may not have been effective in *Queens* because a new solvent tenant was willing to rent the store building at an increased rental immediately and the obtaining of alternate premises by Queens would have offered no relief since the specific location was the liquor store's principal asset in rehabilitation.[69] Barred from such a compromise, the court nevertheless had no authority under Chapter XI to refuse to enforce the lease termination clause because relief under that chapter is limited to adjustment of unsecured claims; extinguishment of the landlord's right to reenter could only have been accomplished properly in a Chapter X proceeding.[70] For the court to have denied the right in an arrangement pursuant to Chapter XI represents an exercise of the court's equity powers in a manner that fails to comport with the statutory framework of the Bankruptcy Act.

Chapter X and some secured creditors really take a beating during the delay." Seidman, *Chapter X or Chapter XI?*, 76 COM. L.J. 33, 34 (1971).

68. *See generally* Herzog, *Bankruptcy Law—Modern Trends*, 37 REF. J. 48 (1963).

69. 503 F.2d at 204.

70. If current recommendations, *see* COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), were to be enacted, the substitution of a new Chapter VII for the present Chapters X and XI would provide for the rehabilitation of the corporate debtor through a variety of means not limited to the adjustment of unsecured claims. *See* Trost, *Corporate Reorganizations Under Chapter VII of the "Bankruptcy Act of 1973": Another View*, 48 AM. BANKR. L.J. 111, 137-38 (1974).