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UNEXPIRED LEASES IN BANKRUPTCY: RIGHTS OF THE AFFECTED MORTGAGEE

PETER A. ALGES*

State law permits a foreclosing mortgagee to evict a subsequent lessee of the mortgagor provided the lessee is joined in the foreclosure proceeding.¹ A mortgagee's rights are less defined, however, when the mortgagor becomes a "debtor"² under the Bankruptcy Reform Act of 1978 (Code). Although several Code provisions touch upon the matter, they do not clearly balance the equities.³

Professor Krasnowiecki analyzed this disparate treatment in an article published shortly after the Code's enactment⁴ and concluded:

If there are leases in [a mortgaged] building that are depressing the value of the building and the landlord goes through a straight bankruptcy,⁵

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1. See generally G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* § 7.12, 451-52 (1980). Absent an agreement between the lessee and the mortgagee as to priority, the lessee's rights in a foreclosure proceeding are determined by the timing of the lease in relation to the mortgage. If the lease preceded the mortgage, the purchaser takes the property encumbered by the lease. If the mortgage preceded the lease, however, the lease is generally extinguished. *Wilson v. Campbell*, 244 Ark. 451, 425 S.W.2d 518 (1968); *Kansas City Mortgage Co. v. Industrial Comm'n*, 555 S.W.2d 58 (Mo. Ct. App. 1977); 127 *Korea House, Inc. v. House of Korea*, 49 A.D.2d 736, 372 N.Y.S.2d 679 (1975).

The rules governing a foreclosing mortgagee's right to bind a subsequent lessee to his lease vary. Compare *Kansas City Mortgage Co. v. Industrial Comm'n*, 555 S.W.2d 58 (Mo. Ct. App. 1977) (not possible for a mortgagee to become a substitute landlord on leases previously executed by the mortgagor) with *Silverstein v. Schak*, 107 Ill. App. 3d 641, 437 N.E.2d 1292 (1982) (foreclosing mortgagee may either evict the mortgagor's lessee or recognize the lessee as his tenant under the existing lease). See generally Comment, *The Effect of a Mortgage Foreclosure on a Lease Executed Subsequent to the Mortgage*, 17 WASH. L. REV. 37 (1942) (describing the rights of foreclosing mortgagees and lessees by reference to the law of several states).

2. A debtor under the Code is a "person or municipality concerning which a case under this title has been commenced." 11 U.S.C. § 101(12) (Supp. V 1981). Collier explained that the Code uses the term "debtor" throughout to avoid the stigma attached to the term "bankrupt." 2 COLLIER ON BANKRUPTCY ¶ 101.12 (15th ed. 1979), citing H.R. REP. NO. 595, 95th Cong., 1st Sess. 310 (1977), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963; S. REP. NO. 989, 95th Cong., 2d Sess. 28 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963.

3. In the analogous situation of the lessee's bankruptcy, the Code is more specific. The Code precludes operation of "ipso facto" or bankruptcy clauses that would effectively divest the interest of a debtor upon the commencement of bankruptcy proceedings. 11 U.S.C. § 365 (Supp. V 1981). The Code also sets out a landlord's claim for future rent against a bankrupt lessee by limiting the claim to the greater of one year's rent payments or 15% of the payments for the balance of the lease term, not in excess of three years. *Id.* § 502(b)(7).

4. Krasnowiecki, *The Impact of the New Bankruptcy Reform Act on Real Estate Development and Financing*, 53 AM. BANKR. L.J. 363 (1979).

5. The Code uses the term "liquidation" rather than "straight bankruptcy." The provisions on liquidation are in chapter 7 of the Code. 11 U.S.C. §§ 701-766 (Supp. V 1981).

the landlord's mortgagee will ordinarily be able to lift the stay⁶ if its claim exceeds the value of the building⁷ and, in any event, if the building is sold it will be sold subject to the mortgage. In a reorganization . . . , however, the stay may not be lifted,⁸ and if the trustee has no power to modify the rent, the landlord's mortgagee may be injured, because it may be required in a "cram down"⁹ to accept cash or extended payments equal to the present value of the building (as depressed by the outstanding leases).¹⁰

Insofar as bankruptcy courts are courts of equity¹¹ designed to balance competing interests,¹² Professor Krasnowiecki's conclusion would frustrate the essential purpose of the bankruptcy system.

This article will consider the arguments available to the mortgagee whose collateral is involved in a bankruptcy proceeding and encumbered by below-market leases.¹³ The thesis advocated is that the correct reading of the Code protects the affected mortgagee by permitting dispossession of the mortgagor-debtor's tenant. This article describes the mortgagee's arguments and supports those assertions by examining the dynamics of reorganization in bankruptcy.¹⁴

THE PRIOR LAW

The best indication of the drafters' intent in balancing equities under the Code may be the common understanding of the parties' rights under prior law.

6. *Id.* § 362. See *infra* note 59.

7. "Since, *ex hypothesi*, the building is not 'necessary to an effective reorganization.'" Krasnowiecki, *supra* note 4, at 375 n.60.

8. 11 U.S.C. § 362(d) (Supp. V 1981).

9. See *infra* text accompanying notes 113-121.

10. There was considerable controversy under the "strong arm" provision of the Bankruptcy Act, § 70(e)(1), whether the trustee could assert the rights of any secured creditor to void any other claim. Kennery, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419 (1967). The Bankruptcy Reform Act expressly states that the trustee may assert only the rights of an *unsecured creditor*, 11 U.S.C. § 544(b). Although the leases are not "claims," it seems clear, by analogy, that the trustee cannot simply terminate the leases merely because the mortgagee would have this power.

Krasnowiecki, *supra* note 4, at 375 n.63. See also *infra* text accompanying notes 96-108.

11. *Local Loan v. Hunt*, 292 U.S. 234 (1934); *In re Flour Mills of Am.*, 27 F. Supp. 559, 560 (W.D. Mo. 1939).

12. "Congressional objective in enacting [the Bankruptcy Act] was to secure for creditors as well as bankrupts the efficient and fair administration of estates." *In re Palfy*, 336 F. Supp. 1268, 1269 (N.D. Ohio 1972).

13. A mortgagee may become party to a bankruptcy proceeding with little or no notice. The Code does not require a debtor to be insolvent to take advantage of the relief offered by the Reform Act. See 11 U.S.C. §§ 109, 301, 303 (Supp. V 1981) (describing the requisites for initiation of a bankruptcy proceeding).

14. The rights of a similarly situated mortgagee in a liquidation proceeding are not examined in this article except incidentally for purposes of comparison. The arguments framed are best understood if the formulation of a plan of reorganization is viewed as a negotiation process. That is, it might not be crucial for a bankruptcy judge to be convinced of the impregnability of the mortgagee's position. It could be sufficient that the debtor's representative understands that the judge may be persuaded to see things as does the mortgagee.

Specifically, how did Chandler Act¹⁵ and pre-Chandler Act¹⁶ principles accommodate the interests considered here? In formulating arguments that protect the mortgagee's interests under the Code, it is helpful to consider the options available to the mortgagee prior to the Reform Act.

Pre-Chandler Act

In a thorough commentary,¹⁷ Professors Creedon and Zinman interpreted the pre-Chandler Act law as permitting the landlord's trustee to reject an unexpired lease yet precluding the trustee from evicting the tenant in mid-lease or increasing the rent.¹⁸ According to Professors Creedon and Zinman, "[t]he statutes, case law and commentaries seemed to assume *sub silencio* that a rejection of the lease by a trustee of a landlord in bankruptcy or receivership could not terminate the tenant's interest in the property or force the tenant to vacate the premises."¹⁹

Creedon and Zinman cited four cases²⁰ in support of that conclusion.²¹ Three of those cases contended in dicta that the landlord's trustee could not dispossess the tenant.²² None of the four cases, however, is unassailable authority for that proposition because a trustee's right to dispossess a tenant was not in issue. Furthermore, none of the cases involved a prior mortgagee.²³ The language in two of the cases illustrates that the pre-Chandler Act law was not as unflinchingly pro-lessee as Creedon and Zinman implied.²⁴

15. Act of June 22, 1938, ch. 575, 52 Stat. 840 (repealed 1979). The Chandler Act, a complete revision of the Bankruptcy Act of 1898, was enacted in response to criticism that prevailing law was "not adapted to existing conditions because of its slow-moving procedural machinery, a breakdown of creditor control, a large number of administrative duties thrust upon the courts, and the domination of administration by attorneys." H.R. REP. NO. 1409, 75th Cong., 1st Sess. (1938).

16. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544 (amended 1938; repealed 1979).

17. Creedon & Zinman, *Landlord's Bankruptcy: Laissez Les Lessees*, 26 BUS. LAW. 1391 (1971).

18. Thus rejection might only excuse the landlord's performance of affirmative executory obligations such as the provision of certain maintenance services. See *Stell Mfg. Co. v. Gilbert*, 372 F.2d 113 (5th Cir. 1966).

19. Creedon & Zinman, *supra* note 17, at 1398.

20. *Vass v. Conron Bros. Co.*, 59 F.2d 969 (2d Cir. 1932); *American Brake Shoe & Foundry Co. v. New York Ry.*, 278 F. 842 (S.D.N.Y. 1922); *Coy v. Title Guar. & Trust Co.*, 198 F. 275 (D. Or. 1912); *In re Hays, Foster & Ward Co.*, 117 F. 879 (W.D. Ky. 1902).

21. Creedon & Zinman, *supra* note 17, at 1399.

22. See *Vass v. Conron Bros. Co.*, 59 F.2d 969 (2d Cir. 1932); *American Brake Shoe & Foundry Co. v. New York Ry.*, 278 F. 842 (S.D.N.Y. 1922); *In re Hays, Foster & Ward Co.*, 117 F. 879 (W.D. Ky. 1902).

23. Later in the same article, Creedon and Zinman did acknowledge that the presence of a prior mortgage alters the equities under a Chandler Act analysis: "[I]f a lease [sic] is in a position where foreclosure of a superior mortgage would cut it off, there may be some merit to the argument that the lease should stand or fall with the mortgage." Creedon & Zinman, *supra* note 17, at 1430-31 n.148.

24. The two cases not discussed in the text, *Vass v. Conron Bros. Co.*, 59 F.2d 969 (2d Cir. 1932), and *American Brake Shoe & Foundry Co. v. New York Ry.*, 278 F.2d 842 (S.D.N.Y. 1922), both state in dicta the rule that the lessee of a bankrupt may not be put out of possession. But neither *Vass* nor *American Brake Shoe* dealt with or even referred to the rights of a lessee where there was a prior mortgage.

In one of the four cases, *In re Hays, Foster & Ward Co.*,²⁵ the court held that the landlord-tenant relationship is terminated when the tenant is adjudicated a bankrupt. The court noted that when the landlord is adjudicated a bankrupt, title to the real property devolves upon the trustee.²⁶ The court emphasized that transferring title to the trustee would not alter the lessee's right to use the property. The court further asserted that change in ownership of real estate never affects the rights of the tenant.²⁷

While the tenant's *rights* may be unaffected, the *tenant* can be adversely affected by a change in ownership. For example, a change of ownership resulting from a mortgage foreclosure sale can extinguish the interest of a tenant who executed a lease subsequent to the mortgage.²⁸ The change in ownership does not diminish the tenant's rights because the tenant has no rights superior to the prior mortgagee in a foreclosure sale. The change in ownership, nonetheless, affects the tenant. Similarly, a bankruptcy court should not automatically protect the lessee's interest when the equities involved are no different from those in a mortgage foreclosure sale under state law.

To protect the lessee's interest without regard to the interest of the prior mortgagee undermines established principles of real estate law. Indeed, a careful reading of *In re Hays* suggests that the court did not maintain the debtor's lessee could never be dispossessed. Acknowledging that the Act authorized the trustee to sell the bankrupt's remainder interest in the land, the court cautioned such a sale does not require destroying the tenant's rights.²⁹ Hence, the court did not mean the trustee *cannot* terminate the lease relationship. Rather, the court meant adjudication does not automatically *mandate* termination of the leasehold.

Creedon and Zinman also cited *Coy v. Title Guarantee & Trust Co.*,³⁰ which involved a lessor for whom a receiver had been appointed.³¹ The *Coy* court upheld the receiver's rejection of a renewal option in a lease. In determining whether the renewal would be burdensome to the estate, the court did not need to decide whether the receiver could dispossess the lessee. In fact, *Coy* contains language that contravenes Creedon and Zinman's argument. Although the court acknowledged that a receiver may not impair a valid contract, it emphasized that a receiver is not bound by the covenants of leases or the lessor's executory contracts. The court further stated that a receiver may abandon or repudiate those covenants and contracts which would be unprofitable to adopt or perform.³² Thus Creedon and Zinman inappropriately relied

25. 117 F. 879 (W.D. Ky. 1902).

26. *Id.* at 885.

27. *Id.* at 884.

28. *See supra* note 1.

29. 117 F. at 884.

30. 198 F. 275 (D. Or. 1912).

31. *Coy*, like *American Brake Shoe & Foundry Co. v. New York Ry.*, 278 F.2d 842 (S.D.N.Y. 1922), involved a pre-Chandler Act equity receivership and was therefore decided by reference to nonstatutory general law.

32. 198 F. at 280. It is unclear what standard is to be applied in rejecting an executory contract under 11 U.S.C. § 365 (Supp. V 1981). Compare *In re Minges*, 602 F.2d 38 (2d Cir. 1979) (adopting the "business judgment" test) with *NLRB v. Bildisco*, 52 U.S.L.W. 4269 (U.S. Feb. 22, 1984) (No. 82-818) (collective bargaining agreement was subject to stricter standard

on *Coy*, which broadly asserts a receiver's right to reject burdensome leases,³³ to support the proposition that a landlord's receiver cannot evict a tenant.

The commentators' misplaced reliance stems from the focus of their inquiry. Precluding a bankrupt landlord from recasting the rent under existing leases is quite different from prohibiting a trustee's taking such action pursuant to his power to sell property of the estate free and clear of certain liens, claims, and interests. If the leased real property is subject to a prior mortgage,³⁴ the equities require consideration of that mortgagee's rights.

Those equities were examined in the Second Circuit's decision of *In re Hotel Governor Clinton*.³⁵ The debtor owned the Hotel Governor Clinton and had leased space for a drug store to the appellants for a term of twenty years and nine and one-half months. The lower court found the mortgage on the premises exceeded the value of the land, buildings, and furnishings. The issue on appeal was whether the court had the power to terminate the lease. Although the lease was explicitly subordinate to the first mortgage lien,³⁶ the court did not support its holding on the lease provisions. Rather the court declared that if a second mortgage could be wiped out in reorganization then so could a lease.³⁷ The court reasoned that although a lease creates an estate in land, that estate is subject to prior mortgages and encumbrances. Moreover, the court recognized that the tenant's leasehold interest constitutes a "claim." Under the Bankruptcy Act,³⁸ a debtor's assets could be sold free from all claims of the debtor. Thus a tenant's claim, made by one claiming through the debtor, would be extinguishable in a reorganization.³⁹

than "business judgment" test, but reference to equities required a finding in favor of rejection). See generally 2 COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.03.

33. The *Coy* court supported this assertion by citing language from *United States Trust Co. v. Wabash Ry.*, 150 U.S. 287 (1893), which addressed the rights of a lessee's receiver: "The general rule applicable to this class of cases is undisputed that an assignee or receiver is not bound to adopt the contracts, accept the leases, or otherwise step into the shoes of his assignor, if in his opinion it would be unprofitable or undesirable to do so. . . ." *Id.* at 299. Thus the *Coy* court, seeking to clarify the right of a lessor's receiver to reject contracts, relied on *Wabash* which dealt with the right of a lessee's receiver to reject contracts. By this analogy, the *Coy* opinion implies that a lessor's receiver has an unfettered right to reject a burdensome lease.

34. See *In re Penn Central Transp. Co.*, 458 F. Supp. 1346, 1356 (E.D. Pa. 1978) ("an appropriate adjustment of the rights of all creditors" may require rejection of a lease where a prior mortgagee is involved).

35. 96 F.2d 50 (2d Cir.), *cert. denied sub nom.*, *Canter v. Ramsey*, 305 U.S. 613 (1938).

36. See *infra* text accompanying notes 142-49.

37. 96 F.2d at 51. For a case in which junior mortgages were extinguished in a reorganization plan, see *In re 620 Church St. Bldg.*, 299 U.S. 24 (1936).

38. Section 77B(h), 11 U.S.C. § 207(h) (repealed 1978) provided:

[T]he property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed, when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention. . . .

39. 96 F.2d at 51. The court cited *In re 620 Church St. Bldg.*, 299 U.S. 24 (1936), for the

The Chandler Act

Section 70(b) of the Chandler Act authorized the trustee to reject unexpired leases, but not to deprive the lessee of his "estate."⁴⁰ Case law construing section 70(b)⁴¹ has generally supported the pre-Chandler Act view of *In re Hotel Governor Clinton* that leases subordinated to a prior mortgage may be terminated.⁴² One of the earliest cases construing the section, *In re Freeman*,⁴³ involved a debtor who owned a residence encumbered by a mortgage and a long-term lease. The trustee arranged to sell the property for \$750 above the outstanding mortgage. The buyer, however, would consummate the sale only if the debtor could deliver immediate possession. The tenant refused to cooperate. The court noted that the tenant's right of possession could preclude a sale of the property for fair value.⁴⁴ Analogizing lessees to vendees under installment sale contracts,⁴⁵ the court advocated eviction when continuing the lease prevents an equitable arrangement with creditors. The court further noted that a tenant injured by the modification of his contract has a remedy because he is deemed a creditor.⁴⁶

Unfortunately for mortgagees, the *Freeman* opinion did not specifically base its holding on the existence of a prior mortgage.⁴⁷ Nevertheless, *Freeman's*

proposition that elimination of the lease under the provisions of § 77B did not render § 77B unconstitutional. *Church St. Bldg.* held a reorganization plan that extinguishes claims having no value does not constitute deprivation of property in violation of the fifth amendment due process clause. *Id.* at 27.

40. 11 U.S.C. § 110(b) (1964). "Most of the commentators on the Bankruptcy Act have urged that the trustee should have no power to recast the rent. None of them seems to have considered the effect of that conclusion on the landlord's mortgagee whose mortgage is superior to the lease." Krasnowiecki, *supra* note 4, at 375 (footnote omitted). Krasnowiecki supports that proposition by citing to Creedon and Zinman, *supra* note 17. As noted, Creedon and Zinman did acknowledge in a footnote that the existence of a mortgage superior to the lease might affect the trustee's rights vis-à-vis the lessee. *See supra* note 23.

41. *See infra* notes 43-52 and accompanying text.

42. *See supra* notes 35-39 and accompanying text.

43. 49 F. Supp. 163 (S.D. Ga. 1943).

44. *Id.* at 165. *See also* Creedon & Zinman, *supra* note 17, at 1430-31 n.148.

45. For treatment of installment sales contracts under the Code, *see generally* Epling, *Treatment of Land Sales Contracts Under the New Bankruptcy Code*, 56 AM. BANKR. L.J. 55 (1982). The relevant Code provisions are 11 U.S.C. §§ 365(i) and (j) (Supp. V 1981).

46. 49 F. Supp. at 165.

47. Commentators have criticized the result of *Freeman* and have explained it away by reference to the prior mortgage.

The court . . . overlooked the fact that there is nothing in the Act giving the trustee or debtor in possession the right to disaffirm an executed performance, and that the lessee has a vested estate that is distinct from the executory covenants contained in the lease. The desire to effect a feasible plan of reorganization cannot override the vested rights of third persons who are not creditors of the debtor. Insofar as the lessee's leasehold is concerned he is as much a stranger to the reorganization case as one who purchased, received and paid for goods of the debtor prior to reorganization The *Freeman* case, therefore, does not represent the proper view of the effect of rejection of an unexpired lease by the debtor-landlord.

6 COLLIER ON BANKRUPTCY ¶ 3.24[1.1] (14th ed. 1969). Creedon and Zinman, *supra* note 17, at 1431, agreed with Collier's analysis of *Freeman*. *See also* 2 COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.09 (updated but unchanged analysis of *Freeman*).

discussion of the equities between the debtor-landlord, mortgagee and tenant properly describes the conflicting interests. The court recognized that the evicted tenant would become an unsecured creditor of the bankrupt estate and would share in the assets realized upon selling the leased premises for an amount *in excess* of the outstanding mortgage. Focusing on the tenant's rights as a creditor, the court argued that a lessee cannot be permitted to wreck an equitable arrangement plan for all creditors carefully worked out in bankruptcy court.⁴⁸

A more recent bankruptcy case considered the trustee's request to dissolve leasehold interests for the sake of the greater good. In the seminal case of *In re Penn Central Transportation Co.*,⁴⁹ the trustees proposed to disaffirm several leases of the bankrupt lessor where the rent was below the fair market rental at the time of the proceeding. The trustees argued that terminating the leases and renegotiating rentals for fair market value would increase the value of the debtor's estate.⁵⁰ The court refused to disaffirm the leases because the mortgages were expressly subordinated to the leases.⁵¹ In addition, the equities did not favor disaffirmance because the only party who could have dissolved the leases under common law, the mortgagee, was expressly subordinated to the lessees.

The *Penn Central* opinion advances the thesis of this article because it suggests that a nonsubordinated prior mortgagee may not be prejudiced for the sake of preserving leasehold interests. *Penn Central's* analysis, however, was limited to the reorganization context. Arguably, the mortgagee's rights are

Another commentator was less harsh in his analysis of *Freeman*:

The *Freeman* decision was correct, but it does not stand for the broad proposition that the lessor provision is limited to straight bankruptcy. All that *Freeman* holds is that where (1) the lease is subordinate to the mortgage, (2) the leasehold has little or no value and (3) the tenant presents no special equities, rejection is proper. Thus limited, *Freeman* is good law.

Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 497 (1964).

48. 49 F. Supp. at 168. The court described the equities involved as follows:

The equities also preponderate in favor of the removal of the tenant If injury is done that can be measured in dollars he becomes a creditor of the debtor and may assert his rights and share with other creditors of the same class in the arrangement proceedings. On the other hand, if he does not yield immediate possession of the premises, the debtor and his family are injured because they lose the small equity now but not later or otherwise realizable, above the mortgage on the home. And the creditors of the debtor, of whom there are twenty, and who are equally as innocent as the tenant insofar as the proceedings in bankruptcy are concerned, will also be injured. If this home were the only asset of the debtor, they might lose their debts entirely. They will certainly lose some substantial part of their debts if the property can not be sold at a price that will produce an excess over the mortgage.

Id. at 167-68.

49. 458 F. Supp. 1346 (E.D. Pa. 1978).

50. *Id.* at 1354. The *Penn Central* court assumed the trustees were correct in concluding that the rental paid by the lessees under the existing leases was less than current fair market rental for equivalent property.

51. 458 F. Supp. at 1356 n.11.

also due significant deference in liquidation. The Code's sale free and clear provisions may also support recognizing the mortgagee's rights in a liquidation proceeding.

In a footnote, the *Penn Central* court referred to the then recently passed House version of the Bankruptcy Reform Act which contained a provision allowing a lessor to reject a lease but not to deprive the lessee of possession. The footnote stated that section 365(h) brings clarity to "an area of bankruptcy practice sorely in need of clarification."⁵² It has not.

THE BANKRUPTCY REFORM ACT OF 1978

Two Code provisions directly affect the rights of a mortgagee whose mortgagor is a landlord subject to bankruptcy proceedings. Section 365(h) purports to clarify the pre-Code confusion regarding the proper construction of the lessee's "estate"⁵³ by replacing vague terminology with more explicit language. The trustee's power to sell assets of the debtor's estate free and clear of all claims, subject to the interest of certain parties, is provided in section 363(f)(1). This portion of the article will consider the language of those two sections, review the pertinent cases, and draw conclusions regarding their application.

Section 365(h): Lessee Possession Guaranteed

Section 365(h)⁵⁴ guarantees the lessee continued possession of the premises

52. *Id.* at 1356 n.10.

53. See generally Creedon & Zinman, *supra* note 17, at 1405-15, for a detailed discussion of the meaning of "estate" under § 70(b) of the Chandler Act. Creedon and Zinman explained the difficulty in defining the term "estate" as follows:

A more difficult question than the meaning of "executory" in the rejection clause, is the meaning of "lessee's estate" in the saving clause in Section 70b. The problem faced by the drafters of the saving clause was in the dual character of a lease. The leasehold is a conveyance, carved out of the landlord's greater interest, leaving the landlord with a reversion after a term of years. . . . But a lease is often more than a conveyance and may contain executory contractual obligations requiring performance in the future by the bankrupt landlord.

Id. at 1405-06.

Krasnowiecki, *supra* note 4, at 370, acknowledged that although the Code "avoids some of the medieval learning that surrounds the concept of an 'estate,'" the Code is "hardly less obscure" on the question of whether the trustee in bankruptcy can recast the lessee's rent.

54. 11 U.S.C. § 365(h) (Supp. V 1981) provides:

(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable non-bankruptcy law.

(2) If such lessee remains in possession, such lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease, and any such renewal or extension, any damages occurring after such date caused by the nonperformance of any obligation of the debtor after such date, but such lessee does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset:

notwithstanding the landlord's bankruptcy. Moreover, subsection (h)(2) implies that the drafters did not intend to sanction modification of the rental rate.⁵³ Any arguments that might be invented to overcome this interpretation of section 365⁵⁶ would do violence to the plain meaning of the provision. Mortgagees' counsel could argue, however, that the general rule of section 365(h) is displaced by more particular considerations when the bankruptcy proceeding implicates the rights of a prior mortgagee. A recent case offers a unique situation in which to consider the ramifications of section 365(h).

In *In re LHD Realty Corp. v. Metropolitan Life Insurance Co.*,⁵⁷ the mortgagee, Metropolitan, was also the lessee of the landlord-debtor, LHD. Metropolitan filed a complaint for relief⁵⁸ from the automatic stay⁵⁹ and LHD

At first impression, this language from the legislative history appears troublesome. "Thus, the tenant will not be deprived of his estate for the term for which he bargained." (emphasis supplied). H.R. REP. NO. 595, 95th Cong., 1st Sess. 349 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6306; S. REP. NO. 989, 95th Cong., 2d Sess. 60 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5846. However, the explanation of "estate" offered by *In re Hotel Governor Clinton, Inc.*, 96 F.2d 50 (2d Cir.), *cert. denied sub nom.*, *Cantor v. Ramsey*, 305 U.S. 613 (1938) clarifies any ambiguity: "A lease creates an estate in the land . . . but this is subject to prior mortgages and encumbrance," (citing *In re Barnett*, 12 F.2d 73, 76 (2d Cir. 1926)). See also *American Brake Shoe & Foundry Co. v. New York Ry.*, 278 F. 842 (S.D.N.Y. 1922) (describing matters of real property leases as properly "determined by [reference to] local law").

A recent decision has held a mortgagee taking possession of real property pursuant to a liquidating plan may not evict a lessee. Insofar as § 365(h) would preclude the trustee's dispossessing the lessee, the mortgagee transferee of the property would be similarly restrained. *Solon Automated Serv., Inc. v. Georgetown*, 22 Bankr. 312 (S.D. Ohio 1982). The court cited no authority whatsoever for its conclusion that § 365 "may not be circumvented by use of Chapter 11 proceedings." *Id.* at 315.

55. The reference to "the rent reserved under such lease" indicates the drafters' focus. This reference indicates Congress only considered rent that is reserved. If the drafters did not intend to preclude modification of the rental rate it would have been sufficient to provide that the "lessee may offset the rent payable for the balance of the term . . . any damages."

56. Because the reference to rent reserved under such lease appears only in the provision describing damages available to a lessee remaining in possession, the trustee could argue that the section circumvents but does not dispose of the issue of rental modification.

57. 20 Bankr. 717 (S.D. Ind. 1982).

58. *Id.* at 718.

59. 11 U.S.C. § 362(d) (Supp. V 1981), "Automatic stay," provides:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under [11 U.S.C. § 362(a)], such as by terminating, annulling, modifying, or conditioning such stay—

- (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or
- (2) with respect to a stay of an act against property, if —
 - (A) the debtor does not have an equity in such property; and
 - (B) such property is not necessary to an effective reorganization.

As the legislative history explained, the automatic stay is pervasive.

Subsection (a) defines the scope of the automatic stay, by listing the acts that are stayed by the commencement of the case. The commencement or continuation, including the issuance of process, of a judicial, administrative, or other proceeding against the debtor that was or could have been commenced before the commencement of the bankruptcy case is stayed under paragraph (1). The scope of this paragraph is broad.

responded with a complaint to modify or set aside the mortgagee's lease.⁶⁰ LHD urged that the doctrine of commercial impracticability⁶¹ was available

All proceedings are stayed, including arbitration, license revocation, administrative, and judicial proceedings. Proceedings in this sense encompass civil actions as well, and all proceedings even if they are not before governmental tribunals.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 340 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6297; S. REP. NO. 989, 95th Cong., 2d Sess. 50 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5836. Exceptions to the stay are listed at 11 U.S.C. § 362(b) (Supp. V 1981). Certainly the foreclosure of a mortgage is precluded by the automatic stay and no exception applies.

The Code's adequate protection provisions have received considerable attention. *See, e.g.,* Gordanier, *The Indubitable Equivalent of Reclamation: Adequate Protection for Secured Creditors Under the Bankruptcy Code*, 53 AM. BANKR. L.J. 299 (1980); Karlen, *Adequate Protection Under the Bankruptcy Code, Its Role in Business Reorganization*, 2 PAGE L. REV. 1 (1982). The mortgagee that is stayed from foreclosing its interest in the real property of the estate may ask that the stay be lifted because its property interest is not adequately protected. Collier explained the source of the Code's adequate protection rules:

A point of disagreement under the Act was whether a stay could, in the sound discretion of the court, be continued in effect even where harm to the secured creditor was fairly obvious. It was possible to read the landmark *Rock Island* case [294 U.S. 648 (1935)] as suggesting that stays and injunctions were always a matter of discretion given jurisdiction over the asset in question. The most extreme case was in *In re Yale Express System, Inc.* [384 F.2d 990 (2d Cir. 1967)] where the court continued a stay in effect where harm appeared obvious on the theory that the secured creditor could be protected with a priority claim at the time of confirmation. The mandatory language of subsection (d) means that *Yale Express* has been overruled insofar as an expense of administration does not constitute adequate protection. [S. REP. NO. 989, 95th Cong., 2d Sess. 54 (1978) *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5840]. . . .

No attempt has been made in the Code to define the term "adequate protection." However, examples are given in section 361 [11 U.S.C. § 361 (Supp. V 1981)] of what might constitute adequate protection and, at least in one instance, of what will not constitute adequate protection.

2 COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 362.07[1] (footnotes omitted). For a criticism of *Yale Express* see Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 32-34 (1974).

For cases considering the adequate protection requirement see *In re C.F. Simonin's Sons, Inc.*, 28 Bankr. 707 (E.D.N.C. 1983); *In re Schaller*, 27 Bankr. 959 (W.D. Wisc. 1983); *In re Lewellyn*, 27 Bankr. 481 (M.D. Pa. 1983); *In re Adams*, 27 Bankr. 582 (D. Del. 1983).

Finally, it is unclear whether relief from the automatic stay is a prerequisite to foreclosure of the mortgagee's interest within the bankruptcy court proceeding. *See Nike, Inc. v. National Shoes, Inc.*, 18 Bankr. 507 (D. Me.), *aff'd, sub nom. In re National Shoes, Inc.*, 20 Bankr. 672 (1st Cir. 1982); *In re East Redley Corp.*, 20 Bankr. 612 (E.D. Pa. 1982); *United States v. Critical Fork Coal Corp.*, 18 Bankr. 422 (W.D. Va. 1982); *Wes-Flo, Inc. v. Wilson Freight Co.*, 14 Bankr. 395 (S.D. Ohio 1981); *Coleman Am. Cos. v. Littleton Nat'l Bank*, 8 Bankr. 384 (D. Kan. 1981).

60. 20 Bankr. at 718.

61. The concept of "commercial impracticability" is explained at U.C.C. § 2-615 (1978) ("Excuse by Failure of Presupposed Conditions"). The official comment to the section explains that the "section excuses a seller from timely delivery of goods contracted for, where his performance has become commercially impracticable because of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting." *Id.*, comment 1. While § 2-615 would of course not apply directly to a lease transaction, its terms may be applied by analogy.

as an alternative to the remedy provided by section 365.⁶² The court disagreed, finding the plain language of section 365 reflected the legislature's intent⁶³ to make that section a debtor's exclusive remedy in executory lease situations.⁶⁴ The court then determined that rejection of the lease by LHD's trustee could not deprive the lessee of possession⁶⁵ and acceptance by the trustee would not impart the power to modify the lease.⁶⁶ The mortgagor was particularly inter-

For critical commentaries on the Code's commercial impracticability concept see Black, *Sales Contracts and Impracticability in Changing World*, 13 ST. MARY'S L.J. 247 (1981); Duesenberg, *Exiting from Bad Bargains Via U.C.C. Section 2-615*, 13 U.C.C. L.J. 32 (1980); Sirianni, *Developing Law of Contractual Impracticability and Impossibility: Part I*, 14 U.C.C. L.J. 30 (1981).

62. Insofar as bankruptcy courts are courts of equity (see 28 U.S.C. § 1481 (Supp. V 1981)) it is not immediately clear why the court in *LHD Realty Corp.* was so reluctant to hear an argument premised upon equitable principles.

63. 20 Bankr. at 719.

64. Because 11 U.S.C. § 365 (Supp. V 1981) is captioned "Executory contracts and unexpired leases" it is no longer necessary to make the threshold determination of if and to what extent a particular lease is "executory." See *In re O.P.M. Leasing Servs., Inc.*, 23 Bankr. 104 (S.D.N.Y. 1982), which recognized that unexpired leases were included within § 365 to indicate an unexpired lease is an executory contract subject to rejection or assumption by a trustee in bankruptcy.

65. It is clear that Congress' 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 [Citing H.R. No. 595, 95th Cong., 2d Sess. 349 (1977) reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6306; S.R. No. 95-989, 95th Cong., 2d Sess. 60 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787]. Thus, "rejection of the lease results merely in the cancellation of covenants requiring performance in the future (e.g., the providing of utilities, repair and maintenance, janitorial services, etc., which LHD maintains are burdensome) by the debtor; rejection does not terminate the lease completely so as to divest the lessee of his estate in the property."

20 Bankr. at 719, citing 2 COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.09. The court also cited *In re Penn Central Transp. Co.*, 458 F. Supp. 1346 (E.D. Pa. 1978), and *In re 1438 Meridian Place, N.W., Inc.*, 11 Bankr. 353 (D.D.C. 1981).

66. As an alternative to termination of the lease, LHD seeks to modify it. Section 365 does not provide for modification of a lease after acceptance. . . . As stated in the Third Circuit [sic] *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3d Cir. 1981): "The trustee . . . may not blow hot and cold. If he accepts the contract, he accepts cum onere. If he receives the benefits, he must adopt the burden. He cannot accept one and reject the other." This general rule is applicable to the instant proceeding before this court. Acceptance of the lease does not allow its modification.

20 Bankr. at 719. The court also cited 2 COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.09, and *In re Pin Oaks Apts.*, 7 Bankr. 364 (S.D. Tex. 1980). *Id.* The crucial language from *Pin Oaks* provided:

It would be dangerous precedent . . . to be in the business of reforming contracts and leases because of changing economic conditions. Depending on the peaks and valleys of our economic circumstances, the courts would be considering in every case whether a contract was equitable or inequitable. In three years, ten years, the other party could return to court arguing that the contract required reformation again. The battle could continue during the entire life of the contract. It was not the intent of Congress for the courts to interfere so drastically in the commercial dealings of parties, negotiated in arms length transactions.

ested in modifying the existing lease because it gave Metropolitan the right to renew for five successive one-year periods at below-market rates.⁶⁷ Metropolitan had made clear its intent to renew at the stipulated rental rate. The court refused to permit the trustee to modify the lease notwithstanding the rather one-sided renewal agreement.⁶⁸

The court next considered Metropolitan's complaint for relief from the stay. Metropolitan sought the relief in order to foreclose the mortgage it held on the LHD premises. The property's potential value without the Metropolitan lease was \$240,000, while its value with the lease was \$119,000.⁶⁹ An examination of Metropolitan's and LHD's financial posture regarding the property convinced the court that relief from the stay should not be granted.⁷⁰ The court remarked that the property's value was kept artificially low by Metropolitan's exercising its five-year renewal option. The court thus decided Metropolitan could not claim lack of adequate protection when Metropolitan itself caused the alleged lack of protection.⁷¹

Whether mortgagee's counsel presented Metropolitan's best argument is questionable. Nevertheless, the court in *LHD Realty Corp.* considered the prescription against the lessee's eviction to be absolute. The presence of the prior mortgagee did not affect the section 365 analysis because the mortgagee as lessee resisted the mortgagor-landlord's complaint to modify the lease. Therefore, the decision does not expressly deny the trustee's right to modify a lease or to evict a tenant if the real property is encumbered by a mortgage prior to the lease. *LHD Realty Corp.* illustrates the mortgagee's predicament in bankruptcy when the real property is encumbered by below-market leases.

In re Pin Oaks Apts., 7 Bankr. 364, 372 (S.D. Tex. 1980).

67. The court acknowledged that "[t]he right of a lessee to exercise a renewal option has been upheld in the State of Michigan. 20 Bankr. at 719. See also *In re Mackie's Petition*, 372 Mich. 104, 125 N.W.2d 482 (1963); *Boden v. Trumpour*, 344 Mich. 133, 73 N.W.2d 462 (1955).

68. 20 Bankr. at 720. See also *In re Pin Oaks Apts.*, 7 Bankr. 364 (S.D. Tex. 1980) (describing the difficulties of permitting modification of the rent renewed under a lease).

69. The [subject real property] . . . has a potential value of approximately \$240,000.00; this being the value of the property without the Metropolitan lease. . . . Due to the terms and effect of the lease, however, the current value is considerably lower. The rent provided for in the lease is insufficient to meet the operating costs and the amount needed for debt servicing. . . . The effect on LHD is a negative cash flow of approximately \$15,000.00 per year.

. . . .

[T]he value of the property will increase by a minimum of \$20,000.00 per year as each year of the lease expires. . . . The negative cash flow LHD is experiencing and will continue to experience is not severe enough to cancel out the \$20,000.00 yearly increase in the value of the property.

20 Bankr. at 720-21. Because the anticipated appreciation rate (\$20,000 per year) exceeded the annual negative cash flow (\$15,000 per year) the court found that Metropolitan was "adequately protected." See *supra* note 59, and refused to lift the stay. *Id.*

70. 20 Bankr. at 720-21.

71. *Id.* at 721.

Section 363(f)(1): Free and Clear Sale by Trustee

Section 363(f)(1)⁷² of the Code permits the trustee⁷³ to sell property of the estate free and clear of other claims⁷⁴ if "applicable nonbankruptcy law" allows sale of that property free and clear of such interests.⁷⁵ The applicable nonbankruptcy law in this context is state mortgage foreclosure law.⁷⁶ A review of state foreclosure actions is appropriate to indicate the extent to which bankruptcy courts will sanction the trustee's right to sell property free and clear of the lessee's interest.

In re Hotel Governor Clinton,⁷⁷ discussed previously, established the principle that a lease subordinate to a mortgage may be avoided by the trustee's sale free and clear of the lease. The more recent case of *In re Outrigger Club*,

72. 11 U.S.C. § 363(f)(1) (Supp. V 1981). 2 COLLIER BANKRUPTCY MANUAL ¶ 363.01 (3d ed. 1981).

73. 11 U.S.C. § 1107 (Supp. V 1981) provides that a "debtor in possession" has all the powers and duties of a trustee. Therefore, reference in this article to the trustee refers also to a debtor in possession.

74. The trustee may sell property under subsections (b) or (c) of section 363. Subsection (b) provides that the trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate. 11 U.S.C. § 363(b) (Supp. V. 1981). Because a sale of real property of the debtor could not likely be "in the ordinary course of business," it is this subsection that the trustee would invoke if the mortgaged real property were to be sold free and clear.

The Code does not supply a construction of the phrase "in the ordinary course of business." Reference, then, may appropriately be made to an analogous provision of the Uniform Commercial Code. See U.C.C. § 1-201(9) (1978).

Subsection (c) applies to disposition of estate property by the trustee in the ordinary course of the debtor's business and, therefore, will not apply in the context under consideration in this article. See 11 U.S.C. § 363(c) (Supp. V 1981).

75. The provision provides, in the disjunctive, the other circumstances that permit the trustee's sale of property of an entity other than the estate. The trustees may also sell such property if:

- (2) such [other] entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of such interests;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Id. The legislative history explained that a sale pursuant to subsection (f) "is subject to the adequate protection requirement. [11 U.S.C. § 361 (Supp. V 1981), see *supra* note 59]. Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale." S. REP. NO. 989, 95th Cong., 2d Sess. 28 (1978), reprinted in U.S. CODE CONG. & AD. NEWS 5963. The dispossessed lessee's claim, then, may attach to any surplus remaining after the prior mortgagee is paid in full. That result follows because the lessee's interest is defined by the nature of the lessee's "estate": a right to use of real property subject to the rights of a prior mortgagee. See discussion of *In re Hotel Governor Clinton*, 96 F.2d 50 (2d Cir.), cert. denied sub nom. *Canter v. Ramsey*, 305 U.S. 613 (1938), *supra* notes 35-39 and accompanying text. The "value" of the lessee's interest that is entitled to adequate protection is most appropriately determined by reference to the applicable state law.

76. See *supra* note 1.

77. 96 F.2d 50 (2d Cir.), cert. denied sub nom. *Canter v. Ramsey*, 305 U.S. 613 (1938). See *supra* text accompanying notes 35-39.

*Inc.*⁷⁸ determined that *Governor Clinton* was still good law under the Chandler Act. In *Outrigger Club* the mortgagee sought an order evicting the debtor's tenants.⁷⁹ The lessees opposed the plan of reorganization⁸⁰ which provided for rejection of the lease. The tenants argued that a lease from a debtor to another could never be rejected under section 116(1) of the prior law.⁸¹ Citing *Governor Clinton*, the court declared that tenants whose lease was expressly subordinated to the mortgage may be dispossessed. The court based its conclusion on the superior rights of the mortgagee rather than the trustee's power to reject executory contracts.⁸²

The result in the *Outrigger Club* case is laudable, but the opinion is most notable for its reliance on *Governor Clinton* despite claims that it was diminished in *In re Mingos*.⁸³ The *Outrigger Club* court correctly maintained that the *Mingos* court did not recede from the essence of *Governor Clinton* that a lease subordinate to an undersecured mortgage⁸⁴ can be terminated in bankruptcy just as it could be in foreclosure.⁸⁵

In *Mingos*, the lessee appealed an order permitting the debtor-lessor's trustee to reject certain covenants in the leases.⁸⁶ Each lease expressly provided that in the event of foreclosure the mortgagee would "not attempt to termin-

78. 9 Bankr. 152 (S.D. Fla. 1981).

79. The tenant, Arch Creek B & G, resisted the application for eviction. The tenant's lease was executed after the debtor granted the mortgage interest. *Id.* at 153.

80. The reorganization plan was structured pursuant to Chapter X of the Bankruptcy Act, "Corporate Reorganizations." 11 U.S.C. §§ 501-676 (repealed 1979).

81. Bankruptcy Act § 116(1), 11 U.S.C. § 516(1) (repealed 1979) provided:

Upon the approval of a petition, the judge may, in addition to the jurisdiction, powers, and duties [hereinabove and elsewhere] in this chapter conferred and imposed upon him and the court—

(1) permit the rejection of executory contracts of the debtor, except contracts in the public authority, upon notice to the parties to such contracts and to such other parties in interest as the judge may designate.

The lessees further contended that by the terms of the lease contracts the mortgagee agreed not to terminate the leases unless the tenants defaulted. The *Outrigger Club* court found that the mortgagees had never agreed to such terms.

The court's analysis suggested an accurate understanding of the relationship between a mortgagee and the necessary subordination of a lease junior to the mortgage.

The objectors rely on the fact that the lease in question contains a specific provision . . . precluding termination in the event of foreclosure. The mortgagees were not parties to the lease. It was, therefore, in clear contravention of the mortgage restriction against long term leases. The lease was junior to the perfected mortgage and, therefore, the lease provision in this instance is totally ineffective.

9 Bankr. at 154.

82. *Id.* at 153, citing *In re Hotel Governor Clinton*, 96 F.2d 50 (2d Cir.), cert. denied sub nom. *Canter v. Ramsey*, 305 U.S. 613 (1938).

83. 602 F.2d 38 (2d Cir. 1979).

84. A lease that is subordinate to an undersecured mortgage is valueless. If a mortgage is undersecured, *ab initio* any claim junior to that mortgage interest will receive no proceeds from the sale of the mortgaged property.

85. 9 Bankr. at 153. The court also concluded "a mortgagee in a bankruptcy liquidation plan retains a right it would certainly have in foreclosure." *Id.* at 154.

86. 602 F.2d at 39.

ate this lease . . . nor interfere with the rights of"⁸⁷ the lessee provided the lessee was not in default. The mortgagee⁸⁸ had initiated foreclosure proceedings in state court and obtained a judgment. The execution of the judgment was stayed by the debtor's filing a Chapter XII petition.⁸⁹ *Minges* did not involve a mortgagee who sought the ouster of a subordinate lessee. Rather, the trustee petitioned the bankruptcy court for permission to reject certain portions of the lease as "burdensome."⁹⁰ On that basis *Minges* is readily distinguishable from *Governor Clinton*.

The *Minges* opinion did consider an issue which has a direct bearing on the mortgagee's rights vis-à-vis a subsequent lessee: whether the court's decision to approve a trustee's rejection of an unexpired lease should be affected by considerations of which party would most benefit from the rejection. The court noted that the parties disagreed on whether benefit to the secured creditors is sufficient to justify rejection of the lease covenant. The court suggested rejection of the lease could be justified merely by finding that general creditors would benefit from the improved value of the property.⁹¹

87. *Id.* at 40.

88. *Id.*

89. Real Property Arrangements By Person Other Than Corporations, Act of July 1, 1898, ch. 541, 30 Stat. 544 as added June 22, 1938, ch. 575, §§ 401-526, 52 Stat. 916, (codified as amended at 11 U.S.C. §§ 801-926 (1976) (repealed 1979)), "Chapter XII is an anomaly. It was designed to accommodate a unique situation in Chicago, Illinois. The justification for separate treatment of individuals during an extension or composition of secured and unsecured debt was unsound then and now. Chapter XII is seldom used and no one favors its retention." *Report of the Commission on the Bankruptcy Laws of the United States, Part I*, H.R. Doc. No. 93-137, Pt. I, 93d Cong., 1st Sess. 240 (1973).

Collier explained that shortly after the Bankruptcy Commission's Report:

[T]he real estate market in the United States collapsed and the debtor's bar discovered that a limited partnership filing for relief under Chapter XII could oust a state court receiver or mortgagee from possession of the debtor's property, could stay foreclosure, and could obtain confirmation of a plan of arrangement which provided for payment of the appraised value of the debtor's property.

5 COLLIER ON BANKRUPTCY ¶¶ 1100.01, .02 n.2 (15th ed. 1983), citing *In re Pine Gate Assoc.*, 2 Bankr. Ct. Dec. (CRR) 1478 (N.D. Ga. 1976) and *In re Marietta Cobb*, 3 Bankr. Ct. Dec. (CRR) 720 (S.D.N.Y. 1977).

90. 11 U.S.C. § 813(1) (1976) (repealed 1979) provided:

Upon the filing of a petition, the court may, in addition to the jurisdiction, powers, and duties [hereinafter and elsewhere in this chapter] conferred and imposed upon it—

(1) permit the rejection of executory contracts of the debtor, upon notice to the parties to such contracts and to such other parties in interest as the court may designate.

The Chapter XII trustee petitioned the court to allow the rejection of those lease agreement portions: (i) requiring the landlord to provide utilities and janitorial service, (ii) granting the tenant right of first refusal on space in the building that became vacant, and (iii) allowing the tenant to renew the lease for five additional two-year periods. *Minges*, 602 F.2d at 40.

91. *Minges*, 602 F.2d at 44. The second circuit remanded for further findings because the available record was inadequate to decide the issue. The remand demonstrates that the creditor should be prepared to document the benefits to the general creditors if the lessee's interest is not favored over the interest of the mortgagee and general creditors.

Minges held open the possibility that a mortgagee may be in a better position in the bankruptcy context than in the state foreclosure situation.⁹² The question reserved in *Minges* suggests the possibility of a court's being even more sympathetic to the mortgagee's rights than this article would urge. Nevertheless, the cases discussed in this section⁹³ indicate that a mortgage having priority over a subordinate lease in a state foreclosure action is likewise entitled to priority in a bankruptcy proceeding. These cases, however, failed to consider simultaneously the trustee's right to reject an unexpired lease and the concomitant right to sell property free and clear of certain interests. This explains the pre-Code confusion regarding a mortgagee's rights vis-à-vis a lessee of the debtor-mortgagor.

*The Application of Section 544(b):
Trustee's Avoidance Powers*

Section 544(b)⁹⁴ of the Code provides that the trustee may avoid a debtor's obligation that would be voidable by an unsecured creditor under the applicable law.⁹⁵ Professor Krasnowiecki interpreted this section as precluding the trustee's sale of mortgaged property for the benefit of the bankruptcy estate.⁹⁶ Krasnowiecki argued that section 544(b) allows the trustee to assert only the rights of an unsecured creditor.⁹⁷ The commentator did not formulate

92. 602 F.2d at 44. Judge Mansfield's concurring opinion considered the balance of the equities. He found as a general rule "the trustee should not play favorites between the lessee and secured creditors by manipulating the obligations affecting them, absent some significant benefit to the creditors generally. To do so would be inequitable." *Id.* at 45 (Mansfield, J., concurring).

93. See *supra* text accompanying notes 78-91.

94. 11 U.S.C. § 544(b) (Supp. V 1981).

95. Section 544(b) gives the trustee avoidance power for interests that are voidable by an unsecured creditor holding a claim that is allowable under § 502 or that is not allowable only under § 502(e). 11 U.S.C. § 502(a) (Supp. V 1981) provides "[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a partner in a partnership that is a debtor in a case under chapter 7 of this title, objects." 11 U.S.C. § 502(e) (Supp. V 1981) provides:

(1) Notwithstanding subsections (a) and (b) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on, or has secured, the claim of a creditor, to the extent that —

(A) such creditor's claim against the estate is disallowed;
(B) such claim for reimbursement or contribution is contingent as of the time of allowance of such claim for reimbursement or contribution; or
(C) such entity requests subrogation under section 509 of this title to the rights of such creditor.

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed subsection (a), (b), or (c) of this section, disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

96. Krasnowiecki, *supra* note 4, at 375 n.63: "Although the leases are not 'claims' it seems clear, by analogy, that the trustee cannot simply terminate the leases merely because the mortgagee would have this power."

97. Krasnowiecki, *supra* note 4, at 375 n.63

the proper application of section 544(b). The following review of the section's legislative history reveals the drafters' intent and delineates the scope of the section's language.

In drafting section 544(b), the drafters seriously considered Professor Kennedy's comments on the prior law, section 70(e).⁹⁸ Kennedy was concerned about the application of *Moore v. Bay*⁹⁹ to the trustee's avoiding powers under section 70(e). While he did not seek a reinterpretation of *Moore v. Bay*,¹⁰⁰ Kennedy urged "that the anomalous doctrine . . . not be extended."¹⁰¹ The anomaly of the case was its distinct and seemingly inexplicable departure from established subrogation doctrine. *Moore v. Bay* provides that if a qualified creditor could avoid a transfer of the bankrupt's property, then the trustee's avoidance power is not limited by the amount of that creditor's claim.¹⁰² *Moore v. Bay* contravenes the subrogation doctrine which allows a person subrogated to obtain no greater rights than the person to whose position he is subrogated.

To limit the consequences of *Moore v. Bay*, Kennedy argued that the trustee should not be permitted to assert the rights of a secured creditor without regard to general subrogation law.¹⁰³ The commentator was concerned that if the trustee could assert the rights of any available secured creditor without being limited by the amount of the secured creditor's claim, grave commercial consequences would result.¹⁰⁴ Kennedy noted that even the most careful secured "creditor could be frustrated by the trustee if the trustee could find a

98. Bankruptcy Act § 70(e), 11 U.S.C. § 110(e) (1976) (repealed 1979).

99. 284 U.S. 4 (1931).

100. "*Moore v. Bay* has survived well laid attacks on its illogicality as well as its inequity, and this paper is not intended to renew them." (footnote omitted). Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1422 (1967). For defenses of the *Moore v. Bay* doctrine, see 2 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES 866-67 (rev. ed. 1940); Schwartz, *Moore v. Bay—Should Its Rule Be Abolished?*, 29 REF. J. 67 (1955); Comment, 17 ARK. L. REV. 46, 56 (1962); Comment, 45 YALE L.J. 504, 506 (1936).

101. Kennedy, *supra* note 100, at 1422.

102. 4B COLLIER ON BANKRUPTCY ¶ 70.95 (14th ed. 1978).

103. Kennedy, *supra* note 100, at 1421, citing Scott, *The Meaning of the Provisions for Recordation of a Transfer as Applicable to Preferences Under the Bankruptcy Act and a Critique of the Decision of the United States Supreme Court in the Case of Moore v. Bay*, 18 VA. L. REV. 149, 266 (1932).

It should be acknowledged here that no one has been so bold as to argue categorically that the trustee should be able to assert the priority of the secured creditor having the topmost lien of any and every kind against the bankrupt's property. My point, hereinafter elaborated, is that if the trustee is allowed to assert the right of a lien creditor or any other variety of secured creditor to prevail over the rights of any other interest in property of a bankrupt estate without regard to the assumptions implicit in the preservation provisions and the law of subrogation generally, there is no basis in the Bankruptcy Act for distinguishing between the kinds of lien the trustee can use to his advantage.

Kennedy, *supra* note 100, at 1424-25 n.20 (emphasis added).

104. *Id.* at 1424. "[I]n fact, the result would be nothing less than a general avoidance of all junior liens and interests in bankruptcy." *Id.* (footnote omitted).

subsequent purchase-money security interest holder who took the precautions prescribed by [U.C.C.] section 9-312(3) or (4)."¹⁰⁵

The Reform Act drafters evidently agreed with Kennedy's concerns. In drafting section 544(b), they explicitly limited the trustee's avoidance powers under the *Moore v. Bay* doctrine to those the trustee could acquire from an existing unsecured creditor.¹⁰⁶ The only remaining substantial application of section 544(b) is in the fraudulent conveyance context.¹⁰⁷ Section 544(b) gives power to the trustee that supersedes the stricture of subrogation law. In contemplation of the evils of fraudulent conveyances, such power may be justified. In fact, section 544(b) returns to creditors what would be theirs if the debtor were not bankrupt.¹⁰⁸

105. *Id.* at 1429 (footnote omitted). U.C.C. § 9-312(3) and (4) (1978) provide:

(3) A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if

(a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9-304); and

(c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

(d) the notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

(4) A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.

For a discussion of the nice distinction between "avoidance" and "priority" see Kennedy, *supra* note 100, at 1429-30 n.40.

106. "Subsection (b) is derived from current section 70(e). It gives the trustee the rights of actual unsecured creditors under applicable law to void transfers. It follows *Moore v. Bay* . . . and overrules those cases that hold section 70(e) gives the trustee the rights of secured creditors." H.R. REP. NO. 595, 95th Cong., 1st Sess. 370 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6326; S. REP. NO. 989, 95th Cong., 2d Sess. 85 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5871.

107. "In modern practice judicial liens are more scarce than hen's teeth and so absent from all but the rarest cases. For these reasons, section 544(b) (and 70(e) of the old law) have been shrunk to the size of pigmies by the enactment of the Uniform Commercial Code." J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* 1018 (2d ed. 1980). See Alces, *The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions*, 61 N.C.L. REV. 655, 677 and n.143 (1983).

108. The most widespread applications of § 544(b) are to set aside transfers of property of the debtor and obligations incurred by the debtor which are fraudulent as to general unsecured creditors under the laws of the particular states, and to set aside bulk sales transactions which fail to comply with the applicable Bulk Sales Acts, including specifically Article 6 of the Uniform Commercial Code. Although § 548 is modeled on the Uniform Fraudulent Conveyance Act, § 544(b) allows the trustee to

The Code's limitation of the *Moore v. Bay* doctrine does not mean the trustee may never take advantage of the rights of a secured party. Section 544(b) merely limits the scope of the trustee's rights. It ensures that the trustee does not use the secured party's rights to exploit the expansive recovery sanctioned by *Moore v. Bay*. That is all that may be inferred from the Code's language. Professor Krasnowiecki attributed more to the section than the drafters intended. Section 544(b) should not be considered an impediment to the trustee's sale free and clear pursuant to section 363(f)(1).

SYNTHESIS

Section 365(h) authorizes the trustee of a landlord-debtor to reject an unexpired lease provided the tenant is not dispossessed. That formulation is consistent with prior law if no prior mortgagee is involved.¹⁰⁹ Pre-Code authority indicates, however, that the formulation is inapposite when rights of a prior mortgagee are implicated. Before the Reform Act, courts devised two methods to safeguard the prior mortgagee's interest. Under the first method, bankruptcy courts asserted that the existence of a prior mortgagee modifies the tenant's right to possession.¹¹⁰ Courts also protected the prior mortgagee by focusing on the trustee's right to sell property free and clear of certain interests. This latter method assured the prior mortgagee the same protection available in a state foreclosure proceeding.¹¹¹ If a foreclosing mortgagee joined the subordinate lessee in the foreclosure proceeding, the mortgagee could avoid that lessee's interest.¹¹²

Section 365(h) should not be interpreted to allow a lessee to avoid eviction merely because his landlord became the subject of a bankruptcy rather than a foreclosure proceeding. Indeed, it is doubtful whether the Code drafters would sanction such an anomalous result. The more cogent view is that

take advantage of helpful peculiarities or longer limitation periods that may exist in some states.

ILLINOIS INST. FOR CONTINUING LEGAL EDUC., BANKRUPTCY PRACTICE UNDER THE BANKRUPTCY REFORM ACT OF 1978 7-20 (1980).

109. See *supra* text accompanying notes 15-52, and *In re Mingos*, 602 F.2d 38, 41 (2d Cir. 1979) ("the weight of authority is that the conveyance aspect of a lease may not ordinarily be unilaterally disturbed by a debtor landlord or his trustee").

110. See *In re Freeman*, 49 F. Supp. 163 (S.D. Ga. 1943); *In re Outrigger Club, Inc.*, 9 Bankr. 152 (S.D. Fla. 1981).

111. See *In re Hotel Governor Clinton*, 96 F.2d 50 (2d Cir.), *cert. denied sub nom. Canter v. Ramsey*, 305 U.S. 613 (1938); *In re Mingos*, 602 F.2d 38 (2d Cir. 1979). See also *supra* text accompanying notes 35-39 and 83-93. As stated by a Missouri court:

There is no privity of either estate or contract between the mortgagee and the lessee of the mortgagor to bind either, and the foreclosure of the mortgage avoids the lease and releases the lessee from any obligation. . . . Whenever the estate which the lessor had at the time of making the lease is defeated or determined, the lease is extinguished with it.

Roosevelt Hotel Corp. v. Williams, 227 Mo. App. 1063, 56 S.W.2d 801, 802 (Ct. App. 1933). See also *supra* note 1 (describing the applicable real property law in this area).

112. With regard to the necessity of joining the lessee in the state foreclosure action see *supra* note 1.

sections 365(h) and 363(f)(1) must be considered in *pari materia*: the trustee's right to sell the mortgaged property free and clear of the lessee's interest may modify the right of the lessee to remain in possession. Under this interpretation, several arguments are available to the mortgagee involved in the bankruptcy of its mortgagor.

The Continued Efficacy of the "Absolute Priority" Rule

The mortgagee whose mortgagor is the subject of a reorganization proceeding may very well face a "cram down." When an "impaired"¹¹³ mortgagee opposes¹¹⁴ the reorganization plan,¹¹⁵ the court cannot confirm the plan unless the mortgagee's interests are protected. Section 1129(b)(1) allows confirmation of the plan if it does not "discriminate unfairly" and it is "fair and equitable."¹¹⁶ This section is labeled the "cram down" because it permits the court to force a plan on a dissenting class of creditors.¹¹⁷

The legislative history of section 1129(b)(1) does not specifically address the mortgagee's rights in the situation considered here. The mortgagee, however, may argue that favoring a tenant over the prior mortgagee "discriminates unfairly" against the mortgagee and the general unsecured creditors.¹¹⁸ The

113. The concept of impairment is explained at 11 U.S.C. § 1124 (Supp. V 1981). "The concept of when a class is 'impaired' . . . is vital. It is necessary to know whether a class that has not voted for acceptance of a plan is impaired or unimpaired under the plan. A class that is not impaired is deemed to have accepted the plan [11 U.S.C. § 1126(f) (Supp. V 1981)]" (footnotes omitted). Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

114. A class that has not voted for acceptance of the plan and which is impaired is deemed a "dissenting" class. Klee, *supra* note 113, at 139.

115. 11 U.S.C. § 1122 (Supp. V 1981) provides for the classification of creditors' claims. A mortgagee's claim will be classified pursuant to subsection (a) which explains that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." Given that formulation, the mortgagee will normally constitute a class of its own. Klee, *supra* note 113, at 150-51 acknowledged that general rule except "when claims are secured by liens of equal rank, e.g., a bond issue secured by a single mortgage."

116. 11 U.S.C. § 1129(b)(1) (Supp. V 1981). This section contains the "cram down" rule.

117. Klee, *supra* note 113, at 141 n.65, citing 124 CONG. REC. H11, 103-04 (daily ed. Sept. 28, 1978) and 124 CONG. REC. S17,420 (daily ed. Oct. 6, 1978).

118. The general creditors . . . will . . . benefit from the foreclosure when the proceeds exceed the amount of the mortgage debt. Such excess proceeds will go to the general bankruptcy estate and will be available for payment of the claims of general creditors. . . . [T]he trustee's use of the property free of the lease pursuant to a plan may produce income to pay debts other than the mortgage debt, thus allowing other creditors to benefit from the rejection of the lease as well.

Siegel, *Landlord's Bankruptcy: A Proposal for Treatment of the Lease by Reference to Its Component Elements*, 54 B.U.L. REV. 903, 926-27 (1974). The commentator incorrectly cited *In re Hotel Governor Clinton*, 96 F.2d 50 (2d Cir.), cert. denied sub nom. *Canter v. Ramsey*, 305 U.S. 613 (1938) for the proposition that "a tenant's lease may be treated as equivalent to a second mortgage in the leasehold property. . . . Thus, the tenant may be accorded the status of a secured creditor." Siegel, *supra*, at 926 n.84. The Second Circuit did not equate a lessee with a second mortgagee in *Governor Clinton* but merely pointed out that if a second mortgagee's interest could be avoided by the first mortgagee in bankruptcy, certainly a lessee could expect no more preferential treatment. 96 F.2d at 51.

subsequent lessee who is given a windfall in bankruptcy is permitted to realize the full value of his bargain at the expense of a mortgagee under a cram down. As noted above, the tenant would have been dispossessed if not for the fortuity of the mortgagor's bankruptcy rather than foreclosure procedure.¹¹⁹ Additionally, to preclude the mortgagee's fully realizing its claim prejudices the rights of all unsecured creditors by decreasing their pro rata share.¹²⁰ While the lessee in possession receives the complete benefit of his bargain, the general unsecured creditors and mortgagee must suffer the vicissitudes of what could be a protracted reorganization.¹²¹

Even if this argument fails, the mortgagee is protected by the "fair and equitable" requirement in the cram down provision. The fair and equitable requirement with regard to a mortgagee includes¹²² satisfying one of three separate requisites. First, the plan may provide that the mortgagee retain a lien against the real property equal to the allowed amount of its claim. The mortgagee may receive deferred cash payments totaling at least the allowed amount of its claim and having a present value equal to the value of the encumbered property.¹²³ Second, the plan may be fair and equitable if it permits the sale free and clear of the mortgaged real property provided the mortgagee

119. See *supra* note 1.

120. An undersecured mortgagee forced to remain in the reorganization proceeding may choose not to make the election to treat its entire claim as secured under 11 U.S.C. § 1111(b)(2) (Supp. V 1981) and may treat its claim as an allowed secured claim equal to the value of the collateral and "an allowed unsecured claim to the extent the collateral is less than the debt." Klee, *supra* note 113, at 153-54.

121. See LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 AM. BANKR. L.J. 99, 122-26 (1983).

122. 11 U.S.C. § 102(3) (Supp. V 1981) provides that "'includes' and 'including' are not limiting."

123. See *infra* text accompanying notes 140-41 (suggesting the proper construction of "value"). The Code distinguishes between a claim's amount and the value of the claim. For example, if a secured creditor is owed \$1000 and the collateral securing repayment of the debt is only \$500, the allowed amount of the creditor's claim is \$1000 and the value of its claim is \$500. So, for a plan to satisfy this first test the lien retained must secure the creditor's claim to the extent of \$1000. The plan must also provide payments totaling \$1000 and having discounted value equal to \$500, the present value of the collateral. See Klee, *supra* note 113, at 155. 11 U.S.C. § 506 (Supp. V 1981) explains that for a secured claim, the allowed amount of the claim will be less than the amount of the debt if the value of the collateral is less than the amount of the debt. That result will, of course, not maintain if the creditor makes the § 1111(b)(2) election.

124. 11 U.S.C. § 363(d) (Supp. V 1981) provides that the secured party may credit bid its claim: "At a sale . . . of property that is subject to a lien that secures an allowed claim, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." The legislative history explained:

The provision indicates that a secured creditor may bid in the full amount of the creditor's allowed claim, including the secured portion and any unsecured portion thereof in the event the creditor is undersecured, with respect to property that is subject to a lien that secures the allowed claim of the sale of the property.

124 CONG. REC. H11,903 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,409 (daily ed. Oct. 6, 1978). See also ILLINOIS INST. FOR CONTINUING LEGAL EDUC., ILLINOIS REAL ESTATE LITIGATION, VOL. II 4-10 to 4-11 (1981) (describing the benefits of a sale of real property within the bankruptcy proceeding).

may credit bid¹²⁴ its claim and the lien attaches to the proceeds of the sale.¹²⁵ A third equitable resolution is to give the mortgagee the "indubitable equivalent" of its allowed claim.

The first alternative does nothing for the mortgagee whose collateral is encumbered by below-market leases. It simply surrenders to the unfortunate analysis of Professor Krasnowiecki. In contrast, the sale free and clear alternative is certainly fair and equitable. Under that alternative, the pro rata shares of general unsecured parties will not be diluted by the mortgagee. In fact, any surplus from the sale free and clear would offset the additional unsecured claim of the dispossessed lessee. Thus a mortgagee should argue that sale free and clear is the only way to assure the "indubitable equivalent" of its claim. Before the trustee will propose such a plan, however, some advantage to the debtor must be shown.¹²⁶

The mortgagee's most persuasive argument centers upon the application of the absolute priority rule to the fair and equitable test in cram down.¹²⁷ Under the absolute priority rule, a class must be provided for in full before any junior class may participate.¹²⁸ Because the Code nowhere displaces the absolute priority rule,¹²⁹ the mortgagee may argue that to favor the lessee by

125. See Klee, *supra* note 113, at 155.

126. See *supra* note 69, discussing the court's valuation analysis in *In re LHD Realty Corp. v. Metropolitan Life Ins. Co.*, 20 Bankr. 717 (S.D. Ind. 1982). The case illustrated how the depressive effect of a below-market lease should bear a relationship to the amount of the unsecured claim that the dispossessed lessee may assert. Additionally, by satisfying the mortgagee's claim the trustee will have found a means to trade a secured claim (that of the mortgagee) for an unsecured claim (that of the dispossessed lessee). A review of the fair and equitable requirement described in 11 U.S.C. § 1129(b)(2)(B) (Supp. V 1981) with regard to unsecured claims confirms that unsecured claims are more easily dealt with in the reorganization plan than are secured claims. A plan is deemed fair and equitable with regard to unsecured creditors if "the holder of any claim or interest that is junior to the claims of such class will not receive or retain on account of such junior claim or interest any property." *Id.*

127. One commentator, writing with regard to the prior law, came close to recognizing the impact of the absolute priority rule on a mortgagee involved in the bankruptcy of its mortgagor:

[I]f the mortgage is superior to the lease and if the plan of arrangement requires the mortgage creditor to accept an extension, reduction or diminution of security, to accord the lessee the same rights as in straight bankruptcy [i.e., liquidation] would be to prefer him over the mortgagee. Any impairment of the rights of the mortgagee enhances the value of the subordinate leasehold.

Silverstein, *supra* note 47, at 495. The commentator did not explore the possibility of a sale free and clear of the lease within the reorganization proceeding.

128. Klee, *supra* note 113, at 143 n.81, citing *Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106 (1939); *Northern Pac. R.R. v. Boyd*, 228 U.S. 482 (1913). See also *In re Penn Central Transp. Co.*, 458 F. Supp. 1346, 1356 (E.D. Pa. 1978):

[R]ejection of a lease in a plan of reorganization . . . may be necessary to an appropriate adjustment of the rights of all creditors, in application of the absolute priority rule. That is, the absolute priority rule would be violated if the lessee's right remained untouched, while the rights of a senior mortgagee secured by the leased property were adversely affected in various ways.

precluding disturbance of the lessee's possession violates class priorities. The mortgagee could again argue that only a sale free and clear of the mortgaged real property is consistent with the absolute priority rule.

The Fifth Amendment as Either Imperative or Policy

Section 361 of the Code illustrates the type of "adequate protection" to which secured parties are entitled when restrained from foreclosing their interests.¹²⁹ The following portion of the section's legislative history indicates the constitutional and policy grounds of adequate protection:

The concept [of adequate protection] is derived from the fifth amendment protection of property interests. . . . It is not intended to be confined strictly to the constitutional protection required, however. The section, and the concept of adequate protection, is [sic] based as much on policy grounds as on constitutional grounds. *Secured creditors should not be deprived of the benefit of their bargain.* . . . Though the creditor might not receive his bargain in kind, the purpose of this section is to insure that the secured creditor receives *in value* essentially what he bargained for.¹³¹

Under the adequate protection concept, a mortgagee may argue that the bankruptcy court's disposition of the subject property should not impair the *value* of the mortgage interest. Even those who would question the application of fifth amendment protections to secured creditors' interests must recognize that the Code's adequate protection requirements focus on the concept of value.

In a recent article,¹³² Professor Rogers maintained that the protection afforded secured creditors is constitutionally mandated by the fifth amendment.¹³³ Professor Rogers acknowledged, however, that "the adequate protection provisions of the new Bankruptcy Code require only that the secured

129. The rule is, however, relaxed in the context of unsecured claims and ownership interests. See 11 U.S.C. § 1129(b)(2)(B) & (C) (Supp. V 1981).

130. See *supra* note 59.

131. H.R. REP. NO. 595, 95th Cong., 1st Sess. 338-339 (1977), reprinted in U.S. CODE CONG. & AD. NEWS 5963, 6295, citing *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273 (1940); *Louisville Stock Land Bank v. Radford*, 295 U.S. 555 (1935). Justice Brandeis, writing for the court in *Radford* explained, "the bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment." 295 U.S. at 589 (footnote omitted).

132. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983).

133. Professor Rogers described his unconstitutional impairment thesis in these terms:

The theory that the fifth amendment placed substantive limits on the ability of the government to restrain secured creditors' rights in reorganization has crystallized into the following proposition: any impairment of the liquidation value of a secured creditor's collateral attributable to the exercise of powers conferred on the reorganization court by bankruptcy legislation is, in the absence of just compensation, a violation of the takings clause of the fifth amendment.

Rogers, *supra* note 132, at 977, citing *In re American Kitchen Foods*, 2 Bankr. Ct. Dec. (CRR) 715 (D. Me. 1976).

creditor be protected against any decrease in the *value of his interest in the collateral*.¹³⁴ The commentator argued that the secured creditor's overall economic position is not protected even if the value of his interest is maintained. For example, the value of the collateral may not be sufficient to cover interest accruing on the debt after the initiation of bankruptcy proceedings.¹³⁵ Protecting merely the value of the collateral offers the mortgagee restitution or reliance protection rather than giving him the benefit of his bargain or expectation protection.¹³⁶ If the fifth amendment is read to protect not only the value of the mortgagee's interest but also the benefit of his bargain, the Code's adequate protection provision fails.¹³⁷ A mortgagee that urges the court to permit sale of the collateral free and clear of the lessee's interest is asking only for that which the fifth amendment and Code policy clearly guarantee—restitution.

To support the argument that the lessee's interest should be avoidable by the sale free and clear mechanism, the mortgagee may argue that protection of restitution interests requires protection of at least the unencumbered market value of the collateral. The court must not itself impair the value of the collateral by permitting a lessee to prevail over the prior mortgagee.¹³⁸ A court should honor the mortgagee's request to sell the collateral free and clear of the lessee's interest if such a sale is the only way to protect the value of the collateral. If the property is not sold, the mortgagee may argue that the value entitled to adequate protection is the value of the mortgaged property unencumbered by subordinate below-market leases. Because the Code does not define "value,"¹³⁹ a mortgagee may urge the foregoing analysis

134. Rogers, *supra* note 132, at 996. See also O'Toole, *Adequate Protection and Postpetition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251 (1982) (considering the issue of adequate protection of postpetition interest).

135. Only secured creditors are entitled to postpetition interest under the Code. See 11 U.S.C. § 506(b) (Supp. V 1981). The typical mortgage, deed of trust, or loan and security agreement will have a sufficiently broad definition of the "liabilities" secured to pick up most imaginable fees, costs, and charges.

136. See J. CALAMARI & J. PERILLO, *CONTRACTS* § 14-4 (2d ed. 1977): "The [restitution interest] represents [the contracting party's] interests in the benefits he has conferred upon the other. The reliance interest represents the detriment he may have incurred by changing his position. The expectation interest represents the prospect of gain from the contract."

137. See Rogers, *supra* note 132, at 997.

138. See *In re Penn Central Transp. Co.*, 458 F. Supp. 1346, 1356 (E.D. Pa. 1978), discussed *supra* text accompanying notes 49-52.

139. 11 U.S.C. § 506 (Supp. V 1981) provides that the "value [of a secured party's interest] shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." See Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984). Addressing the value issue with regard to 11 U.S.C. § 361 "adequate protection" the legislative history explained:

The section does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development. It is expected that the courts will apply the concept in light of the facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result. There are an

in any Code context where its rights are determined by reference to the value of the collateral. For example, this analysis may apply to the Code provisions describing the rights of a secured creditor seeking relief from an automatic stay.¹⁴⁰ In seeking relief, the mortgagee may argue that adequate protection requires the collateral's value to be measured by the market value of the real property unencumbered by the below-market leases. Likewise, the value of the mortgagee's secured claim for purposes of protection in the reorganization plan should be the property's unencumbered market value.¹⁴¹ The drafters' intent is vindicated only if that analysis is adopted. To do otherwise gives effect to Professor Krasnowiecki's formulation and undermines an equitable reorganization. Indeed, if Krasnowiecki's fears are realized, potential mortgagors may have to pay a premium reflecting the risk assumed by a mortgagee whose mortgagor may become a bankrupt landlord.

Section 510 and Principles of Equitable Subordination

Section 510 describes instances in which a bankruptcy court may subordinate one claim, that of the lessee, to another, a prior mortgagee. Subsection (a) permits enforcement of a subordination agreement to the same extent such agreement is enforceable under applicable nonbankruptcy law. Subsection (c) allows a bankruptcy court to apply principles of equitable subrogation.¹⁴² The section provides a mortgagee with two more persuasive arguments. First, by leasing subsequent to the recordation of a mortgage on the property, the lessee has effectively agreed to subordinate its claim to the mortgage. Such is the effect of state real property law, thus the lessee may not argue he detrimentally relied on the right to possession described in section 365. To eliminate any ambiguities, the mortgage instrument should provide that each subsequent lessee execute a subordination agreement.¹⁴³

infinite number of variations possible in dealings between debtors and creditors, the law is continually developing, and new ideas are continually being implemented in this field. The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.

S. REP. NO. 989, 95th Cong., 1st Sess. 54, *reprinted in* U.S. CODE CONG. & AD. NEWS 5787, 5840.

140. 11 U.S.C. § 362(d) (Supp. V 1981).

141. *See supra* note 123; *see also* 11 U.S.C. § 506 (Supp. V 1981) (discussing the determination of secured status).

142. 11 U.S.C. § 510 (Supp. V 1981).

143. An argument by analogy may be framed by reference to the U.C.C. § 2-207 ("battle of the forms") analysis suggested in J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 1-2 (2d ed. 1980). Professor Summers examined whether a warranty disclaimer found in an acceptance form but not found in the offer form may become one of the terms of the integrated contract between the parties. He suggested that consideration of those provisions that the Uniform Commercial Code would supply as a "gap filler" is appropriate.

Summers insists on the relevance of an alternative analysis for those cases in which the express term in the [acceptance] conflicts with a term supplied by a Code gap filler provision. Thus if on the facts [of the particular case] an implied warranty would arise, the disclaimer in the offeree's subsequent form would become a different (not additional) term and would not enter the contract under 2-207(1) and 2-207(2).

Id. A thorough consideration of the parameters of such an argument by analogy is beyond

Because the Code does not define "subordination agreement," a bankruptcy court could infer one from the position of the parties. Provided the mortgage was properly recorded, the lessee would be deemed to have constructive notice of the mortgagee's claim at the time the lease was executed.¹⁴⁴ As a court of equity, the bankruptcy court should give effect to the relative priority of the mortgagee and lessee as such parties viewed their relationship before the bankruptcy proceeding.¹⁴⁵ Substantial authority exists to support a bankruptcy court's finding subordination by implication.¹⁴⁶ This argument merely asks the bankruptcy court to impute the consensual subordination that would obtain in any event by operation of state law.¹⁴⁷

Alternatively, the mortgagee may make a more traditional equitable subordination argument and find support in the applicable legislative history. The drafters clearly intended that principles of equitable subordination follow existing case law.¹⁴⁸ The drafters observed that courts generally subordinate claims only when the claim is susceptible to subordination or when the holder of the claim has acted inequitably.¹⁴⁹ Such case law suggests a lease may be subordinated without a showing of the lessee's inequitable conduct. Thus a mortgagee may argue that the bankruptcy court is not precluded from subordinating the lessee's claim merely because the lessee has acted scrupulously.

CONCLUSION

A mortgagee whose collateral is subsequently encumbered by the mortgagor's below-market leases may be able to avoid the lessee's interests in a bankruptcy proceeding. Section 365 of the Bankruptcy Reform Act seems to guarantee the lessee's right to continued possession of the mortgaged real property. The arguments suggested here, however, assert that a tenant's rights should not frustrate the reasonable commercial expectations of the mortgagee. When properly considered, the most cogent legal reasoning and venerable principles of equity vindicate the mortgagee's priority and mandate ejection or renegotiation of the rent of below-market tenants.

the scope of this article. It is sensible, however, to resolve difficult questions arising under the Bankruptcy Code by reference to generally accepted principles of commercial law. Therefore, the logic of the Summers § 2-207 analysis may impress a bankruptcy court, although no system of gap fillers exists for real property leases.

144. It is impossible to state a general rule about the position under various recording acts of a lessee who leases property without notice of a prior mortgage. At least one court has held a lessee is a "purchaser" for purposes of a recording act but is protected only to the extent of the amount of rent paid before he has notice. *Egbert v. Duck*, 239 Iowa 646, 32 N.W.2d 404 (1948).

145. See *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934); *Bardes v. Hawarden Bank*, 178 U.S. 524 (1900). See also Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 84 (1961), citing *Pepper v. Litton*, 308 U.S. 295 (1939).

146. See Herzog & Zweibel, *supra* note 145, at 91, citing *Prudence Realization Corp. v. Geist*, 316 U.S. 89 (1942); *In re George C. Bruns Co.*, 256 F. 840 (7th Cir. 1919).

147. See *supra* note 1.

148. 124 CONG. REC. H11,095 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,412 (daily ed. Oct. 6, 1978) (emphasis added).

149. *Id.*

This article does not suggest that the Code sanctions a trustee's recasting the rent reserved in a lease between the debtor-landlord and tenant. It is nonetheless reasonable to conclude that a lessee faced with the prospect of eviction may be willing to renegotiate the lease. The arguments offered here should prepare the mortgagee or trustee for such negotiations. In any event, if this article promotes consideration of new means to effect the most equitable results, it has served its intended purpose.