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Benjamin Weintraub

Alan N. Resnick
Maurice A. Deane School of Law at Hofstra University

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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

FIFTH CIRCUIT PRESERVES RIGHTS OF LEASEHOLD MORTGAGEE AS THIRD-PARTY BENEFICIARY OF A "DEEMED REJECTED" LEASE

The Bankruptcy Code gives the trustee or debtor in possession the power, subject to court approval, to assume or reject executory contracts and unexpired leases.[1] The rationale underlying the power to reject is that the trustee or debtor in possession should be insulated from the need to perform contractual obligations that impose burdensome liabilities upon the bankruptcy estate. By rejecting such contracts, damage claims by nondebtor parties are treated in the bankruptcy case as prepetition claims.[2]

For the protection of nondebtor parties, the Bankruptcy Code contains certain time limitations for the trustee to assume or reject executory contracts and unexpired leases. For example, if a nonresidential real estate lease under which the debtor is the tenant is neither assumed nor rejected within sixty days after the filing of a voluntary bankruptcy petition, the lease is "deemed rejected" and "the trustee shall immediately surrender such nonresidential real property to the lessor."[3]

A question that is not answered directly by the Bankruptcy Code is whether a "deemed rejected" lease continues to be an enforceable agreement with respect to the rights of third-party beneficiaries against nondebtor parties. Is a rejected lease one that is considered "terminated" so that all rights of all parties are extinguished? Or is the rejection nothing more than a breach by the debtor that leaves the lease intact with respect to the rights and obligations of others? In a recent case, *In re Austin Development Co.*,[4] the Court of Appeals for the Fifth Circuit explored this issue and held that rejection of a lease by the trustee or debtor in possession did not extinguish the rights of third party beneficiaries.

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* Special Counsel to the law firm of Kaye, Scholer, Fierman, Hays & Handler, New York, N.Y.; member of the National Bankruptcy Conference.

** Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, N.Y.; Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, New York, N.Y.; member of the National Bankruptcy Conference.

[1] 11 U.S.C. § 365(a).

[2] See 11 U.S.C. § 365(g).

[3] 11 U.S.C. § 365(d)(4). The court may, within the sixty-day period and for cause, extend this time period. In an involuntary case, the sixty-day period runs from the order for relief.

[4] 19 F.3d 1077 (5th Cir. 1994).

The Facts

Austin Development Co., a lessee under a long-term ground lease, built a motion picture theater on the leased premises financed with borrowed funds. Sowashee Venture, a general partnership, is the ground lessor. R&S Theaters, Inc. is the sublessee of the premises and is the current operator of the theater. In 1985, Austin borrowed money from Eastover Bank for Savings and used a portion of the funds to pay off the original lender. As security for the loan, Austin gave Eastover a deed of trust on its tenant-leasehold interest in the ground lease and, in addition, gave Eastover an assignment of Austin's interest in the sublease to R&S.

Typically, R&S, as subtenant, paid approximately $11,000 in monthly rental and taxes directly to Eastover, who then applied about $9,000 to Austin's debt, paid Sowashee $1,500 as monthly rent under the ground lease, and held in escrow money for ad valorem taxes.

An important provision in the ground lease, designated as paragraph 21, became the central focus of the *Austin Development* case. This lengthy paragraph granted Austin permission to mortgage all or part of its leasehold estate and granted any future leasehold mortgagee numerous rights as a third-party beneficiary of the ground lease. Similar to the provisions found in nondisturbance agreements between landlords and leasehold mortgagees, the rights granted by paragraph 21 included (1) a requirement that the parties to the ground lease obtain the leasehold mortgagee's written consent before any cancellation, surrender, or modification of the ground lease; (2) the right of the leasehold mortgagee to cure the lessee's defaults; (3) the right of the leasehold mortgagee to nullify any termination declared by the ground lessor, or to indefinitely postpone such termination, by curing all conditions of default; and (4) in the event that the lease is terminated, the right of the leasehold mortgagee to enter into a new lease with the landlord on the same terms as the terminated lease.

Austin's Bankruptcy and Rejection of the Ground Lease

Austin filed a Chapter 11 petition on January 2, 1991, and failed to either assume or reject the ground lease within sixty days after that date. Eastover did not file any motion seeking to compel Austin, as debtor in possession, to assume the ground lease. Therefore, according to Section 365(d)(4) of the Code, the ground lease was deemed rejected and the debtor in possession was required to immediately surrender the premises. Sowashee, as ground lessor, then asked the court to terminate Austin's interest as lessee under the ground lease, to terminate Eastover's deed of trust on Austin's leasehold interest, and to terminate Eastover's interest in the sublease with R&S. On the basis of paragraph 21 of the ground lease, Eas-

tover filed a counterclaim requesting an order compelling Sowashee to enter into a new ground lease with Eastover as ground lessee.

Because R&S, as operator of the theater, obtained a separate nondisturbance agreement with Sowashee, its leasehold rights remained in place despite Austin's bankruptcy and rejection of the ground lease. Therefore, the effect of rejection of the ground lease on the theater's rights to remain in possession of the premises was not considered.

The bankruptcy court and the district court both held in favor of Sowashee and against Eastover in all respects, ruling that rejection of the ground lease under Section 365(d)(4) resulted in a termination of Eastover's third-party beneficiary rights under the ground lease, as well as its rights in the sublease payments. In essence, the lower courts viewed rejection of the ground lease as the termination of all rights thereunder. According to these courts, Eastover lost its security for its loan, and Sowashee was free to treat R&S as its tenant in accordance with the nondisturbance agreement—free and clear of any rights of Eastover.

The Court of Appeals Reverses

The court of appeals began its analysis by stating the issue: "The question presented in this case is what it means when a debtor as a lessee of nonresidential real property fails within 60 days after filing a Chapter 11 case to assume an unexpired lease. Under section 365(d)(4) of the Bankruptcy Code, the lease is 'deemed rejected.' Does the rejection terminate the lease and thus extinguish a security interest taken in the debtor's interest in the lease, a sublease by the debtor-lessee, or similar rights that accrued by and among third parties?"[5]

The court commented that, although this issue arises infrequently, the decisions of the bankruptcy courts that have considered it are "starkly conflicting."[6] One line of cases that was followed by the bankruptcy and district courts in *Austin Development* construes Section 365(d)(4) as an avoiding power against holders of security interests in the leasehold interest of the debtor-tenant who rejects the lease.[7] This line of cases reasons that the language of the Code that states that the debtor must "immediately surrender the premises" upon a "deemed" rejection effects a termination of the lease. "Under these cases, the lease is terminated by operation of federal law and not because of any breach of its terms" and, upon such termination, "security interests in the lease are extinguished."[8]

The court of appeals did not find persuasive this line of cases that

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[5] 19 F.3d at 1080.

[6] 19 F.3d at 1080.

[7] The court of appeals cited, e.g., In re Giles Assocs., Ltd., 92 B.R. 695 (Bankr. W.D. Tex 1988); In re Hawaii Dimensions, Inc., 39 B.R. 606 (Bankr. D. Haw. 1984), *aff'd*. 47 B.R. 425 (D. Haw. 1985).

[8] 19 F.3d at 1081.

treated "deemed rejected" leases, as well as third-party rights thereunder, as terminated. "Flawed by their failure to analyze section 365(d)(4) in harmony with the rest of section 365 and applicable statutory antecedents, these opinions have worked needless and perhaps unconstitutional forfeitures of security interests."[9] The court referred to Section 70(b) of the former Bankruptcy Act, from which Section 365 derives, and noted that the Fifth Circuit held in 1978 that "the deemed rejection of a lease under section 70(b) did not terminate the lease but merely placed the trustee's obligation to perform under the leasehold outside of the bankruptcy administration without destroying the leasehold estate."[10] The court was of the view that the reasoning of its 1978 decision remains persuasive under the Code because Sections 70(b) and 365(d)(4) do not materially differ in the way they effectuate the assumption and rejection power.

The court then focused on the language of Section 365, noting that the terms "rejection," "breach," and "termination" are used differently rather than interchangeably. "Throughout section 365, rejection refers to the debtor's decision *not to assume* a burdensome lease or executory contract. Section 365(g) states that rejection of a lease 'constitutes a breach'. . . . Three circuits, including this one, have held that this language does not mean that the executory contract or lease has been terminated, but only that a breach has been deemed to occur."[11] The court also pointed out that Section 502(g) permits the nondebtor party to a rejected contract or lease to assert a claim for damages as of the date of bankruptcy. "[I]f rejection were deemed a complete, immediate termination, it is not clear what the measure of the creditor's claim would be."[12]

In addition, the court noted that Congress knew how to provide for termination, as opposed to rejection, of an executory contract or unexpired lease when it wanted to. "Termination" is the term used in Sections 365(h), 365(i), and 365(n) as an option that may be available to a timeshare purchaser, a vendee of real property, or a licensee of intellectual property, but only if the trustee has rejected the executory contract. "Accordingly, the trustee may reject any of these contracts,

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[9] 19 F.3d at 1081.

[10] 19 F.3d at 1081. The court was referring to its decision in In re Garfinkle, 577 F.2d 901 (5th Cir. 1978), where the court held that the mortgage of the original lessee from whom the debtor acquired the leasehold was preserved notwithstanding an attempted rejection.

[11] 19 F.3d at 1082. The three circuit court decisions cited by the court are In re Continental Airlines, 981 F.2d 1450, 1459 (5th Cir. 1993) ("[T]o assert that a contract effectively does not exist as of the date of rejection is inconsistent with deeming the same contract breached."); In re Modern Textile, Inc., 900 F.2d 1184, 1191 (8th Cir. 1990); Leasing Serv. Corp. v. First Tennessee Bank, Nat'l Ass'n, 86 F.2d 434, 436–437 (6th Cir. 1987).

[12] 19 F.3d at 1082.

but termination does not occur except at the other party's option. . . . Under an objective reading, the provisions of section 365 may be redundant and complex, but Congress was not confused in its differing usages of the terms rejection, breach and termination."[13]

Moreover, the court of appeals pointed out that breach and termination of a contract are not synonymous terms under state law. "Congress could have chosen to depart from the state law meanings of these terms, but taken as a whole, section 365 suggests that it did not do so."[14]

But if rejection alone is not the equivalent of a termination of an executory contract, what about a "deemed rejection" coupled with the "immediate surrender" of the premises under Section 365(d)(4)? This was still not enough to constitute termination of the lease, according to the court of appeals. Although the court recognized that there are decisions holding that rejection—coupled with the requirement under Section 365(d)(4) that the debtor surrender the premises—must be seen as a termination of the trustee's rights under the lease, the court of appeals criticized that line of reasoning as ultimately resting on a "manufactured definition of termination as 'breach plus surrender of the premises.' "[15] In support of its conclusion, the court in *Austin Development* noted that the word "termination" does not appear in Section 365(d)(4). It also pointed out that "deemed rejected" under Section 365(d)(1) does not result in termination. It is also interesting to see that Section 365(d)(5) provides for termination of an air carrier's lease of an aircraft terminal or gate *before* a "deemed rejection." That is, under Section 365(d)(5), the aircraft terminal or gate lease is "deemed rejected" five days *after* the occurrence of a "termination event." In sum, "[s]ection 365 offers no textual support for equating 'breach plus surrender' with 'termination;' to the contrary, it furnishes good reasons for deducing that Congress did not collapse breach or rejection into the termination of a lease or executory contract."[16]

No Policy Reason to Treat Lease as Terminated

The court's conclusion that Austin's ground lease was not automatically terminated when it was deemed rejected pursuant to Section 365(d)(4) left intact the rights afforded to Eastover Bank as a leasehold mortgagee and third-party beneficiary of the lease. As further support for that conclusion, the court commented that any contrary result that deprives Eastover of its rights under the lease would be "a capricious result that makes no bankruptcy sense."[17] The most adverse consequence of treating the lease as terminated would be the

[13] *Id.* at 1082–1083.
[14] *Id.* at 1083.
[15] *Id.* at 1083.
[16] *Id.* at 1083.
[17] *Id.* at 1083.

forfeiture by operation of law of Eastover's mortgagee rights rather than any loss to the lessor or lessee. "This result has no policy rationale within the scope of section 365's adjustment of rights between the parties to the lease,"[18] the court commented.

If Section 365(d)(4) would have the effect of terminating Eastover's security interest in Austin's leasehold interest, this section would, according to the court of appeals, constitute an avoiding power—similar to the trustee's power to avoid certain liens as preferences or unperfected security interests. However, when the Code grants the trustee an avoiding power, that power is expressly authorized and requires commencement of an adversary proceeding with its attendant procedural protections. In contrast, any avoiding power under Section 365(d)(4) would be "uncharacteristically, an implied authority"[19] triggered by operation of law without any procedural protections. In addition, such an avoiding power—if it would exist under Section 365(d)(4)—would not benefit the bankruptcy estate. The court said that

> "[I]n eliminating the rights of a mortgagee of the debtor-lessee's interest in a lease, the policies justifying avoidance—to enhance the pot of unencumbered assets available to creditors and to discourage a race to the courthouse before bankruptcy—have not been served. The only rights affected by this implied avoidance power are outside of the bankruptcy court's realm because after rejection, the debtor's estate is no longer involved in the leasehold transaction. This extraordinary implied power does not reduce claims against the debtor's estate; if anything, it increases the unsecured claims by the amount of the mortgagee's claim in the 'terminated' lease.
>
> For these reasons, we conclude that a debtor's inaction in timely deciding to assume or reject a lease of nonresidential real property under section 365(d)(4), which leads to a deemed rejection, does not effect a termination of that lease, or, consequently, an implied forfeiture of the rights of third parties to the lease."[20]

Applying this legal analysis to the facts, the court of appeals concluded that when Austin failed to timely assume or reject the ground lease, Sowashee became entitled to file a proof of claim for damages based on Austin's breach, which, pursuant to Sections 365(g) and 502(g), was effective immediately before bankruptcy. Under Section 365(d)(3), Sowashee also was entitled to receive rent from the filing of the petition to the date of the lease rejection. However, since the lease was not terminated upon rejection, Eastover—as third-party beneficiary of paragraph 21 of the lease between Austin and Sowashee—retained its rights against Sowashee. Finally, the court held that "[t]he extent

[18] *Id.* at 1083.
[19] *Id.* at 1083.
[20] *Id.* at 1083.

of Eastover's rights, an issue not adjudicated below, should be decided in state court, because after rejection the debtor's estate had no remaining interest in the outcome of that controversy, which is not 'related to' the bankruptcy as is required for federal jurisdiction."[21]

Conclusion

The reasoning of the court of appeals in *Austin Development* is consistent with recent case law[22] and scholarly articles[23] focusing on the effect of rejection of an executory contract. A prevailing theme that has become apparent in recent years is that rejection is not the same as rescission or termination of an agreement, but is merely the trustee's decision not to assume it. That is, rejection is treated as nothing more than a prepetition breach giving rise to a damage claim against the estate. In all other respects the agreement remains effective. For example, if prior to bankruptcy, a property interest had passed from the debtor to the nondebtor party in accordance with the executory contract, rejection does not result in the reversion or termination of that property interest.[24]

The rejected lease should continue to govern the rights of a nondebtor third-party beneficiary as against a nondebtor party. As the court indicates, there is no good policy reason for not protecting Eastover's rights against Sowashee. It is interesting to note that if Eastover and Sowashee signed a separate agreement providing for the same rights as is contained in paragraph 21 of the lease, the effect of the debtor's rejection of the ground lease on Eastover's contractual right against Sowashee to enter into a new ground lease would never have been an issue.

[21] *Id.* at 1084. The court cited 28 U.S.C. § 1334(b), which governs federal bankruptcy jurisdiction.

[22] See, e.g., In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992) (rejection of employment agreement by debtor employer had no effect on employee's property rights in escrowed bond fund acquired prepetition by the employee under the employment agreement).

[23] See Westbrook, "A Functional Analysis of Executory Contracts," 74 Minn. L. Rev. 227 (1989); Andrew, "Executory Contracts in Bankruptcy: Understanding Rejection," 59 Univ. of Colo. L. Rev. 845 (1988).

[24] See, e.g., In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992).