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Fourth Circuit Finds Middle Ground: A Compromise Between Lessors and Lessees to Recover Post-Petition Lease Obligations for Personal Property

Ian J. Flanagan*

I. INTRODUCTION

Battle has been waged between lessors and lessees of personal property. As an increasing number of industrial companies, retailers, and airline companies are on the brink of bankruptcy, lessors ask themselves the inevitable question, “Will I get paid?” Will the lessor recover payments for the “post-petition” phase, the period between bankruptcy filing and rejection of the lease? For the most part, resolution of this issue is dependent upon the jurisdiction in which the claim is adjudicated.

To illustrate, suppose a lease provides for the rental of a telephone system to an airline company. The duration of the lease is 60 months. The rental fee is approximately $12,000 per month. Prior to the expiration of the lease, the airline company files for bankruptcy. During the fifteen months after petitioning for bankruptcy, the airline company does nothing in regard to the equipment lease. The airline company neither assumes nor rejects the lease, and it does not return the leased goods to the lessor. Instead, the airline company remains idle for fifteen months. Additionally, the lessor of the telephone system remains idle as well. In fact, the lessor only submits one invoice to the airline company during the fifteen month period. After fifteen months, the lessor files a motion to compel assumption or rejection the lease, forcing the airline to finally make a decision. The airline company rejects the lease, prompting the lessor to file an administrative claim for the payments it is owed. During the entire fifteen month period, the airline company has rarely, if ever, used the telephone system. Nonetheless, under the terms of the lease, the airline

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2. Id.
company owes the lessor approximately $200,000. Can the lessor collect payment? And if so, how much does the lessee owe?

The answer to lessor’s inevitable question of whether it will get paid, and, if so, the amount it will get paid, depends upon the jurisdiction in which the airline company files for bankruptcy. The spectrum of relief for the lessor ranges from zero to the entire amount due under the terms of the lease agreement. Thus, in the aforementioned fact pattern, depending upon which jurisdiction bankruptcy was filed, the lessor may receive nothing or the lessor may receive the full $200,000. This stark contrast in compensation for the lessor is perplexing. Until recently, there was no middle ground—the lessor received complete compensation or nothing. This confounding result has sparked creditors and debtors within the leasing industry to wage battle against each other.

Underneath this baffling dichotomy lies the Bankruptcy Code (the “Code”). The drafters of the 1994 amendments to the Code foresaw the problem of lessees lying complacent in regards to assumption or rejection of leases as it clearly requires lessees to timely assume or reject a lease. Yet, their amendment lacks teeth. In other words, the Code does not specifically provide the amount a lessor can recover from a lessee for rent owed during the post-petition phase. And it can be argued that without a provision specifying a remedy for violation of the amended provision, the requirement is unenforceable. If this argument is accepted, then why would a lessee abide by an unenforceable provision? The Code’s silence on a remedy in this context has caused courts to fashion their own remedies.

The Code’s lack of specificity “present[s] a controversy whose resolution [is] of great import.” This debate is not only significant for the immediate parties, the lessor and lessee, it is significant “for the leas-

3. See id.
4. Id.
6. § 365(d)(5) (“The trustee shall timely perform all of the obligations of the debtor, except those specified in section 365(b)(2), first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property . . . until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title”).
7. 3 COLLIER ON BANKRUPTCY ¶ 365.04[6][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2005) (“[S]ection 365(d)(5) is silent as to the consequence of noncompliance, leaving the issue to case law development”). On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAPCPA”). Although the BAPCPA widely affected Title 11 (the Bankruptcy Code), it did not address the issue of this article, namely, what amount, if any, a lessor can recover for the payment owed during the post-petition phase where the lessee neither rejects nor assumes the lease for personal property.
8. Sabino, supra note 1.
9. Id.
ing industry as a whole, given the capital at risk today with bankrupt companies.”

As the number of firms filing for bankruptcy increases exponentially, the leasing industry is fighting to recover past-due payments. Whether lessees are held accountable for their leases depends upon the sitting tribunal’s view. In some cases, the lessor is compensated for all payments owed during the post-petition phase. In a minority of cases, the lessor is compensated to the extent the lessee’s use of the leased goods was actual and necessary to its reorganization. In practice, if the lessee does not use the goods, the minority approach prohibits any compensation to the lessor. The Fourth Circuit’s view reconciles the conflict between the opposing interpretations, while eliminating the inequitable windfall provided by past approaches.

This article addresses the aforementioned duality: lessors receiving nothing or everything. This article also examines the Fourth Circuit’s compromise between the two divergent positions. Part II provides a cursory example of the impact the Fourth Circuit’s opinion has had on the leasing industry. Part III discusses the Code’s lack of detail in providing for a remedy when a lessee fails to timely assume or reject a lease during the post-petition phase. Part IV examines the remedies the majority, minority, and Fourth Circuit have fashioned. Additionally, Part IV analyzes the various remedies the courts have fashioned, including each remedy’s strengths and weaknesses. Part V discusses

10. Id.

11. See In re Pacific-Atlantic Trading Co., 27 F.3d 401 (9th Cir. 1994); In re E. Agri-Sys., 258 B.R. 352 (Bankr. E.D.N.C. 2000). The majority interpretation holds that the lessor is entitled an administrative expense for past-due payments, including rent, taxes, interest, late fees and attorney’s fees, under the lease. In re Midway Airlines Corp., 406 F.3d 229, 235 (4th Cir. 2005). These courts reason that the entitlement to past-due payments as administrative expenses “arises directly under § 365(d) and, as specifically stated in that statute, is independent from § 503(b)(1).” Id.

12. See In re Palace Quality Servs. Indus., Inc., 283 B.R. 868 (Bankr. E.D. Mich. 2002); In re Mr. Gatti’s, 164 B.R. 929 (Bankr. W.D. Tex. 1994). The minority interpretation holds that § 365(d)(5) merely imposes an obligation on the trustee and does not entitle the lessor to an administrative expense for the entire payment due under the lease. The minority of courts reason that the “if the trustee fails to perform his obligations under either section, the lessor must seek relief by invoking the more general remedies of the Code.” In re Midway Airlines Corp., 406 F.3d at 235. If the lessor recoup the payments owed, “it must apply for an administrative expense under § 503(b)(1)(A), seeking recover for actual and necessary use by the estate.” Id.

13. See id. Without the lessee actually and necessarily using the goods, the lessor is not entitled to any payment for amounts owed under the lease agreement. Id. at 236. Moreover, this interpretation leaves open the issue of whether the lessor can recover payment as an administrative expense under § 503(b)(1)(A) for a lessee’s actual use of the leased goods which was not necessary to the reorganization of the estate.

14. Sabino, supra note 1; See also In re Midway Airlines Corp., 406 F.3d 229, 235-36 (4th Cir. 2005).
the implications of the Fourth Circuit's compromising approach. Moreover, Part V explains why the Fourth Circuit approach is aligned with the Code's underlying goal of fostering debtor reorganization and how it produces economically efficient results for society. Finally, Part VI summarizes the overall benefits of the Fourth Circuit approach and urges courts to adopt this approach.

II. BACKGROUND

Until recently, a trustee or debtor in possession in the Fourth Circuit had the ability to postpone its decision whether to refuse to assume or reject a personal property lease without incurring additional post-petition liability.\textsuperscript{15} The Fourth Circuit's recent opinion in \textit{In Re Midway} shifts the burden to the trustee and requires it to be pro-active in assuming or rejecting a lease.\textsuperscript{16} As more companies are in the midst or on the verge of petitioning for bankruptcy,\textsuperscript{17} the Fourth Circuit's decision increases the burden on trustees,\textsuperscript{18} and makes the lessees' ability to avoid post-petition lease obligations unlikely.\textsuperscript{19} In the immediate, this victory for lessors seems to come at the detriment of lessees. However, the Fourth Circuit's opinion creates efficiencies for both parties and increases the lessee's likelihood of rehabilitating.

The impact of the Fourth Circuit's pivotal decision can be exemplified via application to the struggling airline industry. If a trustee or debtor in possession of a bankrupt airline company fails to reject a lease for a fleet of commercial airplanes, the lessor may still be able to recoup all of the obligations owed under the lease, regardless of the airline's use of the leased planes. Even if the airline had no post-petition use for the leased planes, the Fourth Circuit holds the lessee accountable for its trustee's failure to reject the lease and orders payment of the entire post-petition obligation.\textsuperscript{20}

In essence, the Fourth Circuit places a duty upon the trustee to assume or reject a lease the 61st day post-petition in order to avoid liability on the lease.\textsuperscript{21} In the past, the trustee was able to avoid assumption or rejection of the lease, and incur liability only to the extent of its actual and necessary use of the leased goods.\textsuperscript{22} Under the

\begin{itemize}
\item \textsuperscript{15} See \textit{In re Palace Quality Servs. Indus., Inc.}, 283 B.R. 868 (Bankr. E.D. Mich. 2002).
\item \textsuperscript{16} See \textit{In re Midway Airlines Corp.}, 406 F.3d at 235.
\item \textsuperscript{17} In re Midway Airlines Corp., 406 F.3d at 236.
\item \textsuperscript{18} Id. at 240.
\item \textsuperscript{19} Id. at 242.
\item \textsuperscript{20} See id.
\end{itemize}
Fourth Circuit’s interpretation, the lessee is liable for the entire obligation regardless of its use of the leased goods.23

III. Bankruptcy Code

The obligations of debtors with respect to personal property leases have evolved over the last decade or so. When Congress amended the Code in 1994, lessees experienced a change in their post-petition obligations.24 However, the additional provisions enacted by Congress did not delineate an explicit remedial provision if the lessee failed to satisfy its post-petition obligations.25

A. Pre-1994 Approach

Prior to 1994, the obligations of debtors with respect to personal property leases were governed by 11 U.S.C. 365(d)(2).26 Section 365(d)(2) deals with assumption and rejection of executory contracts and unexpired leases.27 Although section 365(d)(2) explicitly states the obligations of debtors with respect to personal property leases, the Code failed to create a remedy for lessors when lessees fail to fulfill their section 365(d)(2) obligations.28 Without such an explicit provision, the creditor could only seek the general remedies provided in the Code.29 Thus, a lessor who sought payment of obligations owed under a lease of personal property “was required in every instance to make application under 11 USC § 503(b)(1)(A),”30 which only reimbursed the “actual, necessary costs and expenses of preserving the estate. . . .”31 The lessor had the burden to demonstrate that the leased goods were actual and necessary to the preservation of the estate.32 This pro-lessee interpretation placed the lessor in a precarious position—to provide evidence of the debtor's necessity for and actual use of the

23. In re Midway Airlines Corp., 406 F.3d at 238.
24. See id. at 234.
25. 3 COLLIER ON BANKRUPTCY, supra note 7.
27. See id. 11 U.S.C. 365(d)(2) states that a “trustee may assume or reject an executory contract or unexpired lease of . . . personal property of the debtor at any time before the confirmation of a plan but the court, on request of any party to such contract of lease, may order the trustee to determine within a specified period of time whet to assume or reject such contract or lease.” Id.
28. In re Midway Airlines Corp., 406 F.3d at 234 (“If the trustee decides to reject the lease, however, the Code does not have a provision that requires the outright cure of any default”).
29. Id. (“Prior to 1994 the lessor’s remedy was to file a claim for an administrative expense under § 503(b)(1)(A)”).
32. See id.; In re United Trucking Service, Inc., 851 F.2d 159 (6th Cir. 1988).
leased goods. The Code expected the lessor to attain evidence of the
debtor's necessity and use of its leased property. Moreover, even if
the creditor was able to satisfy its burden, the debtor would only be
liable for "the period of actual use and only to the extent of real bene-
fit received by the estate." Under the pre-1994 approach, rarely
would a lessor be compensated for payments it is owed under the
lease.

At first glance, the pre-1994 approach seemed to strike a balance
between creditors and debtors—it compensated creditors for debtors' use
of the leased goods. Indeed, the pre-1994 approach was aligned
with Chapter 11's underlying goal of keeping administrative costs to a
minimum in order to rehabilitate the debtor rehabilitation. The pol-
icy behind granting priority to administrative expenses is to provide
creditors payment priority in exchange for their continued supply of
the actual and necessary resources to rehabilitate the debtor. Allowing
full compensation for leased goods is in tension with this policy. Without the "actual and necessary use" language in 503(b)(1)(A),
lessees would be under the obligation of fully compensating lessors for
the time period between the petition date and assumption or rejection
of the lease, regardless of necessity or use. Allowing full compensa-
tion for obligations incurred after rejection of the lease seems to be in
tension with the Code's purpose as well. The Code provides the
debtor "breathing space" to assume or reject a lease before incurring
liability on pre-petition executory contract obligations.

On its face, the pre-1994 approach seemed fair to both creditors and
debtors. However, allowing such breathing space is susceptible to
abuse. Aside from Section 503(b)(1)(A)'s "actual and necessary use" requirement, Section 362(a) provides for an automatic stay and pre-
vents the lessor from recovering the leased goods or terminating the
lease during the "breathing space" period. Moreover, a debtor
could force the trustee to continue performing its duties under the
lease, even though the lessor has received no payment. This abuse
of power created a windfall for the debtor—the debtor was only liable
for the actual and necessary despite the opportunity cost to the credi-

34. See In re Mid-Region Petroleum, 1 F.3d 1130, 1134 (10th Cir. 1993).
35. Id.
tor. In other words, the court focused on the actual and necessary benefit the leased goods provided for the estate, as opposed to the loss the creditor might sustain by virtue of the debtor's continued possession of the leased goods. Upon the realization that this limited compensation created an inequitable windfall in favor of the debtor, Congress revised the Code and enacted Section 365(d)(5).

B. Post-1994 Approach

Before Congress added Section 365(d)(5) to the Code, debtors were allowed an "unspecified period of time to determine whether to assume or reject a lease of personal property." Additionally, the debtor was only liable to the extent it benefited from the use of the leased goods. Congress responded to this unduly burdensome procedure by enacting 11 U.S.C. 365(d)(5). Section 365(d)(5) states:

The trustee shall timely perform all of the obligations of the debtor . . . first arising from or after 60 days after the order for relief . . . under an unexpired lease of personal property, until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof.

Congress inserted the "notwithstanding Section 503(b)(1)" language to make "an affirmative statement . . . that the availability of [a] Section 503(b)(1) administrative claim may no longer be used to excuse trustees from paying post-petition rents on unexpired leases of . . . equipment." Rather than allowing an unspecified period of time to decide whether to assume or reject the lease, Congress intended to compel the trustee to pay the ongoing obligations while it made its decision.

42. 11 U.S.C. § 365(d)(5) (2005). Initially, Congress revised the Code and provided 11 U.S.C. § 365(d)(10). However, 365(d)(10) was redesignated to 365(d)(5). The remainder of this article uses the re-designation, 365(d)(5), in place of what was traditionally 365(d)(10).
47. Id.
49. Id. at 877; See Senator's Hatch's remarks: "This bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of non-residential
Congress modeled Section 365(d)(5) after Section 365(d)(3), which addresses leases of non-residential real property.\textsuperscript{50} Significantly, "both sections impose a duty of timely performance on debtors and both express that the provision is \textit{notwithstanding} 503(b)(1)."\textsuperscript{51} Thus, cases interpreting Section 365(d)(3) are helpful in analyzing Section 365(d)(5).\textsuperscript{52}

Although in concept they are similar, there are differences between Section 365(d)(3) and Section 365(d)(5).\textsuperscript{53} Section 365(d)(5) is limited to Chapter 11 contexts and only applies to obligations due after the 60 day "breathing space" period; whereas, Section 365(d)(3) applies from the initial petition date.\textsuperscript{54} Thus, Section 365(d)(5) is considerably more flexible than Section 365(d)(3).\textsuperscript{55} Yet, both Section 365(d)(3) and Section 365(d)(5) are silent as to the consequences of a debtor's noncompliance with the Code in regard to post-petition obligations. Like Section 365(d)(3), Section 365(d)(5) fails to instruct on the consequences for a debtor who refuses to timely perform all the obligations between the lapse of the 60 day period and rejection of the lease.\textsuperscript{56} Instead, the Code relies on tribunals to fashion a remedy. Unfortunately, the circuits are split as to the extent a lessor should be compensated when a debtor fails to timely perform all its obligations during the post-petition phase.

\textsuperscript{50} In re Midway Airlines Corp., 406 F.3d 229, 234 (4th Cir. 2005); See 11 U.S.C. § 365(d)(3) (2005) (stating that (d)(10) has been redesignated to (d)(5)).
\textsuperscript{51} In re Midway Airlines Corp., at 243 (quoting In re E. Agri-Sys., 258 B.R. 352, 354 (Bankr. E.D. N.C. 2000)).
\textsuperscript{52} Id.
\textsuperscript{53} 3 COLLIER ON BANKRUPTCY, supra note 7.
\textsuperscript{54} Compare 11 U.S.C. § 365(d)(5) (2005) with 11 U.S.C. § 365(d)(3) (2005). Another difference is that 365(d)(3) limits time to cure defaults to sixty days after the order for relief. Id. § 365(d)(3). In contrast, 365(d)(5) allows for an extension to cure. Id. § 365(d)(5). 365(d)(5) permits the court, after notice and a hearing, to order otherwise with respect to the obligations or their timely performance based upon the equities of the case. Id.
\textsuperscript{55} 3 COLLIER ON BANKRUPTCY, supra note 7.
\textsuperscript{56} See In re Palace Quality Services Indus., Inc., 283 B.R. 868, 876 (Bankr. E.D. Mich. 2002) (interpreting the phrase "notwithstanding Section 503(b)(1) of this title" as not including a remedial component).
IV. THE THREE APPROACHES

A. Majority: Lessor Entitled to Full Compensation

The majority of courts hold that Section 365(d)(5) supplies a remedy. They find that a lessor is entitled to assert an administrative expense claim for post-petition default. Under the majority’s interpretation, a lessor is entitled to recover the total amount of payments due under the lease, including rent, taxes, interest, late fees, and attorney’s fees. The majority of courts reason that the administrative expense arises directly from Section 365(d)(5) and, as specifically stated in the Code, independent from Section 503(b)(1). Thus, a lessor is entitled to an administrative expense claim even if the leased property was of no benefit or use to the estate. The majority approach rejects the argument that a lessor is still required to assert a claim via Section 503(b)(1)(A). “[B]y providing for timely performance of all lease obligations, notwithstanding 503(b)(1),” the Code grants priority payment status to the full amount of rent, the majority reasons.

As previously noted, Section 365(d)(3) helps in analyzing Section 365(d)(5) claims. As such, the legislative history of Section 365(d)(3) is influential in determining what Congress intended when it enacted Section 365(d)(5). Section 365(d)(3)’s legislative history indicates that it was enacted to ameliorate the immediate financial burden borne by lessors during the period in which trustees decided whether to assume or reject a lease. In light of its history and language man-

60. In re E. Agri-Sys., 258 B.R. at 354.
61. Id. “The [1994] amendment expressly provides that it overrides section 503(b)(1). This apparently is intended to eliminate an argument over whether accrued rent was ‘actual’ or ‘necessary’ and, hence, entitled to an administrative priority.” 3 COLLIER ON BANKRUPTCY, supra note 7, ¶ 365.04[6][a].
63. In re Midway Airlines Corp., 406 F.3d at 229 (emphasis added).
64. Towers v. Chickering & Gregory, 27 F.3d 401, 403 (9th Cir. 1994).
65. 130 CONG. REC. S8894-95 (daily ed. June 19, 1984) (statement of Sen. Hatch: “The [second] problem is that during the time the debtor has vacated space but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments due under the lease. These payments include rent due under the landlord and common area charges which are paid by all tenants according to the amount of space they lease. In this situation, the landlord is
dating that the trustee perform "all obligations of the debtor . . . notwithstanding [S]ection 503(b)(1)," the majority holds that Section 365(d)(3) authorizes an administrative expense claim for rent at the full contract rate. By analogy, an independent Section 365(d)(5) remedy supports an administrative expense claim for unpaid rents accruing from and after 60 days of petition date, so long as the proceeding remains in Chapter 11 status.

B. Minority: Lessor Entitled To Actual and Necessary Use

The minority of courts hold that Section 365(d)(5) does not entitle a lessor to an administrative expense; rather, the section merely imposes obligations on the trustee. In other words, the minority believes that Section 365(d)(5) does not create a remedy. Instead, Congress knew how to create remedies when it enacted Section 365(d)(5), and its silence was purposeful. The minority urges that if the trustee fails to perform his post-petition obligations, the lessor must seek relief under the general remedies of the Code. For example, "the lessor may move to lift or modify the automatic stay or move to modify or terminate the debtor's right to possession of the property." Under the minority approach, if the lessor wishes to assert a claim for unpaid obligation, it must apply for an administrative expense under Section 503(b)(1)(A) for the actual and necessary use of the property. Unlike the majority's interpretation, administrative expense status is not an entitlement.

forced to provide current services—the use of its property, utilities, security, and other services—without current payment. No other creditor is put in this position. . . . The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of non-residential real property at the time required in the lease. This timely performance requirement will insure that debtor-tenants pay their rent, common area, and other charges on time pending the trustee's assumption or rejection of the lease.”

66. Towers, 27 F.3d at 403.
69. See generally In re Midway Airlines. Corp., 406 F.3d at 235; In re Palace Quality Servs. Indus., Inc., 283 B.R. at 875; In re Mr. Gatti's, 164 B.R. at 944.
70. Sabino, supra note 1.
71. Id.; See In re Palace Quality Servs. Indus., Inc., 283 B.R at 875; In re Mr. Gatti's, 164 B.R. at 944.
72. In re Midway Airlines Corp., 406 F.3d at 235; See In re Mr. Gatti's, 164 B.R. at 944.
73. In re Midway Airlines Corp., 406 F.3d at 235; See In re Palace Quality Servs. Indus., Inc., 283 B.R. at 878.
C. Fourth Circuit: Middle Ground Found

In *In re Midway Airlines*, the Fourth Circuit forged new grounds and placed itself in a compromising position between the two warring factions.\(^{74}\) Intuitively, the Fourth Circuit selected meritorious components from the majority and minority approach and fused them together.\(^{75}\) This compromise allowed the Fourth Circuit to devise an interpretation of the Code devoid of the criticism common to the two divergent approaches.\(^{76}\)

Although the Fourth Circuit agreed with the majority’s ultimate conclusion that a lessor is entitled to recover all obligations due under the lease, including rent, taxes, interest, late fees, and attorney’s fees, as an administrative expense, it disagreed with the majority as to how this conclusion should be reached.\(^{77}\) The Fourth Circuit agreed that Section 365(d)(5) “makes clear that a lessor is entitled to the trustee’s performance of all obligations under the lease.”\(^{78}\) However, it disagreed with the majority’s interpretation that Section 365(d)(5) creates an independent administrative expense claim.\(^{79}\) Instead, it sided with the minority’s argument that when a provision that imposes obligations but does not create a remedy, the aggrieved must seek relief in the general remedies of the Code.\(^{80}\) But right when the Fourth Circuit seemed to be agreeing with the minority’s interpretation, it jettisoned a part of the minority’s interpretation it found “ill considered.”\(^{81}\) The Fourth Circuit disagreed that the remedy lied in Section 503(b)(1)(A).\(^{82}\) Instead, the Fourth Circuit found that the administrative claim should be asserted under the broader 503(b).\(^{83}\) The Fourth Circuit reasoned that this interpretation is consistent with the language of Section 365(d)(5) and avoided the ambiguity and discord evident in the majority approach.\(^{84}\) Indeed, this interpretation was necessary “[t]o avoid conflict with the remainder of the Code.”\(^{85}\)

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\(^{74}\) Sabino, supra note 1; See generally *In re Midway Airlines Corp.*, 406 F.3d 229.

\(^{75}\) See generally *In re Midway Airlines Corp.*, 406 F.3d 229.

\(^{76}\) Sabino, supra note 1.

\(^{77}\) *In re Midway Airlines Corp.*, 406 F.3d at 236.

\(^{78}\) Id. at 235.

\(^{79}\) Id.

\(^{80}\) *In re Midway Airlines Corp.*, 406 F.3d at 236; But see *In re Mr. Gatti’s*, 164 B.R. at 943.

\(^{81}\) Sabino, supra note 1.

\(^{82}\) *In re Midway Airlines Corp.*, 406 F.3d at 236.

\(^{83}\) Id.

\(^{84}\) Id.

\(^{85}\) Sabino, supra note 1.
V. Analysis

Although the two divergent approaches have caused tension in the leasing industry, comparison is useful for highlighting each approach’s flaws. As the Fourth Circuit observed, each approach contains conflicts with the Bankruptcy Code that cannot be reconciled.\(^{86}\) The courts that follow the majority and minority approach have attempted to reconcile their opinions with shallow reasoning. Neither approach is aligned with the Code’s explicit provisions or implicit policies.

A. Majority Approach Defective

Defects are apparent in the majority’s approach. First, there is no language in the Code that grants an independent remedy via Section 365(d)(5).\(^{87}\) Rather, the Code is entirely silent on a specific remedy for a violation of Section 365(d)(5).\(^{88}\) Yet the majority finds a remedy within Section 365(d)(5).\(^{89}\) When a provision of the Code imposes an obligation without providing a remedy, the aggrieved must resort to the Code’s general remedies.\(^{90}\) Accordingly, a lessor’s remedy for a trustee’s failure to perform lies outside of Section 365(d)(5).\(^{91}\) Congressional silence supports this presumption.\(^{92}\)

Again, the majority approach finds a remedy within Section 365(d)(5).\(^{93}\) That is, the majority approach creates a remedy independent of Section 503(b).\(^{94}\) From a technical perspective, this independent remedy is in direct tension with provisions relating to recharacterization of claims upon conversion from Chapter 11 to Chapter 7 bankruptcy.\(^{95}\) When a case is converted from Chapter 11 to Chapter 7, Section 348(d)\(^{96}\) is triggered and adjusts the priorities of claims against the estate that arise after the order for relief was en-

86. *In re Midway Airlines Corp.*, 406 F.3d at 237.
87. 11 U.S.C. § 365(d)(5) (2005); *See In re Mr. Gatti’s*, 164 B.R. at 943
88. Id.
90. *In re Midway Airlines Corp.*, 406 F.3d at 236; *In re Mr. Gatti’s*, 164 B.R. at 943.
91. *In re Midway Airlines Corp.*, 406 F.3d at 236; *See In re Palace Quality Servs. Indus., Inc.*, 283 B.R. at 878.
92. “Congress surely could envision at the time it enacted [365(d)(5)] that some debtors-lessee[s], purposefully or otherwise, would fail to perform.” *In re Mr. Gatti’s*, 164 B.R. at 943. *See also* 11 USC 362(f) (2005); 11 USC 363(e) (2005). Yet, Congress failed to impose any specific remedy for such foreseeable behavior. “The question to ask, in trying to determine Congress’ intent, is why did it not provide a specific remedy. One logical reason is that the Code already contained a number of general remedy provisions.” 164 B.R. at 944.
94. Id.
95. *In re Midway Airlines Corp.*, 406 F.3d at 238
96. 11 U.S.C. 348(d) (2005). Section 348(d) governs the characterization of claims that arise after the order for relief, but before conversion from Chapter 11 to Chapter 7. *Id.*
tered but prior to the conversion.97 Claims arising in the post-petition, pre-conversion gap are “treated for all purposes as if [they] had arisen immediately before the date of the filing of the petition,”98 and are relegated to general unsecured claims.99 Notably, Section 348(d) exempts Section 503(b) administrative expense claims from this re-characterization.100 But because, as the majority argues, Section 365(d)(5) creates a remedy independent of Section 503(b), the Section 348(d) exemption cannot apply.101 Thus, Section 348(d) re-characterizes the Section 365(d)(5) claim as arising prior to the filing of the bankruptcy petition upon conversion. In other words, upon conversion a Section 365(d)(5) independent remedy becomes a general unsecured claim and subordinate to all other post-petition Section 503(b) administrative expense claims. The majority approach has failed to substantively address this re-characterization.102 Despite Section 348(d)’s clear and exclusive exception of only Section 503(b)(1) administrative claims from re-characterization, the majority ignores this explicit language and elevates Section 365(d)(5) claims above Section 503(b)(1) claims.103 Unconvincingly, the majority of courts attempt to rationalize their approach by asserting that without such elevation Section 365(d)(5) “would become a nullity in converted cases.”104

Another problem with the majority approach lies in the prioritization of claims.105 Section 507 of the Code establishes the order of pri-

97. Id.
98. 11 USC 348(d) (2005).
99. See id.
100. Id.
101. Id.; See In re Midway Airlines Corp., 406 F.3d 229, 239 (4th Cir. 2005).
102. While conceding this point, the majority approach argues that relegating a 365(d)(5) independent claim to the equivalent of a pre-petition general, unsecured claim would make 365(d)(5) a “nullity” in conversion cases. In re Midway Airlines Corp., 406 F.3d at 239. It seems this argument against the re-prioritization effect of 348(d) lacks any substance. Id.; See also In re E. Agri-Sys., 258 B.R. 352, 355 (Bankr. E.D.N.C. 2000).
103. In re Midway Airlines Corp., 406 F.3d at 229; see also In re E. Agri-Sys., 258 B.R. at 352.
104. The majority approach finds implications in decisions supporting elevation of 365(d)(5) post-petition claims over 503(b) by creating an entitlement, not just to payment, but to specific performance. In re Midway Airlines Corp., 406 F.3d at 229; see also In re E. Agri-Sys., 258 B.R. at 352. The majority argues that the elevation of 365(d)(5) claims is “consistent with the legislative history of [the provision], which clearly states Congress’s intent to give special protection to qualifying lessors.” In re Midway Airlines Corp., 406 F.3d at 229; see also In re E. Agri-Sys., 258 B.R. at 352. They argue that there is no indication that Congress considered the impact of 348(d) when enacting 365(d)(5), and no reason to suspect that Congress intended to give lessors less favorable treatment under these sections in converted cases. In re E. Agri-Sys., 258 B.R. at 355; see also In re Midway Airlines Corp., 406 F.3d at 229. However, the majority approach confessingly notes that there is “apparent conflict between the literal language of the Code and [the] clear intent of Congress as expressed in legislative history.” In re E. Agri-Sys., 258 B.R. at 355; see also In re Midway Airlines Corp., 406 F.3d at 229.
105. In re Midway Airlines Corp., 406 F.3d at 238.
orities for various types of claims against the estate. First in priority are administrative expenses allowed under Section 503(b). Absent from the list of priorities is any reference to an independent Section 365(d)(5) administrative expense. Without any evidence of super-priority for an independent Section 365(d)(5) claim, it is not clear how a claim under Section 365(d)(5), independent and without the use of Section 503(b), would have priority comparable Section 503(b).

The minority of courts have realized the numerous flaws apparent in the majority approach and criticized the majority for its unconvincing arguments. Although the minority accounts for the defects evident in the majority's approach, its approach contains shortcomings as well.

B. Minority Approach Defective

Like its counterpart, the minority's approach is far from flawless. The minority believes that the remedy for a violation of Section 365(d)(5) lies within Section 503(b)(1)(A). However, this seemingly simple separation of powers between Section 365(d)(5) and Section 503(b)(1)(A) creates striking inconsistencies. First, Section 365(d)(5)'s and Section 503(b)(1)(A)'s language is in direct tension. To illustrate, Section 365(d)(5) requires the lessee to perform all obligations under the lease while in possession of the leased goods. On the other hand, Section 503(b)(1)(A) provides for the lessor to be compensated for only the actual and necessary use of the property.

While Section 365(d)(5) requires the lessee to pay the entire obligation under the lease, Section 503(b)(1)(A) lets the lessee escape by forcing him to pay only to the extent that he used the leased goods. This inconsistency creates incentive for abuse. If the lessee is underutilizing the property, it is in the lessee's best interest to refuse to perform the obligation because the lessee will only have to compensate the lessor for its actual and necessary use of the equipment. In effect, the lessee saves the difference between the actual and necessary use

108. See id.; The majority approach unconvincingly argues that its independent 365(d)(5) claim should be granted the same priority 503(b) claims are granted. In re Midway Airlines Corp., 406 F.3d at 238.
109. In re Midway Airlines Corp., 406 F.3d at 238.
111. In re Mr. Gatti's, 164 B.R. at 935-36.
112. See In re Midway Airlines Corp., 406 F.3d at 235.
and the entire obligation due under the lease. Thus, the minority's approach creates an incentive to violate Section 365(d)(5)'s mandates. Apart from the incentive this inconsistency creates, Section 365(d)(5)'s explicit "notwithstanding Section 503(b)(1)" language means that irrespective of whether the payments required under the lease meet the usual requirements for administrative expense status (e.g., actual and necessary), they are unconditionally due. By requiring the trustee to pay "all obligations of the debtor," Congress could not have intended for courts to look into whether the debtor utilized the property and to what extent.\textsuperscript{115}

Illustrating the obvious defects in the two divergent approaches provides a foundation for analysis of the Fourth Circuit's approach in \textit{In re Midway Airlines}. Noting the inconsistencies in the two previous attempts, the Fourth Circuit found middle ground and fashioned a third approach.\textsuperscript{116}

**C. Fourth Circuit Accounts for the Flaws of the Majority and Minority Approaches**

The Fourth Circuit held that the general provisions of Section 503(b) provide a remedy for a Section 365(d)(5) violation.\textsuperscript{117} The Fourth Circuit found that Congress enacted Section 365(d)(5), and its provision "notwithstanding 503(b)(1)" to relieve lessors of the burden of finding a remedy under Section 503(b)(1)(A).\textsuperscript{118} The Fourth Circuit believes the lessor's remedy lies in Section 503(b).\textsuperscript{119} Unlike the narrower Section 503(b)(1)(A), Section 503(b) does not require actual and necessary use for granting a remedy.\textsuperscript{120}

Finding relief for a Section 365(d)(5) violation in Section 503(b), rather than Section 503(b)(1)(A), reconciled the two seemingly inconsistent provisions.\textsuperscript{121} Requiring the aggrieved party to pursue action under Section 503(b)(1)(A) limits the amount the party can recover—only the lessee's actual and necessary use.\textsuperscript{122} Again, Section 365(d)(5) requires that the lessee perform all obligations "notwithstanding 503(b)(1)."\textsuperscript{123} Section 365(d)(5) does not prohibit a claim under Sec-

\textsuperscript{115} In re Wingspread Corp., 116 BR 915, 926 (Bankr. S.D.N.Y 1990) (applying the notwithstanding analysis to a 365(d)(3) claim).

\textsuperscript{116} Sabino, supra note 1, at 7; See In re Midway Airlines Corp., 406 F.3d at 235-36.

\textsuperscript{117} In re Midway Airlines Corp., 406 F.3d at 236.

\textsuperscript{118} Id.

\textsuperscript{119} Id.

\textsuperscript{120} 11 U.S.C. § 503(b) (2005).

\textsuperscript{121} Sabino, supra note 1, at 7; See In re Midway Airlines Corp., 406 F.3d at 236.


tion 503 all together; rather, it affords a claim for relief under the broader provisions of Section 503(b) for recovery of all payments owed under the lease.\(^{124}\)

More importantly, unlike the majority, the Fourth Circuit reconciled its approach with the prioritization provisions of the Code.\(^{125}\) As the minority pointed out, the majority’s interpretation was vague as to how an independent Section 365(d)(5) administrative expense would be entitled to priority comparable to that of a Section 503(b) claim.\(^{126}\) Yet, an administrative expense claim under Section 503(b) for unpaid lease payments due under Section 365(d)(5) is explicitly given priority by Section 507(a).\(^{127}\)

Like Section 507(a), Section 348(d) creates priorities for claims against the estate.\(^{128}\) However, Section 348(d) re-prioritizes claims upon conversion from Chapter 11 to Chapter 7 bankruptcy.\(^{129}\) Again, the Fourth Circuit was able to reconcile its interpretation with the re-prioritization provisions of Section 348(d).\(^{130}\) If, as the majority argued, Section 365(d)(5) creates an independent administrative expense, it would be subject to loss of priority upon conversion to Chapter 7.\(^{131}\) Conversely, if a Section 503(b) administrative expense claim was made, it would be exempted from priority loss.\(^{132}\) A Section 503(b) is the only type of claim that Section 348(d) excepts from its general rule.\(^{133}\) Therefore, a Section 503(b) claim keeps its priority throughout the conversion from Chapter 11 to Chapter 7.

The Fourth Circuit’s middle ground interpretation is comforting. Its remedy is found inside the Code and outside of Section 365(d)(5), while adhering to the explicit language of that section. It eliminates the “actual and necessary use” language restriction of Section 503(b)(1), while keeping the rest of the section generally applicable.\(^{134}\) Its approach keeps intact the “most vital characteristics of a Section 503 post-petition expense: it arises after the debtor enters bankruptcy and the estate benefits from the post-petition usage of the lease-

\(^{124}\) 11 U.S.C. § 503(b) (2005); See In re Midway Airlines Corp., 406 F.3d at 229.
\(^{125}\) See In re Midway Airlines Corp., 406 F.3d at 239.
\(^{129}\) Id.
\(^{130}\) In re Midway Airlines Corp., 406 F.3d at 239.
\(^{132}\) In re Midway Airlines Corp., 406 F.3d at 239; See § 348(d).
\(^{133}\) In re Midway Airlines Corp., 406 F.3d at 239 (citing § 348(d)).
\(^{134}\) Sabino, supra note 1.
hold.” Aligned with these vital characteristics, the Fourth Circuit holds the trustee accountable for “the full price for the opportunity to use the [leased] property.” In the end, the Fourth Circuit approach finds middle ground between the majority and minority approach without comprising clarity or consistency.

VI. IMPLICATIONS

While the Fourth Circuit may have found the middle ground between the majority and minority of interpretations, it can be argued that, in practice, its decision creates a windfall for lessors. Indeed, at first glance, the Fourth Circuit’s interpretation is advantageous to les- sors. As scholars noted, “the Fourth Circuit’s decision in Midway could represent a true turning point in vindicating the rights of lessors, as they inevitably come into conflict with lessees that have tumbled into bankruptcy.”

Prior to 1994, lessees were rarely liable for full payment of the lease during the post-petition phase. In effect, there was disincentive to timely reject or assume a lease. If the trustee prematurely assumed the lease and realized the property was not necessary to the organization, it would be liable for the entire post-petition obligation. Alternatively, if the trustee waited until it could make a more informed decision as whether to assume or reject, it would be in no worse of a position—if it assumed the lease it would be liable for full compensation and if it rejected the lease it would be liable only for the use of the leased goods. On the other hand, if the lessee eventually rejected the lease, the lessor was not compensated for his lost opportunity cost—the period that the lessor could have re-leased the goods to a solvent lessee.

It seems Congress was apprised of this windfall when, in 1994, it enacted Section 365(d)(5). By adding the “notwithstanding 503(b)(1)” language to the analysis, Congress intended to eradicate the windfall lessees were receiving at the detriment of lessors. No

135. Id.
136. In re Midway Airlines Corp., 406 F.3d at 237.
137. Sabino, supra note 1, at 2.
138. Id.
139. Sabino, supra note 1.
140. Under the pre-1994 approach, lessees sought relief under 11 U.S.C. § 503(b)(1)(A) which only provides relief to the extent of the lessee’s actual and necessary use of the leased goods.
141. See Senator Hatch’s remarks, supra note 67; In re Midway Airlines Corp., 406 F.3d 229, 237 (4th Cir. 2005) (“Congress essentially made the determination that the trustee must pay the full price (as reflected by the lease terms) for the opportunity to use the property.”).
142. See Senator Hatch’s remarks, supra note 67.
longer would the trustees be able to remain idle in their decisions, only to escape liability by rejecting the lease. The enactment of Section 365(d)(5) places an affirmative duty on lessors to make a timely decision on whether to assume or reject a lease. Liability for all post-petition obligations serves as a negative reinforcement for trustees to fulfill their duty of timely assumption or rejection of the lease. It is foreseeable that this form of negative reinforcement will be criticized by some.

Concededly, liability for the entire post-petition obligation may be extremely detrimental to the debtor's rehabilitation. Moreover, some may argue that this approach is in tension with the Code's purpose behind prioritizing claims—immediate reimbursement to creditors necessary to rehabilitate and reorganize the debtor. By requiring payment to a creditor whose services may be ancillary to reorganization, the debtor may be deprived of funds that could be beneficial if distributed elsewhere. Nevertheless, these conflicts are negligible compared to the sizeable long-run benefits.

If the majority and minority of courts adopt the Fourth Circuit's compromising interpretation, the lasting advantages will outweigh the short-term negative consequences. To illustrate, the first cases arising under the new approach will serve as a warning to future trustees. Over time, trustees will realize the full liability awaiting them if they fail to timely reject a lease. This realization will generate efficiencies in their decision-making process. By addressing this decision within the sixty day period, the trustee will eliminate unnecessary leases. Under the "actual and necessary use" remedy, the trustee may have delayed its decision to assume or reject unnecessary leases. The Fourth Circuit's approach forces the trustee to address the lease and its effect on reorganization. Put differently, the Fourth Circuit's approach forces the trustee to cut away long-term unnecessary and excess costs. Thus, over time, the long-term advantages will overshadow the short-term disadvantages.

The advantages to the lessor are obvious while the advantages to society are less-obvious. The Fourth Circuit's approach forces the trustee to timely reject the lease or face full liability. If the trustee timely rejects the lease, the lessor is able to repossess its goods and pursue other opportunities. The ability to pursue other opportunities

143. The lessee/trustee is liable for the entire payment due under the lease regardless of use.
allows the lessor to draw revenue from its goods; the debtor can re-
lease its goods to solvent, paying lessees. Additionally, freeing the
lessor's resources and allowing it to pursue other opportunities creates
social efficiencies. In contrast, holding up the lessor's goods during
the post-petition phase, only to have the trustee reject the lease, pro-
hibits another potential lessee from leasing the goods. Rather than
generating revenue, the goods remain stagnant while depreciating,
thus producing negative revenue. This stagnation has an effect on so-
ciety as well. Assuming there are limited resources in the economy, a
future lessee's inability to lease the goods from the lessor, because the
lessor's goods are tied up with an insolvent lessee, likely will create
inefficiencies in the future lessee's operations. Until the future lessee
can lease the goods, it must operate less efficiently. In this context,
not only has the untimely decision of the trustee injured the immedi-
ate party to the transaction—the lessor—it has indirectly harmed a
future lessee.

In the face of full liability, a trustee will most likely timely reject a
lease of unused and unnecessary goods. In effect, the Fourth Circuit's
punishment for untimely rejection forces the trustee to reject the lease
in a timely manner. This negative reinforcement forces the trustee to
free the property. With the property back in its hands, the lessor is
able to lease it to another future lessee. In this context, the Fourth
Circuit's approach allows property to be fully utilized by society. In
addition, the Fourth Circuit's approach creates efficiencies for the im-
mediate parties to the transaction—the insolvent lessee has curtailed
its costs and the lessor has realized upon its opportunity costs and
increased profits.

VII. Conclusion

In the end, a seemingly unfavorable approach for lessees has proved
beneficial and efficient to lessees and lessors, as well as society. In the
cases to follow, it will behoove the majority and minority to adopt the
Fourth Circuit's approach. Not only does it reconcile the two previous
interpretations, it is consistent with the text and structure of the Code
and in harmony with Congress' intent. Furthermore, it does not
serve one party at the loss of another; it creates benefits for all.

146. Sabino, supra note 1; See In re Midway Airlines Corp., 406 F.3d 229 (4th Cir. 2005).