

# Michigan Law Review

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Volume 99 | Issue 4

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2001

## Rejection Versus Termination: A Sublessee's Rights in a Lease Rejected in a Bankruptcy Proceeding Under 11 U.S.C. § 365(D)(4)

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### Recommended Citation

Vivek Sankaran, *Rejection Versus Termination: A Sublessee's Rights in a Lease Rejected in a Bankruptcy Proceeding Under 11 U.S.C. § 365(D)(4)*, 99 MICH. L. REV. 853 (2001).

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## NOTE

### Rejection Versus Termination: A Sublessee's Rights in a Lease Rejected in a Bankruptcy Proceeding Under 11 U.S.C. § 365(d)(4)

Vivek Sankaran

When a party files for bankruptcy under chapter 11 of the United States Code,<sup>1</sup> the court typically appoints a trustee to handle all of the party's financial obligations.<sup>2</sup> The trustee's responsibilities include investigating the financial condition of the debtor, the operation of the business, the desirability of continuing the business, and any other matter relevant to the disposition of the bankrupt estate.<sup>3</sup>

If a bankrupt party holds a commercial lease,<sup>4</sup> the trustee possesses two options for dealing with the lease.<sup>5</sup> One option is to reject the lease, which ends the bankrupt party's obligation to adhere to the provisions of the lease.<sup>6</sup> The trustee may decide to reject the lease because the rent of the property is above the market price or because the par-

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1. 11 U.S.C. § 365 (1994). Chapter 11 provides bankrupt parties:

[T]he legal option of assuming the contract, thereby receiving the benefits of its provisions at the costs of meetings its obligations on a priority basis, or rejecting the contract, thereby foregoing all benefits but absolving themselves of further obligations and relegating the other party to the status of pre-petition creditor for unsatisfied liabilities.

Laura B. Bartell, *Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts*, 103 DICK. L. REV. 497, 498 (1999).

2. 11 U.S.C. §§ 1104-1106.

3. § 1106(a)(3).

4. § 365(d)(4) only involves the assumption or rejection of an "unexpired lease of *non-residential real property*." *Id.* (emphasis added). Accordingly, this Note focuses on the rejection of commercial leases.

5. § 365(a).

6. Rejection is a bankrupt party's decision not to assume the obligations set forth in the lease. See *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1082 (5th Cir. 1994) ("Throughout § 365, rejection refers to the debtor's decision *not to assume* a burdensome lease or executory contract."); *Commercial Trading Co. v. Lansburgh (In re Garfinkle)*, 577 F.2d 901, 905 (5th Cir. 1978) ("[A]ssumption and rejection refer to the bankruptcy trustee's decision to administer or to refuse to administer assets of the bankrupt."); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 845, 848 (1988) ("[Rejection] is simply a bankruptcy estate's decision not to assume, because the contract or lease does not represent a favorable or appropriate investment of the estate's resources.").

ticular leased premises are not needed.<sup>7</sup> The second option is to assume the lease, which requires the bankrupt estate to take on the obligations set forth in the lease.<sup>8</sup> The assumption of a lease permits the bankrupt party to receive benefits from the lease, such as the continued use of the property and rent derived from subletting the property, at the cost of meeting its obligations.<sup>9</sup> According to 11 U.S.C. § 365(d)(4) (the “surrender provision”), if the trustee for the bankrupt party fails to either reject or assume the lease within sixty days of filing for bankruptcy, the lease is deemed rejected automatically, and the trustee must immediately surrender the property to the lessor.<sup>10</sup>

Chapter 11 also defines the rights of a lessee when its lessor files for bankruptcy and the trustee rejects the lease. Section 365(h)(1)(A)(ii) (the “applicable nonbankruptcy law provision”) states that, in such situations, the lessee possesses the right to remain on the property for the duration of the lease to the extent permitted “by applicable nonbankruptcy law.”<sup>11</sup> In situations involving the subletting of property, the applicable nonbankruptcy law provision suggests that, when a bankrupt lessee or sublessor rejects the original lease, the sublessee of the original lease should also have the right to

7. See David L. Bleich, Clarence W. Olmsted & Benzion J. Westreich, *Tenants Beware: Rights Threatened If Lessor in Bankruptcy Rejects a Lease*, 211 N.Y.L.J., Feb. 9, 1994, at 5 (discussing the rationale behind rejecting or assuming a lease, focusing specifically on the limitations of the lessee’s rights after the lessor rejects the lease).

8. See Andrew, *supra* note 6, at 846-47 (stating that assumption “refers to a bankruptcy estate’s agreement to take on the obligations of the bankruptcy debtor on some pending contract or lease.”).

9. Bartell, *supra* note 1, at 498 (discussing the options of the bankrupt party under the Bankruptcy Code):

[T]he Code provides them the legal option of assuming the contract, thereby receiving the benefits of its provisions at the cost of meeting its obligations on a priority basis, or rejecting the contract, thereby foregoing all benefits but absolving themselves of further obligations and relegating the other party to the status of pre-petition creditor for unsatisfied liabilities.

10. 11 U.S.C. § 365(d)(4):

[I]n a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

11. § 365(h)(1)(A)(ii) (“[I]f the term of such lease has commenced, the lessee may retain its rights under such lease . . . to the extent that such rights are enforceable under applicable nonbankruptcy law.”). Examples of “applicable nonbankruptcy law” include state law and specific contractual provisions. See, e.g., *In re Dial-A-Tire Inc.*, 78 B.R. 13, 16 (Bankr. W.D.N.Y. 1987) (giving subtenants the right to assert relevant state law to protect their property interests); *Block Props., Inc. v. Am. Nat’l Ins. Co.*, 998 S.W.2d 168, 176 (Mo. Ct. App. 1999) (allowing subtenants to rely on terms of the sublease to preserve their interests in the lease).

remain on the premises as permitted by “applicable nonbankruptcy law.”<sup>12</sup>

When a party that subsequently files for bankruptcy subleases property to a third party, it is both a lessor and a lessee. It is a lessor because it is subleasing the property to another party; but it is a lessee because it is leasing the property from another. Because of the multiple roles of the bankrupt sublessor, both the surrender provision and the applicable nonbankruptcy law provision seem to apply when the sublessor rejects the lease or when the lease is deemed rejected.<sup>13</sup> While the applicable nonbankruptcy law provision provides the sublessee with the right to assert nonbankruptcy law to preserve its rights under the rejected lease, the surrender provision appears to mandate the sublessor to surrender immediately the property to the original lessor upon rejection.<sup>14</sup> The explicit language in section 365 appears to provide both the sublessee and the lessor the right to occupy the property after the bankrupt sublessor rejects the lease.

The key question to resolve is whether, in a subletting situation, the rejection of a lease due to the trustee’s failure to act under the surrender provision that results in the immediate surrender of the property to the lessor terminates the lease and extinguishes all rights of third-party sublessees under the lease. If rejection under this provision terminates the lease, a sublessee has no recourse under the applicable nonbankruptcy law provision, since the lease no longer exists.<sup>15</sup> If, however, rejection does not terminate the lease, but rather stands as a breach of the lease, the sublessee may be able to look to the applicable nonbankruptcy law provision to assert its right to remain in the property.<sup>16</sup>

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12. § 365 (h)(1)(A)(ii); *Dial-A-Tire*, 78 B.R. at 16 (“The application of these subsections [§ 365(d)(4) and § 365(h)(1)(A)(ii)] produces the anomalous result of the Debtor being obligated to surrender the Premises, but [the subtenant] not necessarily having to.”).

13. See *Dial-A-Tire*, 78 B.R. at 16 (recognizing that § 365(d)(4) provides that, upon rejection, non-residential real property must be immediately surrendered to the lessor, while § 365(h)(1) provides that, upon rejection of a lease of non-residential real property, the lessee may remain in the property to the extent permitted by applicable nonbankruptcy law”).

14. *Id.*

15. The termination of a lease means that the lease no longer exists and a solvent party cannot assert its rights under the lease. *Eastover Bank for Sav. v. Sowsashee Venture (In re Austin Dev. Co.)* 19 F.3d 1077, 1082 (5th Cir. 1994) (pointing out that a solvent party could not collect damages on a terminated lease); *Block Props.*, 998 S.W.2d at 174 (“If we find that Food Barn’s rejection of the master lease resulted in its termination, our inquiry would end as the termination of the master lease would also terminate all of the rights and obligations thereunder, including the respondents’ right to possess and sublet the property.”); 3 COLLIER ON BANKRUPTCY ¶ 365.09[3], at 365-75 (Lawrence P. King ed., LEXIS Publishing 15th ed. 2001) (“[I]f rejection of the lease worked a termination, it would be difficult to justify granting the other party to the . . . lease a damage claim for rejection, which the lessor is given by section 502(g).”).

16. *Tebo v. Elephant Bar Rest., Inc. (In re Elephant Bar Rest., Inc.)*, 195 B.R. 353, 356 (Bankr. W.D. Pa. 1996) (recognizing that a sublessee of a rejected lease has the ability to assert nonapplicable bankruptcy law to preserve its rights under 11 U.S.C. § 365(h)(1)(A)(ii)

The future of parties subleasing commercial property depends on the resolution of this crucial issue. The surrender provision is invoked when a bankrupt sublessor fails to assume or reject a lease within sixty days after filing for bankruptcy.<sup>17</sup> If, as a matter of federal law, sublessees' rights are terminated pursuant to the surrender provision, their rights are forfeited without the opportunity for a court to address their interests. Consequently, this policy of automatic forfeiture would increase the transaction costs<sup>18</sup> of entering into subleases because it would force sublessees to perform extensive credit checks to assess the probability of potential sublessors' filing for bankruptcy.

A number of bankruptcy courts have addressed the apparent conflict between the surrender provision and the applicable nonbankruptcy law provision. Some courts have determined that, in enacting the surrender provision, Congress intended for property to revert immediately to the lessor upon rejection by the bankrupt sublessor, even in a subletting situation.<sup>19</sup> Other courts, relying on the applicable nonbankruptcy law provision, have held that the property rights of a sublessee are matters of nonbankruptcy law.<sup>20</sup> These courts have found that once the bankrupt sublessor's actions result in the rejection of a

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because the lease was only breached and not terminated); *Block Props.*, 998 S.W.2d at 174 (same). See *supra* note 11 for examples of "applicable nonbankruptcy law."

17. § 365(d)(4).

18. Transaction costs are defined as "the costs associated with the transfer, capture, and protection of rights." YORAM BARZEL, *ECONOMIC ANALYSIS OF PROPERTY RIGHTS* 4 (2d ed. 1997).

19. *E.g.*, *Chatlos Sys., Inc. v. Kaplan*, 147 B.R. 96, 100 (Bankr. D. Del. 1992) ("[W]hen a lease is deemed rejected pursuant to § 365(d)(4), any subleases under that primary lease must also be deemed rejected since the sublessee's rights in the property extinguish with those of the sublessor."); *In re 6177 Realty Assocs., Inc.*, 142 B.R. 1017, 1019 (Bankr. S.D. Fla. 1992) ("Rejection of a non-residential lease results in termination of the lease. Once the underlying lease is terminated, leasehold mortgages or sublessees retain no interest that can be pursued in bankruptcy court or state court."); *In re Child World, Inc.*, 142 B.R. 87, 89 (Bankr. S.D.N.Y. 1992) ("[T]he debtor's rejection of the prime lease also resulted in rejection of the sublease and deprived the sublessee . . . of any right to occupy the leased premises following such rejection."); *Keaty & Keaty v. Loyala Assocs. (In re Stalter & Co.)*, 99 B.R. 327, 330 (E.D. La. 1989) ("A law that commands two mutually exclusive events cannot be obeyed. The only rational view is that § 365(h) does *not* afford the [subtenant] a right against the [sublessor] to occupy the Leased Premises after . . . the rejection of the Master Lease.").

20. *E.g.*, *Elephant Bar Rest.*, 195 B.R. at 357 (concluding that the subtenant "retains possessory rights in the premises to the extent that its sublease is recognized under Colorado state law notwithstanding that the lessee/sublessor (i.e., the debtor) retains no further right to possess such premises"); *Dial-A-Tire*, 78 B.R. at 16 ("[T]he dual rejection which occurred here will leave [the landlord] and [the subtenant] to vie for possession of the premises according to New York Law."); *Envireco Int'l Motors, Inc. v. Elmhurst Transmission Corp. (In re Elmhurst Transmission Corp.)*, 60 B.R. 9, 10 (Bankr. E.D.N.Y. 1986) ("If a debtor's lease is rejected in bankruptcy, 11 U.S.C. § 365(h)(1), affords his subtenants no more than their rights under state law."); *Block Props.*, 998 S.W.2d at 174-75 ("After reviewing the language of § 365, we find the logic and reasoning of the latter cases, holding that the rejection of an unexpired lease constitutes a breach of the lease, not a termination, to be more persuasive.").

leased premise, sublessees can assert applicable nonbankruptcy law in state courts.<sup>21</sup> By applying the applicable nonbankruptcy law provision instead of the surrender provision, these jurisdictions hold that the rejection of a lease does not necessarily extinguish the rights of third-party sublessees to the lease.<sup>22</sup>

This Note argues that a lease deemed rejected under the surrender provision ends the bankrupt sublessor's interest in the lease but does not terminate the rights of a sublessee. State property law, rather than federal law, should determine the sublessee's rights when the primary lease is deemed rejected. Part I argues that Congress intended that rejection and termination have different meanings. Congress did not evince an intent, contrary to the suggestion of some courts, for a rejected lease to be terminated. Congress further demonstrated its intent to preserve the rights of sublessees by incorporating the phrase "immediately surrender" into the surrender provision. Part II asserts that, since the surrender provision does not terminate third-party sublessee interests to the lease, the applicable nonbankruptcy law provision should govern the rights of a sublessee. Once a lease is "immediately surrendered," the sublessee should have the opportunity to assert its rights in state court since the proceedings no longer involve bankruptcy law. This Note concludes, in Part III, that the surrender provision provides parties with an incentive to enter into subleases because, under that provision, the distinction drawn between rejecting and terminating a lease reduces the transaction costs of entering into such an agreement. This distinction furthers Congress's desire to encourage the efficient use of property through section 365 of the Bankruptcy Code.

## I. CONGRESS'S USE OF REJECTION AND TERMINATION IN SECTION 365

Congress intended that rejection and termination have different meanings in section 365 of the Bankruptcy Code<sup>23</sup> so that a lease rejected under the surrender provision would not be terminated. Courts

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21. Some federal courts, when confronting issues raised under § 365(h)(1)(A)(ii), have refused to deal with nonbankruptcy issues. See *Dial-A-Tire*, 78 B.R. at 16 ("That matter is not properly before the Court. Nor could it be, since 'federal courts acting in the bankruptcy context should deal with state law only to the extent such is necessarily and directly implicated by the bankruptcy issues' " (quoting *In re Nanodata Computer Corp.*, 74 B.R. 766, 771 (W.D.N.Y. 1987)); *Elmhurst Transmission Corp.*, 60 B.R. at 10 ("The debtor's bankruptcy case is near completion and the contemplated litigation between the debtor's former landlord and the debtor's former tenant will not affect the debtor's bankruptcy estate. Thus, the court abstains from hearing the case . . .").

22. See *supra* note 20 (citing cases preserving sublessees' rights under § 365(h)(1)(A)(ii)).

23. See 11 U.S.C. § 365 (1994).

reading the surrender provision to find that a sublessee's rights are extinguished upon the bankrupt sublessor's rejection of the lease interpret the phrase "immediately surrender" to convey Congress's intention that a rejected lease be terminated.<sup>24</sup> Although the statutory provision does not mention termination,<sup>25</sup> these courts reason that Congress used rejection and termination interchangeably throughout the statute.<sup>26</sup> Assuming that Congress did not intend different meanings between rejection and termination throughout section 365, these courts developed their own interpretation of what it means to "immediately surrender" a lease.<sup>27</sup>

This section asserts, to the contrary, that Congress intended to preserve the differences between rejection and termination in section 365. Section I.A argues that Congress clearly differentiated between rejection and termination throughout section 365. Section I.B asserts that Congress incorporated the terms into the statute with an understanding of the consequences accompanying rejecting and surrendering a lease under the common law. Courts, therefore, should adhere to the definitions of rejection and surrender used in the statute and understood under the common law, and should not equate the surrendering of a lease with the termination of all third-party sublessee interests to the lease.

#### A. *Different Meanings of Rejection and Termination*

The provisions of section 365 may be redundant and complex, but Congress's varied usage of rejection and termination does not reflect confusion. A careful examination of section 365 indicates that Con-

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24. See e.g., *Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077, 1080-81 (9th Cir. 1989) ("Surrender of property . . . has the effect of terminating the enterprise that operates there. If Congress intended passive rejection of a lease to be subject to court approval, it would not have required the drastic step of immediate surrender."); *6177 Realty Assocs.*, 142 B.R. at 1019 ("The surrender remedy specially provided in § 365(d)(4) by Congress embodies a federal policy to ensure that unless extended by the Court, landlords obtain possession of their property within sixty (60) days . . ."); *In re Giles Assocs., Ltd.*, 92 B.R. 695, 698 (Bankr. W.D. Tex. 1988) ("The breach plus surrender obligation can only be seen as termination of any of the trustee's or debtor's rights in the leasehold."); *In re Southwest Aircraft Servs., Inc.*, 53 B.R. 805, 810 (Bankr. C.D. Cal. 1985) ("By requiring that upon rejection under § 365(d)(4), 'the trustee shall immediately surrender such nonresidential real property to the lessor,' it is clear Congress intended that rejecting a lease terminates the lease.").

25. Section 365(d)(4) simply states that, upon rejection, the property should be "immediately surrender[ed]" to the landlord. 11 U.S.C. § 365(d)(4).

26. See *Giles*, 92 B.R. at 698 ("[C]ongress could have and should have used consistent terms, but Congressional inconsistency creates no presumptions."); *Southwest Aircraft Servs.*, 53 B.R. at 810 ("By requiring that upon rejection under § 365 (d)(4), 'the trustee shall immediately surrender such nonresidential property to the lessor,' it is clear Congress intended that rejecting a lease terminates the lease.").

27. See *supra* note 19 (citing cases equating the term "immediately surrender" with termination).

gress intended the differences between rejecting a lease and terminating a lease and drafted the statute with this knowledge, using the terms in a consistent manner. The distinct use of these terms by Congress creates the presumption that it intended them to have different meanings.<sup>28</sup>

Congress evinced its understanding of the limited consequences of rejecting a contract in section 365. Throughout the section, rejection refers to the bankrupt sublessor's decision not to assume a burdensome lease.<sup>29</sup> Congress characterized the rejection of a lease as a breach of the lease,<sup>30</sup> granting the solvent party to the lease a damages claim when the conditions of the lease are not fulfilled.<sup>31</sup> If the lease no longer existed after the rejection (i.e., the lease was terminated), then the solvent party would have no recourse since its rights under the lease presuppose the existence of the lease.<sup>32</sup> Thus, a reading of the statute equating rejection with termination is inconsistent with Congress's grant of a damage claim to the sublessee.<sup>33</sup>

Congress also demonstrated its understanding of termination by specifically authorizing the termination of leases in section 365 in certain situations. Termination, commonly understood as the complete

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28. The overwhelming majority of courts have held that the use of different language by Congress creates a presumption that it intended the terms to have different meanings. *E.g.*, *Barnes v. United States*, 199 F.3d 386, 389 (7th Cir. 1999) (per curiam); *Cabell Huntington Hosp. Inc. v. Shalala*, 101 F.3d 984, 988 (4th Cir. 1996); *Legacy Emanuel Hosp. & Health Ctr. v. Shalala*, 97 F.3d 1261, 1265 (9th Cir. 1996); *United States v. Baridal*, 31 F.3d 216, 218 (4th Cir. 1991); *Wash. Hosp. Ctr. v. Bowen*, 795 F.2d 139, 146 (D.C. Cir. 1986); *In re Sims*, 185 B.R. 853, 857 (Bankr. N.D. Ala. 1995); *Adams v. Hartconn Assocs., Inc.*, (*In re Adams*), 212 B.R. 703, 709 (Bankr. D. Mass. 1997).

29. See *Eastover Bank for Sav. v. Sowahee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1082 (5th Cir. 1994) (finding that Congress defined rejection to encompass a power to breach rather than a power to terminate); Andrew, *supra* note 6, at 883 (“[W]hat the estate’s representative is rejecting is the contract or lease *asset*, which conceivably could carry continuing obligations with it into the estate on an administrative basis. Rejection simply prevents the *estate* from unadvisedly stepping into such liabilities. The liabilities are not repudiated . . . the lease liabilities remain intact after rejection . . .”).

30. 11 U.S.C. § 365(g). (“[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease.”). See *Austin*, 19 F.3d at 1082 (“Rejection is treated as a breach to preserve the rights of the party whose lease with the debtor has been rejected . . .”).

31. 11 U.S.C. § 502(g) (“A claim arising from the rejection, under section 365 of this title . . . of an . . . unexpired lease of the debtor that has not been assumed shall be determined and shall be allowed . . .”).

32. *Austin*, 19 F.3d at 1082 (“Rejection is treated as a breach to preserve the rights of the party whose lease with the debtor has been rejected by providing a prepetition claim; if rejection were deemed a complete, immediate termination, it is not clear what the measure of the creditor’s claim would be.”).

33. *Id.* (recognizing that a rejected lease cannot be terminated because Congress granted the solvent party a damages claim under the rejected lease); 3 COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 365.09[3], at 365-75 (“[I]f rejection of the lease worked a termination, it would be difficult to justify granting the other party to the contract or lease a damage claim for rejection, which the lessor is given by section 502(g).”).



cessation of the lease,<sup>34</sup> is used in sections (h),<sup>35</sup> (i),<sup>36</sup> and (n)<sup>37</sup> of section 365 as an option available to the purchaser of an interest in a timeshare project, the vendee of real property, or the licensee from the debtor of a right to intellectual property if the trustee of the bankrupt party has rejected an executory contract. In each of these statutory provisions, Congress used the terms "rejection" and "termination."<sup>38</sup> For example, section 365(h) reads, "[I]f the rejection by the trustee amounts to such a breach . . . then the lessee under such lease may treat such lease as terminated by the rejection . . ."<sup>39</sup> If Congress did not intend the differences between rejection and termination, then the use of both terms in sections (h), (i), and (n) would be superfluous, for every rejected lease would be terminated automatically. Courts have consistently cautioned against interpreting a statute in a manner that results in a superfluous term.<sup>40</sup>

Furthermore, when specifying the differences between rejection and termination, Congress only allowed the solvent party, here the

34. See 3 COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 365.09[3], at 365-74 (describing the effects of termination) ("If rejection terminates the . . . lease, such termination may have consequences that affect parties other than the debtor and the other party to the . . . lease. For example, termination upon a lessee's rejection may affect the rights of a leasehold mortgagee, a sublessee or an assignee of a lessee's rights. Similarly, termination upon a lessor's rejection may affect the rights of a lessee, sublessee or at times, a leasehold mortgagee.")

35. 11 U.S.C. § 365(h)(1)(A)(i) states, "If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms . . . then the lessee under such lease may treat such lease as terminated by the rejection . . ."

36. 11 U.S.C. § 365(i)(1) reads, "If the trustee rejects an executory contract of the debtor for the sale of real property or for the sale of a timeshare interest under a timeshare plan, under which the purchaser is in possession, such purchaser may treat such contract as terminated . . ."

37. 11 U.S.C. § 365(n)(1)(A) states, "If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect . . . to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms . . ."

38. See *supra* notes 35-37 (quoting statutory language).

39. 11 U.S.C. § 365(h)(1)(A)(i) (1994).

40. Courts have universally held that statutes should not be construed to make surplusage of any provision. *E.g.*, *United States v. Alaska*, 521 U.S. 1, 59 (1997); *Walters v. Metro. Educ. Enters. Inc.*, 519 U.S. 202, 209 (1997); *Gustafson v. Alloyd Co.*, 513 U.S. 561, 574-75 (1995); *United States v. Nordic Vill., Inc.*, 503 U.S. 30, 36 (1992); *Northwest Forest Res. Council v. Glickman*, 82 F.3d 825, 833-34 (9th Cir. 1996); *Stuart v. Carter (In re Larsen)*, 59 F.3d 783, 788 (8th Cir. 1995); *Faraone v. City of East Providence*, 935 F.Supp. 82, 87 (D.R.I. 1996); *Connecticut Dep't of Income Maint. v. Hoffman (In re Willington Convalescent Home, Inc.)*, 72 B.R. 1002, 1007-08 (D. Conn. 1987), *aff'd*, 850 F.2d 50 (2d Cir. 1988), *aff'd*, 492 U.S. 96 (1989); *United Res. Sys., Inc. v. Meinhart (In re Meinhart)*, 211 B.R. 750, 753 (Bankr. D.Colo. 1997); *McCrary v. Barrack (In re Barrack)*, 201 B.R. 985, 989-90 (Bankr. S.D. Cal. 1996); *In re Cason*, 190 B.R. 917, 928 (Bankr. N.D. Ala. 1995), *rev'd*, 217 B.R. 598 (B.A.P. 9th Cir. 1998).

sublessee, the power to terminate a lease.<sup>41</sup> The only places in the Bankruptcy Code where termination of a lease is permitted<sup>42</sup> are situations where “the trustee’s rejection amounts to such a breach as would entitle the [party] to treat such lease . . . as terminated by virtue of its own terms . . . .”<sup>43</sup> Under the statute, although the trustee of the debtor may reject any of the contracts, termination fails to occur unless the solvent party desires that course of action.

Courts that have defined “immediately surrender” to signify the termination of a lease have erred in two significant ways. First, these courts ignore the fact that Congress explicitly authorized the situations in which it wanted to provide one of the parties with the ability to terminate the lease.<sup>44</sup> Since Congress did not provide bankrupt sublessors with the option to terminate a lease under the surrender provision, courts should not interpret the provision to grant sublessors with such a power.<sup>45</sup> Second, Congress gave the power to terminate a lease only to the solvent party, and only in situations where the sublessor’s rejection amounts to a breach of the lease.<sup>46</sup> By giving the bankrupt sublessor the ability to terminate a lease under the surrender provision, these courts have interpreted the statute in a manner that directly contradicts congressional policy.

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41. *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1082 (5th Cir. 1994) (finding that, under the Bankruptcy Code, “the trustee may reject any of these contracts but termination does not occur except at the other party’s option”).

42. The Bankruptcy Code only gives the solvent party the right to terminate the following types of contracts or leases: a timeshare lease under § 365(h)(1), a vendee of real property under § 365(i), or a licensee of the debtor for intellectual property under § 365(n)(1)(A). The solvent party is permitted to terminate the contract or lease in these situations because the bankrupt party’s rejection of the contract or lease amounts to such a breach that termination is in the best interest of the solvent party. *See Austin*, 19 F.3d at 1082-83.

43. *Id.* at 1082-83 (quoting 11 U.S.C. § 365(h)(1) and § 365(n)(1)) (“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.”).

44. *See supra* text accompanying note 42 (citing statutory provisions in which Congress explicitly authorized termination).

45. Courts have generally presumed that, where Congress includes particular language in one section of a statute, but omits it in another section of the same act, Congress acted intentionally and purposely in the disparate inclusion or exclusion. *See Bates v. United States*, 522 U.S. 23, 29-30 (1997); *Field v. Mans*, 516 U.S. 59, 67 (1995); *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647, 654 (B.A.P. 9th Cir. 1998); *Gendron v. United States*, 154 F.3d 672, 674 (7th Cir. 1998) (per curiam, *cert denied*, 526 U.S. 1113 (1999)); *Goncalves v. Reno*, 144 F.3d 110, 131 (1st Cir. 1998), *cert denied*, 526 U.S. 1004 (1999); *Savage v. IRS (In re Savage)*, 218 B.R. 126, 132 (B.A.P. 10th Cir. 1998); *Green Tree Credit Corp. v. Thompson (In re Thompson)*, 217 B.R. 375, 378 (B.A.P. 2d Cir. 1998); *United States v. Gonzalez-Chavez*, 122 F.3d 15, 17 (8th Cir. 1997); *Cramer v. Commissioner*, 64 F.3d 1406, 1412 (9th Cir. 1995); *Haas v. IRS (In re Haas)*, 48 F.3d 1153, 1156-57 (11th Cir. 1995). *But see Halverson v. Slater*, 129 F.3d 180, 186 (D.C. Cir. 1997); *Innovative Health Sys., Inc. v. City of White Plains*, 117 F.3d 37, 47 (2d Cir. 1997).

46. *See supra* note 42 (citing provisions in which Congress authorized the termination of contracts or leases). In all those situations, the party empowered to terminate was the solvent party.

The statutory provisions illustrate that Congress sought to define the rights of both bankrupt sublessors and solvent sublessees in a rejected lease. No part of the Bankruptcy Code suggests, however, that rejection necessarily leads to the complete cessation of the lease, terminating all third-party sublessee interests to the lease.<sup>47</sup> Thus, courts should view the decision to reject a lease only as a decision to breach, rather than as a decision to terminate the lease.<sup>48</sup>

B. *Incorporation of Common Law Definitions of Rejection and Surrender into the Bankruptcy Code*

It is a well-established canon of statutory construction that, when Congress uses terms in a statute that have specific meanings under the common law, Congress is presumed to incorporate those meanings into the statute unless the statute otherwise dictates.<sup>49</sup> Some courts have assumed that Congress did not intend for there to be any differences between termination and rejection and used the terms interchangeably.<sup>50</sup> This Section argues, however, that the absence of specific language indicating Congress's intent to deviate from the common law definitions of rejection and surrender in section 365, along with Congress's consistent use of rejection and termination throughout the statute,<sup>51</sup> indicates that Congress adhered to the common law understanding of the terms.

1. *Common Law Definition of Rejection*

Congress's usage of the term rejection in section 365 accords with the common law understanding of the term. Under the common law of property, the rejection of a lease did not amount to the termination or

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47. See *Austin*, 19 F.3d at 1083 ("Section 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 . . .").

48. See *supra* note 30 (citing statutory provision equating "rejection" with "breach").

49. Courts overwhelmingly have held that where Congress uses terms that have accumulated settled meaning under the common law, a court must infer, unless the statute otherwise dictates, that Congress meant to incorporate the established meaning of the terms. *E.g.*, *Beck v. Prupis*, 120 S. Ct. 1608, 1615 (2000); *United States v. Wells*, 519 U.S. 482, 491 (1997); *Field*, 516 U.S. at 69; *United States v. Shabani*, 513 U.S. 10, 13 (1994); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322-23 (1992); *Cnty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 739 (1989); *A.M. Flint Glass Workers Union v. Anchor Resolution Corp.*, 197 F.3d 76, 80 (3d Cir. 1999); *United States v. Mann*, 161 F.3d 840, 866 n.85 (5th Cir. 1998).

50. See *supra* note 26 (citing cases where courts have assumed that Congress used rejection and termination interchangeably throughout the Bankruptcy Code).

51. See *supra* Section I.A for a discussion on Congress's usage of rejection and termination.

revocation of the lease.<sup>52</sup> Rejection was simply a bankrupt party's decision not to assume a lease because the lease did not represent a favorable or appropriate investment of the estate's resources.<sup>53</sup> Rejection did not affect the substantive rights of the parties to the lease, but merely meant that the bankrupt estate would not become a party to it.<sup>54</sup> Thus, the common law meaning of rejection was simply not to assume the obligations in the lease.

Under the common law, rejecting a lease had the limited effect of a breach or abandonment by the debtor or trustee, rather than the greater effect of a complete termination of the lease.<sup>55</sup> Because the rejection of the lease did not terminate all rights under the lease, the common law left it open to the sublessee to prove that under non-bankruptcy law it was entitled to retain its interest when the debtor lessee breached the lease.<sup>56</sup> Properly used, rejection referred to the bankruptcy trustee's decision to administer or to refuse to administer assets of the bankrupt party, not to the complete termination of the lease.<sup>57</sup>

Congress could have chosen to depart from the common law meaning of rejection. Furthermore, Congress could have departed from the overwhelming majority of state property laws holding that rejection, merely a breach of the lease, did not terminate the lease with respect to third-party sublessees' interests.<sup>58</sup> The statute and leg-

52. Andrew, *supra* note 6, at 921 (describing "rejection" under the common law: "Rejection of the contract by the estate — the estate's decision not to assume — is not a rescission or cancellation of the contract. It is merely the estate's decision not to become obligated on it." (emphasis added) (footnote omitted)).

53. *Id.* at 848-49 ("Simply put, the election to 'assume or reject' is the election to assume or not assume, 'rejection' is the name for the latter alternative.").

54. *Id.* at 848.

55. *Id.*

56. 3 COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 365.09[3][a], at 365-75 ("When the debtor is lessee, recognition that rejection of the lease does not terminate all rights under the lease leaves it open to the sublessee or leasehold mortgagee to prove that under nonbankruptcy law it is entitled to retain its interest even if the debtor-lessee breached the lease.").

57. Andrew, *supra* note 6, at 848 ("[R]ejection is not the revocation or repudiation or cancellation of a contract or lease, nor does it affect contract or lease liabilities.").

58. Congress has equated the rejection of a lease with a breach of the lease. 11 U.S.C. § 365(g) (1994). Most state courts have held that a breach of the lease does not terminate the lease. *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1073,1083 (5th Cir. 1994) ("It is also worth pointing out . . . that breach and termination of leases . . . are not synonymous terms under state law."); *Resolution Trust Corp. v. Cramer*, 6 F.3d 1102, 1108 (5th Cir. 1993) (describing options available to landlords under Texas law); *Blue Barn Assocs. v. Picnic 'N Chicken, Inc. (In re Picnic 'N Chicken, Inc.)*, 58 B.R. 523, 525 (Bankr. S.D. Cal. 1986) ("California law provides that a breach of a lease is not synonymous with the termination of that lease."); *In re Storage Tech. Corp.*, 53 B.R. 471, 474 (Bankr. D. Col. 1985) ("Under the law of the state of California, and virtually every other state, a breach of a real property lease is not synonymous with termination of the lease.") (footnote omitted); *Block Props. Co. v. Am. Nat'l Ins. Co.*, 998 S.W.2d 168, 174-75 (Mo. Ct. App. 1999) ("After reviewing these cases and the language of § 365, we find the logic and reason-

islative history, however, do not convey any evidence of Congress's intent to deviate from the common law definitions and therefore, the presumption must stand that Congress recognized the common law meaning of rejection and intended it as a means for the bankrupt lessee to rid itself of unwanted liabilities, without affecting the interests of third party sublessees to the lease.<sup>59</sup>

## 2. *Protection of Sublessees' Rights by Using the Phrase "Immediately Surrender"*

The incorporation of the phrase "immediately surrender" in the surrender provision provides further support that Congress incorporated the common law definition of rejection. Controversy exists over whether Congress included the phrase "immediately surrender" in the surrender provision to convey that a rejected lease is terminated.<sup>60</sup> Under the common law of property, however, courts universally have held that the rights of sublessees are unaffected by the lessors' surrendering of property.<sup>61</sup> Because the common law preserves a sublessee's rights in a surrendered lease, Congress's usage of the phrase

ing of the latter cases, holding that the rejection of an unexpired lease constitutes a breach of the lease, not a termination, to be more persuasive."); *Wendlandt v. The Sommers Drug Stores Co.*, 551 S.W.2d 488, 490 (Tex. Civ. App. 1977) (holding that there is no implied termination of a lease).

59. See *supra* note 49 (citing cases supporting the judicial presumption that Congress incorporates the common law meaning of terms unless the statute otherwise dictates).

60. See *supra* note 19 (citing cases interpreting the term "immediately surrender" to mean that a rejected lease is terminated).

61. *Goldberg v. Tri-States Theatre Corp.*, 126 F.2d 26, 28 (8th Cir. 1942) ("[I]t is a well settled rule in equity that a surrender by a lessee, where no right of forfeiture has accrued, will not ordinarily be allowed to defeat the interests or equities of third persons in the term."); *Northridge Hosp. Found. v. Pic 'N' Save No. 9, Inc.*, 232 Cal. Rptr. 329, 332 (Ct. App. 1986) ("The general rule is that the rights of a subtenant cannot be affected by a voluntary surrender of the master lease."); *Parris-West Maytag Hotel Corp. v. Cont'l Amusement Co.*, 168 N.W.2d 735, 738 (Iowa 1969) ("The surrender of a primary lease does not affect a sublease. It remains in full force and effect, and the lessor of the primary lease, or his successors, becomes the lessor of said sublease."); *Warnert v. MGM Props.*, 362 N.W.2d 364, 368 (Minn. Ct. App. 1985) ("The surrender of a primary lease does not affect a sublease. It remains in full force and effect, and the lessor of the primary lease, or his successor, becomes the lessor of said sublease." (quoting *Parris-West*, 108 N.W.2d at 738 (internal quotation marks omitted))); *McDonald v. May*, 69 S.W. 1059, 1061 (Mo. Ct. App. 1902) ("[T]heir [subtenants'] rights will not be destroyed or impaired by a surrender of the main lease . . ."); *Shaw v. Creedon*, 32 A.2d 721, 723 (N.J. Ch. 1943) ("[T]he sublessee acquires an interest in the land which cannot be defeated by any act or omission of the sub-lessor that does not derogate from the rights of the original lessor; therefore, after sub-letting, the original lessee cannot affect the interest of the sublessee by a surrender to the original lessor."); *Baum v. Tazwell*, 61 A.2d 12, 15 (N.J. Essex County Ct. 1948) ("The surrender of a lease by a lessee to his lessor, after a sublease, will not be permitted to operate as to defeat the estate of the sublessee." (quoting 32 AM. JUR. *Landlord and Tenant* § 425, at 345 (1941) (internal quotation marks omitted))); see also JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* 471 (4th ed. 1998) ("[I]f the original tenant merely gives up the primary lease voluntarily — 'surrenders' it, the rights of possession of sublessees . . . remain intact." (citation omitted)).

“immediately surrender” is consistent with its intention to preserve sublessees’ rights in a rejected lease.

Under the common law, the surrender of a primary lease does not affect a sublease.<sup>62</sup> The lease remains in effect, and the lessor of the primary lease becomes the lessor of the sublease, thereby removing the bankrupt party from the relationship.<sup>63</sup> The surrender does not affect the rights of sublessees, not parties to the original lease, that are created in a sublease before the surrender.<sup>64</sup>

Thus, a common law interpretation of the phrase “immediately surrender” would not terminate the rights of a sublessee in a rejected lease. Rather, the common law states that a surrender of a lease by the bankrupt lessee does not diminish, in any way, the rights of the sublessee to the property.<sup>65</sup> This interpretation, which preserves the rights of sublessees, also accords with the common law understanding that the rejection of a lease ends only the bankrupt party’s responsibilities in the lease.<sup>66</sup> Because Congress’s usage of the phrase “immediately surrender” in section 365 is consistent with the common law understanding of the term, courts should not deviate from such an interpretation to hold that the rights of a subtenant are extinguished once the property is “immediately surrendered.”<sup>67</sup>

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62. *Northridge Hosp. Found.*, 232 Cal. Rptr. at 332; *Warnert*, 362 N.W.2d at 368; *Parris-West*, 168 N.W.2d at 738; *Baum*, 61 A.2d at 14-15; *Shaw*, 32 A.2d at 723; *Goldberg*, 126 F.2d at 28; *McDonald*, 69 S.W. at 1061; see also *DUKEMINIER & KRIER*, *supra* note 61, at 470.

63. *Parris-West*, 168 N.W.2d at 738. Typically, under the common law, the surrendering of a lease when there were no subtenants in the lease resulted in the termination of the lease. Usually, surrendering property connoted a tenant’s offer to end a tenancy. If the surrender was effectuated, then the lessee’s liability for future rent was extinguished since the lease no longer existed. As described by the Supreme Court of Iowa, “A surrender, as the term is used in the law of landlord and tenant, is the yielding up of the estate to the landlord so that the leasehold interest becomes extinct by mutual agreement among the parties.” *Id.* at 738.

64. The rationale behind this rule is that the “subtenant is entitled to protection from acts by sublessors that destroy or impair rights the sublessors themselves transferred in a sublease agreement.” *Warnert*, 362 N.W.2d at 368.

65. *Northridge Hosp. Found.*, 232 Cal. Rptr. at 332 (“The general rule is that the rights of a subtenant cannot be affected by a voluntary surrender of the master lease.”); *Parris-West*, 168 N.W.2d at 739 (“The rights of persons not parties to the original lease which have accrued before the surrender are not in any way affected thereby. A surrender by the lessee does not affect an assignee of the lease, or a sublessee, or anyone holding under the lessee . . . .”) (quoting 51 C.J.S. *Landlord and Tenant* § 1291, at 412); see also *supra* note 62 (citing other cases supporting this proposition).

66. Under the common law, the rejection of a lease does not terminate the lease. It merely ends the bankrupt party’s obligations under the lease. The retention of subtenant rights in a surrendered lease accords with this view of rejection because both views emphasize that a rejected lease is not terminated. Third-party rights are preserved in both a rejected lease and a surrendered lease. See *supra* Section I.B.1 for a discussion of the common law definition of rejection.

67. See *supra* note 49 (citing cases supporting the proposition that Congress incorporates the common law definitions of terms unless otherwise noted).

In summary, because Congress did not evince an intent to deviate from the common law understanding of rejection and surrender, the presumption stands that Congress incorporated the common law definitions into the statute.<sup>68</sup> This interpretation is furthered by the fact that Congress used rejection and termination differently and distinctly throughout the Bankruptcy Code<sup>69</sup> and incorporated the phrase “immediately surrender” into the surrender provision, which, under the common law, preserves the rights of subtenants in a lease deemed rejected by a bankrupt sublessor.

## II. PROVIDING SUBLESSEES WITH THE OPPORTUNITY TO ASSERT THEIR PROPERTY INTERESTS

Since, as Part I established, rejecting a lease under the surrender provision does not terminate third-party sublessee interests to the lease, a sublessee retains its rights in the lease through the applicable nonbankruptcy law provision.<sup>70</sup> Congress included the applicable nonbankruptcy law provision to provide nonbankrupt lessees and sublessees with the opportunity to assert their property interests in a commercial lease.<sup>71</sup> The provision codifies a balance between the rights of a bankrupt lessor and the rights of its tenants.<sup>72</sup> The preservation of a sublessee’s rights under this section also comports with Congress’s desire to allow bankrupt parties to rid themselves of unwanted liabilities and Congress’s desire to encourage the efficient use of commercial property. Section II.A argues that Congress intended that the applicable nonbankruptcy law provision preserve the rights of sublessees in a lease when the original lessee files for bankruptcy. Section II.B asserts

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68. See *supra* note 49.

69. See *supra* Section I.A for a discussion of Congress’s distinct usage of rejection and termination.

70. 11 U.S.C. § 365(h)(1)(A)(ii) states:

If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease . . . that are in or appurtenant to the real property for the balance of the term of such lease . . . to the extent that such rights are enforceable under applicable nonbankruptcy law.

71. See *In re Aube*, 158 B.R. 567, 568 (Bankr. D.R.I. 1993) (“In construing this section, courts have held that ‘the statute was designed to preserve a lessee’s possessory interests in its leasehold . . .’” (quoting *In re Lee Rd. Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993))); *Lee Rd.*, 155 B.R. at 60 (Bankr. E.D.N.Y. 1993) (“[C]ourts construing § 365(h) have concluded that the statute was designed to preserve a lessee’s possessory interests in its leasehold . . .”); *Wood Comm. Fund I, Inc. (In re Wood Comm. Fund I, Inc.)*, 116 B.R. 817, 818 (Bankr. N.D. Okla. 1990) (“The debtor cannot deprive the lessee of its possessory property interest in the leased premises.”); *LHD Realty Corp. v. Metro. Life Ins. Co. (In re LHD Realty Corp.)*, 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982) (“It is clear that Congress’ intent was . . . protecting the property rights of the lessee.”).

72. *Lee Rd.*, 155 B.R. at 60 (“In enacting § 365(h), Congress sought to ‘codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants . . .’” (quoting *In re Stable Mews Assocs.*, 41 B.R. 594, 599 (Bankr. S.D.N.Y. 1984))).

that the limited rights the sublessee retains in a rejected lease accord with the notion of allowing a bankrupt sublessor to rid itself of unwanted liabilities. Finally, Section II.C argues that the interpretation of the applicable nonbankruptcy law provision giving sublessees the right to maintain their interest in a rejected lease accomplishes the main goal of the surrender provision, which is to prevent commercial property from being unused.

### A. *The Rights of Sublessees*

The applicable nonbankruptcy law provision defines the rights of sublessees in a rejected lease.<sup>73</sup> The provision states that, if the term of the lease has commenced and the debtor rejects the lease, the lessee may “retain its rights under such lease . . . to the extent that such rights are enforceable under applicable nonbankruptcy law.”<sup>74</sup> This section explicitly gives a party whose lease has been disrupted by the bankruptcy of its lessor the opportunity to protect its rights by asserting applicable nonbankruptcy law.

The legislative history behind the applicable nonbankruptcy law provision evinces Congress’s intent to guarantee sublessees the right to retain their leasehold interests. In enacting the section, Congress sought to balance the rights of a bankrupt party with the rights of its tenants by preserving certain expectations of parties to real estate transactions.<sup>75</sup> Congress concluded that rejection of a lease by a bankrupt sublessor should not deprive a sublessee of its estate for the term for which it bargained.<sup>76</sup> To further this goal, Congress gave sublessees the right to remain in possession of the property.<sup>77</sup> Moreover, the Sen-

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73. 11 U.S.C. § 365(h)(1)(A)(ii) (1994).

74. § 365(h)(1)(A)(ii) states that:

[I]f the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease . . . and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

75. *See Lee Rd.*, 155 B.R. at 60 (“Congress sought to ‘codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants’ by preserving certain expectations of parties to real estate transactions.” (quoting *Stable Mews*, 41 B.R. at 594)); S. REP. NO. 95-989, at 60 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5846 (“If the lessee remains in possession, he may offset the rent reserved under the lease . . . but does not have any affirmative rights against the estate for any damages after the rejection that result from the rejection.”); H.R. REP. NO. 95-595, at 349-50 (1977), *reprinted in* 1998 U.S.C.C.A.N. 5963, 6305-06.

76. H.R. REP. NO. 95-595, at 349-50, *reprinted in* 1978 U.S.C.C.A.D. at 6305-06; S. REP. NO. 95-989, at 60, *reprinted in* 1978 U.S.C.C.A.N. at 5846 (“[T]he tenant will not be deprived of his estate for the term which he bargained.”).

77. The Senate Report reads, “The subsection permits the lessee to remain in possession of the lease property . . . .” S. REP. NO. 95-989, at 60, *reprinted in* 1978 U.S.C.C.A.N. at 5846; *see also supra* note 71 (citing cases construing Congress’s intent).



ate Report to the Bankruptcy Code specifically emphasized that this right to possession applies to both lessees and sublessees.<sup>78</sup>

Congress's identification of the sublessor as a possible bankrupt party<sup>79</sup> in the legislative history of the applicable nonbankruptcy law provision shows that it anticipated that the bankruptcy would affect sublessees.<sup>80</sup> The inclusion of sublessors in the legislative history also shows that Congress did not intend the bankruptcy of a sublessor to disrupt the interests of sublessees. Terminating the rights of sublessees upon rejection of the primary lease would not honor Congress's intent. Such a holding would undoubtedly disrupt the interests of sublessees, who expect their rights in the property to extend until the completion of the sublease. Thus, the plain language in the statute and the legislative history show that Congress intended for nonbankruptcy law to govern the rights of sublessees in a rejected lease.

### B. *Sublessees' Limited Rights in a Rejected Lease*

The applicable nonbankruptcy law provision limits the rights that a sublessee possesses in a rejected lease to enable the bankrupt sublessor to rid itself of unwanted liabilities.<sup>81</sup> As stated above, the surrender provision gives a bankrupt party the ability to reject a commercial lease and thereby end its obligations under the lease.<sup>82</sup> At first glance, the applicable nonbankruptcy law provision, which gives sublessees the opportunity to preserve their property interests, appears to force the bankrupt sublessor to fulfill its commitments set forth in the lease. Permitting sublessees to remain on the leased premises makes the bankrupt sublessor deal with one of its unwanted obligations, and thus runs contrary to a bankrupt party's objectives in rejecting a lease.

While preserving the sublessee's rights in the sublease, the applicable nonbankruptcy law provision balances the sublessee's possessory interest with the bankrupt sublessor's desire to escape the burden of

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78. The Senate Report states, "Subsection (h) protects real property lessees of the debtor if the trustee rejects an unexpired lease under which the debtor is the lessor (or sublessor)." S. REP. NO. 95-989, at 60, *reprinted in* 1978 U.S.C.C.A.N. at 5846.

79. *See also supra* note 77 (citing Senate's inclusion of sublessors as an example of a potential debtor).

80. Although Congress did not explicitly mention sublessees in the statutory history, its reference to sublessors and its strong language protecting the possessory rights of lessees strongly suggests that it intended § 365(h)(1)(A)(ii) to dictate the rights of sublessees.

81. *See In re Aube*, 158 B.R. 567, 568-69 (D.R.I. 1993) (noting that courts have held that the statute allows a "debtor-lessor to escape the burden of providing continuing services to a tenant" (quoting *In re Lee Rd. Partners, Ltd.*, 155 B.R. 55, 60) (Bankr. E.D.N.Y. 1993) (internal quotation omitted)); *In re Arden & Howe Assocs., Ltd.*, 152 B.R. 971, 974 (Bankr. E.D. Cal. 1993) (stating that § 365(h) "does not require the landlord to perform its obligations under the lease.").

82. 11 U.S.C. § 365(d)(4) (1994).

the sublease.<sup>83</sup> Specifically, Congress, when enacting the provision, protected the interests of the bankrupt sublessor to rid itself of unwanted obligations by limiting its responsibilities to sublessees.<sup>84</sup> These limitations further illustrate that Congress intended to balance the interests of sublessees and bankrupt sublessors, which is consistent with Congress's usage of the term "rejection" in section 365 of the Bankruptcy Code.<sup>85</sup>

Following rejection, the applicable nonbankruptcy law provision entitles the sublessee to assert nonbankruptcy law to retain the three "essential elements of a lease — possession, term and rent."<sup>86</sup> The sublessee's leasehold estate cannot be diminished, changed, or modified due to a bankruptcy court's intervention.<sup>87</sup>

To maintain a balance between the rights of a sublessee and the rights of the bankrupt sublessor, the applicable nonbankruptcy law provision limits a sublessee's rights in the property. Specifically, the sublessee can only attempt to preserve its right of possession for the remainder of the term set forth in the lease for the specified rent.<sup>88</sup> The section does not require the bankrupt sublessor to perform its obligations under the lease.<sup>89</sup> For example, the "rejection of the lease results in the cancellation of covenants requiring performance in the future (e.g., the providing of utilities, repair and maintenance, janitorial

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83. See *supra* note 75 (citing sources recognizing Congress's intent to balance the interests of both the debtor and the nondebtor).

84. *Upland/Euclid, Ltd. v. Grace Rest. Co. (In re Upland/Euclid, Ltd.)*, 56 B.R. 250, 252 (B.A.P. 9th Cir. 1985) (holding that a debtor/lessor cannot deprive the lessee of its possessory interest in the lease but "may reject a lease, provide no more services, and stop the flow of funds" to the property).

85. The term "rejection" connotes Congress's desire to balance the interests of the bankrupt and solvent parties. Under the common law, rejection allows a bankrupt party to rid itself of unwanted obligations, while preserving the rights of a subtenant under the lease. See *supra* Section I.B.1 (discussing the limited concept of rejection under the common law).

86. *Arden & Howe*, 152 B.R. at 975 (stating that a landlord's obligations in a rejected lease are limited); see also *Lee Rd.*, 155 B.R. at 60-61 (holding that the scope of the Bankruptcy Code provision allowing lessee to remain in "possession" of leasehold following trustee's rejection of unexpired lease of real property is not limited to lessees in physical possession of premises).

87. See *Solon Automated Servs., Inc. v. Wood Comm. Fund I, Inc. (In re Wood Comm. Fund I, Inc.)*, 116 B.R. 817, 818 (Bankr. N.D. Okla. 1990) (holding that debtor's/lessor's rejection of unexpired lease in no way diminished, changed, or modified lessee's leasehold estate).

88. See 11 U.S.C. § 365(h)(1)(A)(ii) (1994); see also *In re Harborview Dev. 1986 Ltd. P'ship*, 152 B.R. 897, 901 (D. S.C. 1993); *Arden & Howe*, 152 B.R. at 974; *In re Carlton Rest.*, 151 B.R. 353, 357 (Bankr. E.D. Pa. 1993); Bleich et al., *supra* note 7 (discussing the rights that a lessee has in a rejected lease).

89. *Arden & Howe*, 152 B.R. at 974 (Section 365(h)(2) "protects the lessee from rent increases or other exactions by the landlord except as provided in the lease. But it does not require the landlord to perform its obligations under the lease").

services)” by the bankrupt sublessor.<sup>90</sup> The sublessee also does not have the power to assign the lease to a third party.<sup>91</sup> Furthermore, a sublessee’s rights against the sublessor for damages occurring after rejection caused by the nonperformance of any of the bankrupt party’s obligations under the lease are restricted to an offset against the rent reserved under the lease.<sup>92</sup> The sublessee has no other rights against the sublessor for damages resulting from rejection.<sup>93</sup> The sublessor may reject the lease, provide no more services, and, consequently, stop the flow of incoming funds that benefit the sublessee.<sup>94</sup> The only thing it cannot do is deprive the sublessee of its property interest in the leased premises.<sup>95</sup>

Congress limited the remedies available to the sublessee to maintain a balance between the interests of the bankrupt sublessor and the rights of the sublessee.<sup>96</sup> While the Code provides sublessees with a limited number of rights, it does not purport to saddle the sublessor with an unwanted obligation for any period beyond that required to prevent the dispossession of the sublessee.<sup>97</sup> This balance is consistent with the notion that by rejecting a lease, the bankrupt sublessor seeks

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90. *LHD Realty Corp. v. Metro. Life Ins. Co. (In re LHD Realty Corp.)*, 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982).

91. *Carlton*, 151 B.R. at 356-57 (holding that a tenant who remained in possession of leased premises after bankrupt landlord had rejected the lease had only a personal right to possession and therefore could not assign the lease).

92. 11 U.S.C. § 365(h)(1)(B).

93. § 365(h)(1)(B) states:

If the lessee retains its rights under subparagraph (A)(ii), the 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 for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

94. The only thing the sublessor must do is allow the sublessee to remain in the property. The sublessor does not have to provide any help to the sublessee to maintain the property. *Solon Automated Servs., Inc. v. Wood Comm Fund I, Inc. (In re Wood Comm. Fund I, Inc.)*, 116 B.R. 817, 818 (Bankr. N.D. Okla. 1990) (“[R]ejection of the lease results merely in the cancellation of covenants requiring performance in the future . . . by the debtor; rejection does not terminate the lease completely so as to divest the lessee of his estate in the property.” (quoting *LHD Realty*, 20 B.R. at 719 (quoting 2 COLLIER ON BANKRUPTCY, *supra* note 15, ¶ 365.09, at 354-43 (15th ed. 1979)) (internal quotation marks omitted) (alternation in the original)).

95. *Id.*

96. See *In re Stable Mews Assocs., Inc.*, 41 B.R. 594, 597 (Bankr. S.D.N.Y. 1984); *LHD Realty*, 20 B.R. at 719; see also S. REP. NO. 95-989, at 60 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5846; H.R. REP. NO. 95-595, at 349 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6306-06.

97. See *Carlton* 151 B.R. at 356 (“That Code section . . . allows only a lessee the choice to remain in possession under the terms of the lease. It does not provide that the lease continues, but merely accords a lessee the choice to remain in a rented premise under the terms of the lease.”).

to rid itself of the burdensome obligations set forth in the lease. This framework also is consistent with the idea that Congress used the word "rejection" in section 365 to preserve the rights of sublessees in a lease.

### C. *Facilitating the Efficient Use of Commercial Property*

Providing sublessees the opportunity to preserve their interests in a rejected lease assures the use of commercial property, which is one of the main purposes behind the surrender provision.<sup>98</sup> Courts holding that a sublessee has no rights in a rejected lease have interpreted the provision to represent a federal policy to ensure that a bankruptcy does not result in the long-term vacancy of commercial property.<sup>99</sup> The preservation of a sublessee's interest in a rejected lease, however, accords with this intention because the commercial property will not be left vacant when the surrender provision is invoked.

The surrender provision states that a lease is rejected automatically if the "trustee does not assume or reject an unexpired lease of nonresidential real property . . . within 60 days."<sup>100</sup> After the rejection, the trustee needs to "immediately surrender" the lease to the lessor.<sup>101</sup> Congress enacted this section to remedy the long-term vacancy or partial operation of space by a bankrupt tenant.<sup>102</sup> As described by Senator Orrin Hatch,

Because of the unprecedented number of bankruptcy cases and the consequent delays in the bankruptcy courts, tenant space has been vacated for extended periods of time before the bankruptcy court forced the trustee to decide whether to assume or reject the lease . . . . The bill would lessen the problems caused by extended vacancies and partial operation of tenant space by requiring that the trustee decide whether to assume or reject nonresidential real property within 60 days after [the party files for bankruptcy].<sup>103</sup>

Thus, Congress passed the surrender provision to ensure the use of commercial property.

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98. See *Eastover Bank for Sav. v. Sowahee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1081 (5th Cir. 1994) (describing how § 365(d)(4) was enacted to lessen the vacancy period for lessors to debtors by requiring a firm 60-day assume/reject decision).

99. See, e.g. *In re Bernard*, 69 B.R. 13, 14 (Bankr. D. Haw.) ("Under Section 365(d)(4), this immediate surrender of the premises upon rejection of the lease was to enable the lessors to once again rent the premises and to earn income from the demised premises."); see also *supra* note 24 (citing courts finding Congress's desire to ensure that commercial property is not left vacant).

100. 11 U.S.C. § 365(d)(4) (1994)

101. § 365(d)(4).

102. 103 CONG. REC. 20,088 (1984) (statement of Sen. Hatch), reprinted in 1984 U.S.C.C.A.N. 598.

103. *Id.*, reprinted in 1984 U.S.C.C.A.N. 598-99.

Although the legislative history of the surrender provision does not refer specifically to sublessees, retaining sublessees avoids the problems that the statute aimed to solve. The sublessee occupies the leased premise when the bankrupt sublessor files for bankruptcy and rejects the lease. In most situations, the disruption caused by rejecting a lease will not even be apparent because the space will continue to be rented even after the rejection.<sup>104</sup> Preserving the rights of the sublessee, therefore, will ensure the occupation of the leased premises.<sup>105</sup>

To summarize, the legislative history behind the applicable non-bankruptcy law provision suggests that Congress intended that the provision protect the rights of sublessees when their bankrupt sublessors reject a lease pursuant to the surrender provision. The limited rights afforded to the sublessee under applicable nonbankruptcy law provision are consistent with the idea that a bankrupt sublessor can rid itself of its burdensome obligations by rejecting a lease. This interpretation is also consistent with the primary purpose behind the surrender provision, which is to ensure the use of commercial property.

### III. AUTOMATIC FORFEITURE POLICY INCREASES TRANSACTION COSTS

One of the fundamental purposes of section 365, particularly the surrender provision, is to encourage the efficient use of property.<sup>106</sup> An interpretation of the surrender provision justifying the automatic for-

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104. The Fifth Circuit adopted a similar argument to preserve the rights of a solvent leasehold mortgagee in a rejected lease. See *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1081 n.6 (5th Cir. 1994). The *Eastover* court stated:

It is true that § 365(d)(4) is part of the 1984 'shopping center' amendments to the Bankruptcy Code and that it sought to lessen the vacancy period for lessors to debtors in such cases by requiring a firm 60-day assume/reject decision. This goal of protecting lessors does not conflict with the protection of leasehold mortgagee's rights, however, because a mortgagee would have to comply with the lease in order to take it over from the debtor. The lessor would have to be satisfied.

*Id.* (internal citation omitted).

105. As the next Section will illustrate, allowing the landlord the choice to either continue the sublessor's lease or terminate it and release the property would not lead to the efficient use of the property. Such a policy would increase the transaction costs associated with entering into subleases because of the uncertainty in property rights that would be created if the sublessor filed for bankruptcy. For example, in a regime that provided landlords with the above option, a sublessee would have to perform extensive background checks of the sublessor as well as enter into a second contract with the landlord to ensure that its operations will be unaffected by the bankruptcy. These unnecessary efforts would be avoided by preserving the sublessee's rights in a rejected lease.

106. See 130 CONG. REC. 20,088 (1984), reprinted in 1984 U.S.C.C.A.N. 598 (describing that one of the problems that the bill was seeking to remedy was the misuse of commercial property) ("The first problem which this bill would remedy is the long-term vacancy or partial operation of space by a bankrupt tenant."); H.R. REP. NO. 95-595, at 349 (1977), reprinted in 1978 U.S.C.C.A. 5963, 6305-06; see also *supra* Section II.C (discussing the purposes behind the enactment of § 365(d)(4)).

feiture of the sublessee's right to occupy the leased premises would lead to the inefficient use of property by increasing the transaction costs of entering into subleases.<sup>107</sup>

A policy of automatic forfeiture would increase the transaction costs of entering into subleases because sublessees would have to perform extensive credit checks of their sublessors before entering into such agreements to avoid entering into subleases with parties likely to go bankrupt.<sup>108</sup> The costs of these credit checks would depend on the availability of information. After performing these credit checks, parties who anticipate that their sublessor may file for bankruptcy will be deterred from entering into such agreements. If the sublessor files for bankruptcy, then the sublessees' rights would be extinguished automatically, as a matter of law.

A simple example illustrates the detrimental consequences that would result from a policy of automatic forfeiture following rejection. Assume that Company *X* enters into a fifteen-year lease with Company *Y*, where Company *X* is the lessor and Company *Y* is the lessee. During the fourth year of the lease, Company *Y* decides that it wants to relocate its business to another state. To balance its desire to relocate with its obligations under the lease, Company *Y* begins to solicit potential sublessees for the property.

Company *Z* expresses interest in entering into a sublease for the commercial property. Company *Z* knows that if Company *Y* files for bankruptcy during the course of its subtenancy, its rights to the property will be extinguished, as a matter of law, without Company *Z* having the ability to assert its interest in the property. Therefore, before entering into the sublease, Company *Z* will perform an extensive investigation into the credit history of Company *Y*. The investigation will force Company *Z* to expend unnecessary financial resources to assess Company *Y*'s likelihood of filing for bankruptcy.

In short, the forfeiture policy increases the transaction costs of entering into subleases because potential sublessees would have to perform extensive credit checks of the sublessor's financial history. Al-

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107. See BARZEL, *supra* note 18, at 4-5. Barzel explains why the presence of these costs is inefficient. He argues that, when transaction costs are high, rights are never complete because people will not find it worthwhile to gain the entire potential of their assets. The reason is that, relative to their value, some of the attributes of the assets, in this case, the sublease, are costly to measure. Consequently, the attributes of the assets are not known to the fullest extent to prospective owners. Thus, the transfer of these assets entails costs resulting from the party's (the sublessee's) attempts to determine the valued attributes of these assets and from its attempt to capture those attributes that, because of the transaction costs, are poorly delineated. Barzel concludes, "Exchanges that otherwise would be attractive may be forsaken because of such exchange costs." *Id.* at 5.

108. Potential sublessees may already perform background investigations of sublessors. In a regime where rejection equals termination, however, these investigations would have to be unnecessarily comprehensive because of the draconian ramifications of an incorrect assessment of the sublessor's chances of filing for bankruptcy.

though generally it is good public policy to encourage parties to perform investigations into the financial background of other parties in the contract, a policy of automatic forfeiture imposes draconian penalties for performing incomplete investigations.<sup>109</sup> In the above example, if Company Z incorrectly assumes that Company Y has no chance of filing for bankruptcy, and Company Y subsequently files for bankruptcy, then Company Z loses its rights in the property as a matter of law.<sup>110</sup>

The harsh consequence of performing incomplete credit investigations, along with the relatively high number of commercial entities that file for bankruptcy each year,<sup>111</sup> significantly increases the transaction costs of entering into commercial subleases.<sup>112</sup> This unintended policy consequence runs contrary to the objectives of section 365, which through the surrender provision seeks to encourage the most efficient use of property.<sup>113</sup>

An interpretation of the surrender provision that protects the sublessee's rights in a rejected lease eliminates these unnecessary transaction costs. Sublessees would not have to perform extensive credit investigations to assess the likelihood of the sublessor filing for bankruptcy because their property interests would not hinge on the sublessor's financial status. For the same reason, sublessees would not have to base their decision to enter into subleases on sublessors' chances of bankruptcy. The elimination of these transaction costs, which unnecessarily hinder the completion of sublease agreements, would honor Congress's desire to facilitate the efficient exchange of property.

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109. See *LHD Realty*, 20 B.R. at 720 ("It would be dangerous precedent . . . to be in the business of reforming (or terminating) contracts and leases because of changing economic circumstances. Depending on the peaks and valleys of our economic circumstances, the court would be considering in every case whether a contract was equitable or inequitable." (quoting *In re Pin Oaks Apartments*, 7 B.R. 364, 372 (Bankr. S.D. Tex. 1980) (internal quotation marks omitted) (alternation in original))).

110. See *supra* note 15 and accompanying text (supporting proposition that lessee has no rights in a terminated lease).

111. In 1998, over 44,000 businesses filed for bankruptcy in the United States. ABI World, Filing Statistics, <http://www.abiworld.org/stats/newstatsfront.html> (2001) (last visited Feb. 17, 2001).

112. This section focuses on only one particular transaction cost, performing credit investigations of potential sublessors, created by a system equating rejection and termination. This system would also create other transaction costs, including costs of associated with the disruption of the sublessee's business. These costs include a potential loss of customers, finding another piece of commercial property, and moving expenses associated with the relocation of the business.

113. See *supra* text accompanying note 106 (discussing purposes behind 11 U.S.C. § 365(d)(4)).

## CONCLUSION

The above analysis indicates that sublessees in a commercial lease should be able to preserve their interests in a rejected lease by asserting applicable nonbankruptcy law. In drafting the Bankruptcy Code, Congress adopted the distinct, common law definitions of rejection, termination, and surrender. Congress did this in order to balance the bankrupt sublessor's interest in ridding itself of unwanted obligations with the sublessee's desire to continue its occupation of the leased premises. Congress maintained this balance by permitting sublessees to remain in the leased property after the rejection of a lease, while limiting their rights in the property.

This interpretation of the statute, while preserving the rights of the sublessee, also facilitates the efficient use of property by reducing the high transaction costs associated with sublessees' performing costly investigations to assess the sublessor's chances of bankruptcy. This interpretation also allows sublessees to enter into subleases confidently without the fear of the bankruptcy of sublessors disrupting their business operations.