



## **AMERICAN ASSOCIATION OF PORT AUTHORITIES**

### **Port Administration and Legal Issues Seminar: “Addressing Port Development Challenges”**

**(Outline of Bankruptcy-Related Issues)**

**February 12, 2007  
Marriot Biscayne Bay Hotel  
Miami, Florida**

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## I. OVERVIEW OF BANKRUPTCY

Modern bankruptcy law is designed to provide relief to financially troubled entities and insure fair and equitable treatment for creditors and other parties holding claims or interests against those entities.

The bankruptcy laws are established pursuant to federal statute. Thus, individual states do not have authority to enact their own bankruptcy laws or statutes. The federal bankruptcy statute currently in effect is known as the “Bankruptcy Code.” The Bankruptcy Code was enacted in 1978 and has been amended by Congress several times since its enactment, most recently by the so-called Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Amendments”).

To facilitate the application and administration of the bankruptcy laws, Congress has created a system of federal bankruptcy courts. These courts are located in different federal districts throughout the United States. Typically, there are several bankruptcy judges located within a single district. Each bankruptcy proceeding commenced within a particular district will ordinarily be assigned to one of the bankruptcy judges sitting in that district. That judge will then generally be responsible for presiding over all matters arising in that bankruptcy case.

As more fully described below, there are different types of bankruptcy proceedings that a debtor may file. The different types of proceedings are set forth as distinct “Chapters” of the Bankruptcy Code. Specifically, these Chapters include: (a) Chapter 7 (Liquidation); (b) Chapter 9 (Adjustment of Debts of a Municipality); (c) Chapter 11 (Reorganization); (d) Chapter 12 (Adjustment of Debts of a Family Farmer With Regular Annual Income); and (e) Chapter 13 (Adjustment of Debts of an Individual With Regular Income).

Ordinarily, commercial enterprises (as opposed to individuals) will seek relief either under Chapter 7 or Chapter 11 of the Bankruptcy Code. Municipal entities such as public port authorities are not eligible to file for relief under either Chapter 7 or Chapter 11. Under certain circumstances, however, a municipality such as a public port authority may be eligible to seek relief under Chapter 9 of the Bankruptcy Code. *See generally*, F. Morrison, The Insolvency of Public Entities in the United States, 50 Am. J. Com. L. 567, 569 (2002)(describing the potential eligibility of public port authorities to seek relief under Chapter 9 of the Bankruptcy Code).

Among other eligibility requirements, a municipality wishing to file for Chapter 9 bankruptcy must be “specifically authorized” by state law to do so. Ordinarily, this means that there must be a state statute that expressly grants the municipality and/or port authority the express right to seek protection under the federal bankruptcy laws.

### *A. Chapter 7 Proceedings*

Chapter 7 is designed as a liquidation proceeding and is available to individuals, corporations, partnerships and other business and non-business entities.

Upon the commencement of a Chapter 7 case, essentially all of the debtor's property interests become part of a "bankruptcy estate." A trustee is then appointed who is charged with the responsibility of liquidating the assets of the bankruptcy estate and distributing the resulting proceeds to the debtor's creditors in accordance with the priority scheme set forth in the Bankruptcy Code. Typically, if the debtor that has filed for Chapter 7 relief is a business entity (as opposed to an individual), it will simply cease operating following the commencement of the bankruptcy proceeding (that is, if it has not already done so prior to the bankruptcy filing).

### *B. Chapter 11 Proceedings*

Chapter 11 is designed to enable financially troubled companies to restructure their outstanding debts and liabilities so that they can emerge out of bankruptcy and continue operating as more financially viable businesses. Unlike in a Chapter 7 proceeding, a trustee is not automatically appointed in a Chapter 11 proceeding. Instead, the debtor is allowed to remain in control of its assets and continue operating its business. Under certain circumstances, however, a bankruptcy court may appoint a trustee to take control over a Chapter 11 debtor's assets and business operations. This might occur, for instance, if it were shown that the debtor's management were incompetent or engaging in some type of misconduct.

The debtor's primary goal in a Chapter 11 proceeding is to develop a "Chapter 11 plan of reorganization." The plan of reorganization sets forth the debtor's proposal for how it will restructure its existing debts so that it can successfully reorganize and emerge out of bankruptcy.

Under the requirements imposed under the Bankruptcy Code, a plan of reorganization must divide the claims of the debtor's creditors into different "classes" and then propose how each class of claims is to be treated. If the treatment proposed for a particular class modifies or alters the rights and interests of those creditors holding claims in that class, the class is deemed to be "impaired."

In order to become binding on the debtor's creditors, a plan of reorganization must be "confirmed" by the bankruptcy court. A plan of reorganization cannot be confirmed unless the bankruptcy court determines that the plan complies with a series of requirements set forth in the Bankruptcy Code. Before this determination is made, however, copies of the plan must first be distributed to all creditors holding claims in any class that is impaired under the plan. These creditors then have the right to vote either to "accept" or "reject" the plan.

Generally, a plan of reorganization will not be confirmed unless creditors holding a sufficient number and dollar amount of claims in each impaired class vote to accept the plan. By invoking the so-called “cramdown” provisions of the Bankruptcy Code, however, a debtor can obtain confirmation of a plan notwithstanding the fact that one or more classes of creditors has voted to reject the plan. To obtain confirmation under the cramdown provisions, a debtor must demonstrate that the treatment it has proposed with respect to each rejecting class of claims is “fair and equitable” and that the rejecting class is not being unfairly discriminated against under the plan.

The confirmation of a plan of reorganization discharges the debtor’s existing debts and liabilities and effectively replaces them with the commitments and obligations set forth in the debtor’s plan.

Often, a company that files for protection under Chapter 11 will not be able to obtain confirmation of a plan of reorganization. In such instances, the debtor may propose a “plan of liquidation” which provides for the liquidation of its remaining assets and the distribution of the resulting proceeds to its creditors. As in the case of a plan of reorganization, a plan of liquidation must be confirmed by the court before it becomes binding on creditors and parties-in-interest. As an alternative to proposing a plan of liquidation, a Chapter 11 debtor that is unable to successfully reorganize may simply convert its Chapter 11 proceeding to a Chapter 7 proceeding.

### *C. Chapter 9 Proceedings*

Chapter 9 of the Bankruptcy Code sets forth a debt relief proceeding that is only available to governmental units such as public port authorities and other types of “municipalities.” Much like in a Chapter 11 proceeding, the municipal debtor’s principal objective in a Chapter 9 proceeding is to obtain confirmation of a debt adjustment plan.

During the Chapter 9 proceeding, the municipal debtor continues in control of its assets and financial affairs (*i.e.*, the municipality does not relinquish control to a bankruptcy trustee).

Like a Chapter 11 plan of reorganization, a Chapter 9 debt adjustment plan must separate the claims of the municipal debtor’s creditors into separate “classes.” The claims placed in a particular class must be substantially similar and the plan must propose the same treatment for those claims placed in a particular class. Unless the Chapter 9 plan proposes to leave the rights of the creditors placed in a particular class unaltered (or to cure any default and honor any ongoing obligations owing to the creditors), then the class is considered “impaired” and the members of the class are entitled to vote to accept or reject the Chapter 9 plan.

In order to confirm a Chapter 9 debt adjustment plan, the Bankruptcy Court must determine that the plan meets certain statutory requirements. Again, as is in the case

of a Chapter 11 proceeding, the Bankruptcy Court may confirm a Chapter 9 adjustment plan even if one or more classes of impaired claims votes (in the requisite dollar amount and number) to reject the plan. In order to confirm a plan under such circumstances, however, the bankruptcy court must determine that the plan is “fair and reasonable” and does not “discriminate unfairly.” In a Chapter 11 case, these standards may require either that unsecured creditors receive payment in full or, alternatively, that existing equity interests receive nothing and are effectively wiped out. In a Chapter 9 case, there are no equity interests. Accordingly, a Chapter 9 plan may propose to pay unsecured creditors less than full payment and still be confirmed provided that the other conditions for confirmation are satisfied. The confirmation of Chapter 9 debt adjustment plan ordinarily discharges a Chapter 9 debtor of its pre-confirmation obligations. Those obligations are then substituted by the obligations provided for under the Chapter 9 Plan.

## II. THE BANKRUPTCY ESTATE

Immediately upon the commencement of a bankruptcy proceeding, a “bankruptcy estate” is created. 11 U.S.C. §541. Under the provisions of Bankruptcy Code Section 541, this estate is deemed to consist of “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. §541(a)(1). As more fully described below, those property rights and interests that become part of a bankruptcy estate are immediately protected by the so-called “automatic stay” provisions set forth in Bankruptcy Code 362(a). The latter provisions essentially prohibit creditors and other parties-in-interest from attempting to exercise control over property of the bankruptcy estate unless they first obtain permission from the bankruptcy court to do so. See 11 U.S.C. §362(a).

Although Bankruptcy Code Section 541 establishes the scope of property rights and interests that become part of a debtor’s bankruptcy estate, it does not define what those rights and interests are. Instead, bankruptcy courts must look to state law or other applicable non-bankruptcy law to determine the nature and extent of a debtor’s interest in a particular item of property. Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918 (1979)(“Property rights under section 541 are defined by state law.”); see also Nobleman v. American Savings Bank, 508 U.S. 324, 329, 113 S.Ct. 2106, 2110 (1993)(citations omitted) (“Congress has left the determination of property rights in the assets of a bankrupt’s estate to state law, since such property interests are created and defined by state law.”)

While Congress intended the definition of “property of the estate” to be extremely broad, it is well-established that if a debtor merely holds a possessory and/or purely legal interest in an asset, then the asset should not be treated as part of the bankruptcy estate but, instead, should be relinquished or otherwise made available to the party or parties who hold equitable title and/or interest in the asset. See, e.g., Beiger v. Internal Revenue Service, 496 U.S. 53, 59, 110 S.Ct. 2258, 2263 (1990); Matter of AI Copeland Enterprises, Inc., 991 F.2d 233, 236-7 (5<sup>th</sup> Cir. 1993); In re Joliet-Will County Community Action Agency, 847 F.2d 430, 431 (7<sup>th</sup> Cir. 1988)(“once the trustee

determines that the assets in the hands of the estate are not property of the estate, he should abandon the assets”) .

For instance, if a debtor is holding goods or other property under a bailment or storage arrangement, then notwithstanding the debtor’s bankruptcy filing, the owner is entitled to take possession of the goods or property from the debtor (that is, upon proper payment of any storage or related charges due and owing to the debtor). City of Paterson v. R & S Electrical Contracting (Matter of Slattery, Inc.), 54 B.R. 642, 643 (Bankr. D. N.J. 1985)(property held by debtor as a bailee is not property of the debtor’s bankruptcy estate); Witherell v. STN Enterprises, Inc. (In re STN Enterprises, Inc.), 45 B.R. 955, 958 (Bankr. D. Vt. 1984)(same).

Thus, in the first of our hypotheticals, if, upon the commencement of its bankruptcy proceeding, Chablis were in possession of goods belonging to a shipper, receiver, carrier or other customer and/or user of the port, the goods should not be treated as property of Chablis’ bankruptcy estate (that is, except to the extent that Chablis were entitled to assert some type of storage or maritime lien against the goods under applicable nonbankruptcy law). Accordingly, assuming Chablis has no such lien rights, then notwithstanding Chablis’ bankruptcy filing, the owner of the goods should be able to obtain possession of the goods from Chablis by presenting an appropriate bill of lading or other title documents. *Cf. In re Victoria Alloys, Inc.*, 261 B.R. 424 (Bankr. N.D. Ohio 2001)(Chapter 11 debtor’s bankruptcy estate had no claim to goods delivered to port of New Orleans as billing of lading was issued in the name of debtor’s parent company).

Nonetheless, it is conceivable that Chablis may refuse to relinquish the goods within its possession on the basis that it has some type of possessory lien or interest in the goods that renders the goods property of its bankruptcy estate. In the event Chablis were to assume such a position, the owner of the goods may very well be reluctant to assert any additional pressure on Chablis to relinquish the goods for fear that if Chablis is ultimately determined to hold an equitable interest in the goods, any assertion of pressure on Chablis to relinquish possession of the goods may be perceived as an attempt to assert control over property of the bankruptcy estate—conduct that would constitute a violation of the Bankruptcy Code’s “automatic stay” provisions and could potentially subject the offending party to sanctions from the bankruptcy court (see below).

Faced with the latter possibility, the property owner may—as is hypothesized—opt to forgo any direct confrontation with Chablis and, instead, attempt to pressure Port Blackwater to procure the release of the goods.

Under such a scenario, Port Blackwater would essentially face the same risks as the property owner with regard to confronting Chablis directly about releasing the goods—that is, any unilateral attempt by Blackwater to compel Chablis to relinquish possession may be perceived as a violation of the automatic stay and, as such, could

potentially subject Blackwater to sanctions. Accordingly, once Chablis is in bankruptcy, there may be few (if any) steps that Port Blackwater can unilateral undertake to compel Chablis to release the goods.

Conceivably, one preventive measure that Port Blackwater could consider is attempting to include a provision in its lease agreement with marine terminal operators (such as, Chablis) under which the operator agrees up-front that under specified conditions, it will not attempt to assert any liens against or otherwise refuse to relinquish possession of a customer's goods. Having agreed up-front to such a provision, the operator—in the event it subsequently files for bankruptcy—will have a much more difficult time attempting to claim that the customer's goods somehow constitute property of the operator's bankruptcy estate.

### **III. THE AUTOMATIC STAY**

As noted above, the commencement of bankruptcy proceeding immediately and automatically triggers application of the Bankruptcy Code's "automatic stay" provisions. The automatic stay functions as a "statutory injunction" prohibiting creditors of a bankrupt debtor from engaging in a wide-range of activities without first seeking and obtaining appropriate relief from the bankruptcy court presiding over the debtor's bankruptcy proceedings. Those activities subject to the provisions of the automatic stay include: (a) the commencement or continuation of any judicial, administrative or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case; (b) the enforcement against the debtor or the property of the estate of a judgment obtained before the commencement of the case; (c) any act to create, perfect or enforce any lien against property of the estate; (d) any act to create, perfect or enforce any lien against property of the debtor, for a claim that arose before the commencement of the case; and (e) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case. See 11 U.S.C. §362(a).

The automatic stay represents one of the fundamental protections afforded under the Bankruptcy Code. The principal purpose of the automatic stay is to provide bankruptcy debtors with a temporary "breathing spell" in which they may attempt to address their financial affairs without the interference and distraction of their creditors' ongoing collection and enforcement activities.

Although the automatic stay is intended to be far-reaching in its scope and application, Congress recognized that there are certain circumstances in which parties should be allowed to proceed against a debtor or its property without first seeking and obtaining relief from the bankruptcy court. Accordingly, Bankruptcy Code Section 362(b) sets forth a series of exceptions to the "automatic stay." Included among these exceptions is the so-called "police powers" exception. See 11 U.S.C. §362(b)(4). Under the latter exception, a governmental unit need not obtain prior approval from the

bankruptcy court before commencing or continuing an action to exercise and/or enforce its police and regulatory power against a debtor or a debtor's property. *Id.*

As bankruptcy courts have been quick to point out, the police powers exception only entitles a governmental unit to act unilaterally for the purpose of addressing or promoting matters of public health, safety and/or similar import. Thus, a governmental unit cannot invoke the police powers exception to undertake actions against a debtor or the debtor's property that are designed solely to advance the governmental unit's economic and commercial interests. *See, e.g., In re Corporacion de Servicios Medicos Hospitalarios de Fajardo*, 805 F.2d 440, 445 (1<sup>st</sup> Cir. 1986)(governmental unit's attempt to terminate hospital management and operation contract with debtor did not fall within the police powers exception to the automatic stay); *In re National Environmental Waste Corp.*, 191 B.R. 832, 835 (Bankr. C.D.Cal. 1996)(city's termination of waste hauling contract with debtor did fall within the police powers exception to the automatic stay).

Accordingly, it appears clear that Port Blackwater would not have the ability to terminate Chablis' month-to-month hold-over tenancy without first obtaining appropriate relief from the bankruptcy court presiding over Chablis' bankruptcy proceedings.

#### **IV. BANKRUPTCY DEBTOR'S UNIQUE RIGHTS WITH RESPECT TO EXECUTORY CONTRACTS AND UNEXPIRED LEASES**

Bankruptcy Code Section 365 gives bankruptcy debtors and/or trustee unique powers to deal with unexpired leases and other "executory contracts"<sup>1</sup> to which the debtor remains a party at the time it files for bankruptcy relief. Specifically, Bankruptcy Code Section 365 empowers a bankruptcy debtor or trustee to undertake one of the three following actions with respect to an unexpired lease: (a) it can "reject" the lease; (b) it can "assume" the lease; and (c) it can assume the lease and assign it to a third party.

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<sup>1</sup> The term "executory contract" is not defined in the Bankruptcy Code. Nor have bankruptcy courts been able to arrive at a uniform definition or formulation for this term. Traditionally, courts have relied on the so-called "Countrymen test" under which a contract is considered "executory" for purposes of the Bankruptcy Code's assumption and rejection provisions if the contract is one under which the obligation of both the debtor and the non-debtor party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other party. *See V. Countrymen, Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 460 (1973). More recently, however, a number of courts have rejected this test in favor of what they considered to be a more functional approach. *See, e.g., Cohn v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687, 708-9 (Bankr. S.D.N.Y. 1992)(where court applies "functional" approach to determine that expired employment contract covering debtor's general counsel was "executory contract" that could be rejected by debtor).



By rejecting a real property lease under which it is lessee, a debtor effectively relieves the bankruptcy estate of any further obligation to continue performing under the lease (*e.g.*, paying rent under the lease, etc). Once the debtor rejects the lease, it must ordinarily surrender possession of the leased property to the lessor. See 11 U.S.C. §365(d)(4)(A). The lessor is then entitled to assert a claim against the debtor's bankruptcy estate for any damages it sustains as a result of the debtor's election not to continue to perform under the lease. See 11 U.S.C. §502(g). The lessor's claim, however, is treated as an unsecured, non-priority claim and is subject to a statutory "cap" or "ceiling" based upon the amount of rent payments required for the remaining term of the lease. *Id.*, 11 U.S.C. §502(b)(6).

Alternatively, if a debtor assumes an unexpired lease under Bankruptcy Code Section 365, the lease will remain in effect and both parties will be responsible for fulfilling their ongoing obligations under the lease. In order to assume a lease, a Chapter 11 debtor must: (a) cure—or provide adequate assurance that it will promptly cure—all defaults (except for certain enumerated exceptions set forth in the Bankruptcy Code Section 365(b)(1)(A) and (2)) existing under the lease; (b) compensate—or provide adequate assurance that it will promptly compensate—the lessor for any pecuniary loss that the lessor sustained as a result of the debtor's defaults; and (c) provide adequate assurance of its (*i.e.*, the bankrupt lessee's) future performance under the lease. *Cf. In re Eagle Bus Mfg., Inc.*, 148 B.R. 481 (Bankr. S.D.Tex.,1992)(debtor that assumed lease agreement with port authority was required to pay interest on its delinquent rent payments as part of its "cure costs").

Finally, if a debtor assumes and assigns a lease to a third party assignee, the third party assignee becomes responsible for fulfilling all of the debtor's future obligations under the lease and the debtor (and its bankruptcy estate) are relieved of any further obligation or liability under the lease. In order to assume and assign a lease, a Chapter 11 debtor must satisfy the conditions for assumption set forth above except that instead of providing adequate assurance of its future performance under the lease, the debtor must provide adequate assurance of the assignee's future performance.

A debtor may seek to assume and assign a lease if, for instance, the rental rates set forth in the lease are below the current market rental rates, in which case a third party assignee might be willing to pay the debtor's bankruptcy estate a handsome sum for the privilege of stepping into the debtor's shoes under the debtor's existing lease agreement (and the below market rent rates contained therein). That way, the third party assignee can avoid having to negotiate a new lease directly with the lessor at the current market rental rates.

Bankruptcy Code Section 365 empowers a bankrupt lessee to assign a lease agreement to a third party assignee even though the lease agreement expressly prohibits the lessee's assignment of the lease or conditions any such assignment upon the lessor's prior consent. Specifically, Bankruptcy Code Section 365(f)(1) provides

that a bankruptcy trustee or Chapter 11 debtor-in-possession may assign an executory contract or unexpired lease notwithstanding a contractual “provision . . . that prohibits, restricts, or conditions [such] assignment.” See 11 U.S.C. §365(f)(1). Courts have relied upon the latter statutory provision not only to invalidate explicit anti-assignment clauses in a lease agreement but also as a basis for refusing to enforce other terms in a lease that might impede the debtor’s ability to assign the lease to a third party assignee. See, e.g., In re Rickel Home Centers, Inc., 240 B.R. 826, 832 (D.Del 1999) (lease term which restricted use to home improvement centers was unenforceable as de facto anti-assignment clause); In re Jamesway Corp., 201 B.R. 73, 77 (Bankr. S.D.N.Y. 1996) (lease provision that required debtor to pay landlord a percentage of profits realized from assignment of leases had the practical effect of restricting, conditioning, or prohibiting debtor’s right to assign lease and was therefore unenforceable under § 365); In re Mr. Grocer, Inc., 77 B.R. 349, 352 (Bankr. D.N.H. 1987) (right of first refusal granted to landlord was unenforceable against debtor seeking to assume and assign lease because provision restricted or conditioned assignment of the lease).

Although bankruptcy debtors and/or trustees seeking to assign a lease agreement are free to disregard contractual restraints on assignability, they remain subject to any restraints on assignability that exist under some independent statute or common law rule. See 11 U.S.C. §365(c). Thus, if there exists some independent statutory or common law that prohibits a lessee from assigning a particular lease agreement without the lessor’s consent, a bankruptcy debtor will not be permitted to assume and/or assign the lease under Bankruptcy Code Section 365 unless it obtains the lessor’s consent. See, e.g., In re Catapult Entertainment, Inc., 165 F.3d 747 (9<sup>th</sup> Cir. 1999), *cert. denied*, 120 S.Ct. 369 (2000).

The Bankruptcy Code gives Chapter 11 debtors one-hundred and twenty (120) days from the commencement of their bankruptcy case to decide whether to assume or reject a nonresidential real property lease. 11 U.S.C. §365(d)(4). A bankruptcy court may extend this initial decision period for an additional ninety (90) days. Id. Beyond that, the bankruptcy court cannot extend the debtor’s decision period without the lessor’s consent. Id.

During the intervening time—that is, the period between the commencement of the debtor’s bankruptcy case and the debtor’s decision to assume or reject a lease—the debtor is required to “timely perform all [post-bankruptcy filing] obligations” arising under the lease. See 11 U.S.C. §365(d)(3). Thus, pending its decision to assume or reject a lease, a debtor must timely pay all post-bankruptcy filing rent obligations accruing under the lease. In the event that the debtor fails to do so, the lessor will be entitled to recover such rent as an administrative priority claim. See, e.g., In re Thinking Machine Corporation, 67 F.3d 1021, 1024 (1<sup>st</sup> Cir. 1995); In re Klein Sleep Products, Inc., 78 F.3d 18, 30 n. 7 (2<sup>nd</sup> Cir. 1996); In re Montgomery Ward Holding Corp., 268 F.3d 205, 210-211 (3<sup>rd</sup> Cir. 2001); Norritech v. Geonex Corporation, 204 B.R. 684, 690-1 (D. Md. 1997) *aff’d* Geonex Corporation v. Norritech, 120 F.3d 261 (4<sup>th</sup> Cir. 1997); In

re Koenig Sporting Goods, Inc., 203 F.3d 986, 989 n. 2 (6<sup>th</sup> Cir. 2000); Matter of Handy Andy Home Improvements Centers, Inc., 144 F.3d 1125, 1128 (7<sup>th</sup> Cir. 1998); In re Cukierman, 265 F.3d 846, 851 (9<sup>th</sup> Cir. 2001). Ordinarily, in a Chapter 11 proceeding, such administrative priority claims must be paid in full. See 11 U.S.C. §1129(a)(9).

If a lease agreement has already expired or been terminated prior to a lessee's bankruptcy filing, it is not subject to the provisions of Bankruptcy Code Section 365, for Bankruptcy Code 365 only applies to unexpired lease agreements. Cf. In re Erie Builders Concrete Co., 98 B.R. 737 (Bankr. W.D. Pa. 1989)(debtor could not seek to "revive" lease agreement with port authority that had terminated prior to the debtor's bankruptcy filing). If, however, a debtor remains in possession of property as a hold-over tenant, the debtor's holdover tenancy will be considered an asset of the bankruptcy estate and will (at least, theoretically) be subject to the provisions of Bankruptcy Code Section 365. See 11 U.S.C. §365(m)("For purposes of this section 365 . . . leases of real property shall include any rental agreement to use property."); In re Brewer, 233 B.R. 825, 827-8 (Bankr. E.D Ark. 1999)(hold-over tenancy constitutes an unexpired lease for purposes of 11 U.S.C. §365); In re Scott, 209 B.R. 777, 781 (Bankr. S.D. Ga. 1977)(same).

Moreover, because the hold-over tenancy constitutes part of the debtor's bankruptcy estate, the automatic stay provisions prevent the lessor from attempting to terminate the lease without first obtaining relief from the bankruptcy court. If, however, all the debtor has is a holdover tenancy subject to a one-month notice of termination, then that is all that the debtor can assume and/or assign under Bankruptcy Code Section 365. Accordingly, if the debtor were to assume such a tenancy, then immediately following such assumption, the lessor could send out a notice of termination notice and effectuate a termination of the lease one-month later.<sup>2</sup> Under such circumstances, the tenancy may not be considered an asset necessary for an effective reorganization and, thus, the lessor may be obtain to relief from the bankruptcy court to terminate the lease long before the debtor's deadline for deciding whether to assume or reject. See, e.g., In re Premier Automotive Services, Inc., 343 B.R. 501, 520-1 (Bankr. D. Md. 2006 (port authority granted relief from the automatic stay to terminate debtor's month-to-month tenancy because long-term value of tenancy to bankruptcy estate was a "mere illusion"); In re Schewe, 94 B.R. 938, 949-950 (Bankr. W.D. Mich. 1989)(Landlord's desire to terminate month-to-month tenancy at will was "itself" cause to modify the automatic stay.).

Thus, turning to the facts of our first hypothetical, Port Blackwater cannot unilaterally act to terminate Chablis' hold-over tenancy but, instead, must seek first relief from the bankruptcy court before undertaking any such measures. Assuming, however, Chablis' holdover tenancy is subject to termination upon one-month's notice, Port Blackwater's chances of obtaining the foregoing relief may be fairly high for the

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<sup>2</sup> Once a lease has been assumed under Bankruptcy Code Section 365, the nondebtor lessor can exercise its rights under the lease without violating the provisions of the automatic stay. See In re University Medical Center, 973 F.2d 1065, 1075 (3<sup>rd</sup> Cir. 1992).

bankruptcy court is not likely to view the hold-over tenancy as an asset necessary for Chablis's effective reorganization.

## V. PREFERENCES

Under the Bankruptcy Code's preference provisions, a bankruptcy trustee or Chapter 11 debtor-in-possession has the authority to avoid and recover certain payments made by the debtor prior to bankruptcy. In order to constitute a "preference" and, thereby, be subject to avoidance and recovery, a payment made by a debtor must meet each of the five following elements: (1) it must be made to a creditor; (2) it must be to or on account of a pre-existing debt or obligation; (3) it must be made at time when the debtor is "insolvent;" (4) it must be made on or within 90 days before the commencement of the bankruptcy case<sup>3</sup>; and (5) it must enable the creditor to receive more than it would have received if the debtor were liquidated in a Chapter 7 proceeding. See 11 U.S.C. §547(b).

The Bankruptcy Code's preference provisions are generally recognized as serving two important policy goals: (1) promoting equality of distribution among similarly situated creditors; and (2) discouraging creditors of financially troubled companies from employing overly aggressive collection efforts and unnecessarily forcing these companies into bankruptcy. In the case of the first of these goals, the drafters of the Bankruptcy Code were concerned that a financially troubled company—realizing that it did not have enough assets to pay all of its creditors and that it would ultimately have to file bankruptcy—might choose to use the company's limited resources to pay the claims of certain "favored" or "preferred" creditors. This, of course, would mean that while a few, select creditors might be made whole, the company's remaining creditors would have to seek recovery from a significantly diminished pool of assets. The preference provisions help prevent such an inequitable result from occurring by discouraging financially troubled companies from making such payments and by insuring that in the event such payments are made, the bankruptcy trustee has a means of recovering the payments for the benefit of all creditors.

Because the collection remedies that exist outside of bankruptcy are generally structured in such a way that those creditors that act first may recover in full while less aggressive creditors recover nothing, creditors will often be inclined to enforce their collection rights and remedies upon the first sign that a debtor is experiencing financial difficulty. Indeed, they may be compelled to do so simply to insure that they are not "beat to the punch" by a competing creditor. As the drafters of the Bankruptcy Code recognized, this will have the effect in many instances of creating a "race to the courthouse" in which a company's creditors—each vying to recover its particular claim

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<sup>3</sup> This ninety day period is extended to one year in the case of creditors who qualify as an "insider." Although the Bankruptcy Code's definition of "insider" is broad and open-ended, ordinary trade creditors will generally not be considered insiders unless they have some unique affiliation with the debtor (e.g., if they are a subsidiary of the debtor)

in full before a rival creditor has an opportunity to do so—end up unnecessarily carving up what was otherwise an economically viable company. The preference provisions discourage such a result from occurring by providing bankruptcy trustees and Chapter 11 debtors-in-possession with a means of forcing creditors to forfeit certain recoveries or other advantages they secure by aggressively enforcing their collection rights and remedies against a financially distressed debtor.

Although they are ultimately intended to promote the policy objectives described above, the preference provisions are drafted in objective terms and, thus, often operate in a very mechanical fashion. Consequently, a creditor that has neither been favored by the debtor nor overly aggressive in its collection practices may end up being sued for a preference.

There are a number of different defenses that may be available in a preference action. One of the most important defenses for creditors is the so-called “ordinary course” defense. Under this defense, a creditor will not be required to return a payment that otherwise constitutes a preference provided it can demonstrate each of the following elements: (1) the underlying debt paid by the payment must have been incurred in the “ordinary course” of both the creditor’s and the debtor’s businesses; and (2) either (a) the payment must have been made in the ordinary course of the creditor’s and debtor’s conduct of business with one another; or (b) the payment must have been made in accordance with norms of the relevant industry. Prior to the 2005 amendments to the Bankruptcy Code the creditor was required to prove all three of these elements; however, the 2005 Amendments liberalized the defense by providing that to prevail, the creditor need only prove that the transaction was entered into in the ordinary course of business and that the payment was made EITHER in the ordinary course of business of the two parties to the transaction OR was consistent with the norms of the relevant industry.

The “industry” prong of the ordinary course defense focuses on whether the alleged preferential payment was made in a manner consistent with what is considered ordinary in the parties’ respective industries. For the most part, courts have been liberal in their application of this prong of the ordinary course defense. Thus, a payment will generally be considered to have been made “according to ordinary business terms” unless it is paid in a manner that significantly deviates from “industry norms.” For instance, if no one in the parties’ respective industries ever pays by means of wire transfer, a payment by wire transfer may arguably fail to satisfy the industry prong of the ordinary course defense. Since the importance of this prong was enhanced by the 2005 amendments it is uncertain that this “liberal” interpretation will continue. One of the key issues in establishing this defense is defining the relevant industry.

In addition to the ordinary course defense, another important defense available to parties sued in a preference action is the “subsequent new value” defense. Under this defense, a preference defendant is entitled to reduce its potential preference liability by the amount of any “new value” that it provided to the debtor after receiving a

preferential payment. Thus, for instance, if a port authority receives a January rent payment of \$30,000 from a marine terminal operator on February 1 and the operator continues to occupy the terminal for the remainder of the month (*i.e.*, February) before filing for bankruptcy, the port authority will be entitled offset the value of the operator's rent-free occupation of the terminal during the month of February against any preference liability it might otherwise have with regard to the January rent received on February 1. See, *e.g.*, Southern Technical College, Inc. v. Hood, 89 F.3d 1381,1385 (8<sup>th</sup> Cir. 1996).

Another statutory preference defense is the “substantially contemporaneous exchange” defense. This defense protects payments that: (a) were intended by the parties to be a contemporaneous exchange for new value; and (b) were, in fact, substantially contemporaneous with the exchange of new value. Pursuant to this defense, a port authority that is a lessor under a lease agreement that provides for monthly rent to be paid in advance at the beginning of each month may be protected from any preference liability in the lessee's bankruptcy proceeding provided the lessee's pre-bankruptcy payments to the debtor substantially coincided with the beginning of each month. See, *e.g.*, In re Garrett Tool & Engineering, Inc., 273 B.R. 123, 126 (E.D.Mich. 2002).

Although not one of the enumerated statutory defenses, courts also recognize that a bankruptcy estate cannot use the Bankruptcy Code's preference provisions to recover pre-bankruptcy payments made under an expired lease or other executory contract that the bankruptcy estate ultimately assumes under Bankruptcy Code Section 365. See, *e.g.*, In re Kiwi International Air Lines, Inc., 344 F.3d 211 (3rd Cir. 2003)(debtor's assumption of operating agreement with port authority prevented bankruptcy estate from attempting to recover pre-bankruptcy payments made to port authority under the operating agreement).

Finally, it should be noted that previously, state entities (including state port authorities) would seek to dismiss preference suit filed against them on the basis that such suits violated the principles of sovereign immunity. See, *e.g.*, In re Midway Airlines, Inc., 175 B.R. 239 (Bankr. N.D. Ill. 1994)(port authority unsuccessfully contends that it is not subject to preference liability on state sovereign immunity grounds). In a decision rendered last year, the Supreme Court rejected this argument and held that by ratifying the “uniform laws of bankruptcy” clause in Article I of the U.S. Constitution, states had effectively waived sovereign immunity with respect to actions arising out of a bankruptcy proceeding. See Central Virginia Community College v. Katz, 546 U.S. 356, 126 S.Ct. 990 (2006). Accordingly, it is now clear that a state port authority cannot defend against a preference suit by invoking principles of sovereign immunity—at least, not if it has filed a proof of claim against the bankruptcy estate. Cf. 11 U.S.C. §106(c)(providing that a governmental unit that files a proof of claim against the bankruptcy estate waives sovereignty immunity for claims constituting property of the bankruptcy estate).

Turning again to the facts in our first hypothetical, it is conceivable that Chablis' bankruptcy estate could ultimately attempt to bring a preference action against Port Blackwater for the rent payments that Blackwater received during the 90 day period preceding Chablis' bankruptcy filing. Depending upon the timing of these payments relative to the accrual of Chablis' rent obligations, Blackwater may have a partial or complete defense to such a preference action under either the ordinary course, subsequent new value, or contemporaneous exchange defenses.

## VI. ANTI-DISCRIMINATION PROVISIONS

Pursuant to Bankruptcy Code Section 525, governmental units are prohibited from revoking, suspending or refusing to renew a license, permit, charter, franchise or other similar grant to a bankruptcy debtor "solely" because the debtor: (a) has sought protection under the Bankruptcy Code; (b) became insolvent; or (c) has not paid a debt that is dischargeable in bankruptcy. 11 U.S.C. §525(a); *see, e.g., F.C.C. v. NextWave Personal Communications Inc.*, 537 U.S. 293, 123 S.Ct. 832 (2003)(Federal Communications Commission's cancellation of C-Block broadband personal communications spectrum licenses previously awarded to bankruptcy debtor violated Bankruptcy Code Section 525's anti-discrimination provisions).

Because these so-called "anti-discrimination" provisions are only triggered when the government is acting "solely" on one of aforementioned grounds, a governmental unit will not be prohibited from revoking or suspending a permit, license or similar right if it has an independent, non-discriminatory basis for doing so. *Cf. In re Premier Automotive Services, Inc.*, 343 B.R. 501, 516-7 (Bankr. D. Md. 2006)(port authority's refusal to authorize sublease with debtor was not based "solely" on debtor's bankruptcy and, thus, was not actionable under Bankruptcy Code Section 525).

Thus, under the facts of hypothetical 1, Chablis could only assert a claim against Port Blackwater under Bankruptcy Code Section 525 if it could demonstrate that Blackwater refused to agree to renew and/or re-negotiation a new lease with Chablis "solely" because of Chablis' bankruptcy proceeding and/or perceived financial insolvency. Based upon the facts given, such a showing does not seem likely.