No. 21-0909

IN THE

Supreme Court of the United States

OCTOBER TERM, 2021

IN RE TERRAPIN STATION, LLC, DEBTOR,

TOUCH OF GREY ROASTERS, INC.,
Petitioner,
v.

CASEY JONES, CHAPTER 7 TRUSTEE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Thirteenth Circuit

BRIEF FOR RESPONDENT

Team R. 42
Counsel for Respondent

Oral Argument Requested

QUESTIONS PRESENTED

I. When a creditor supplies ordinary-course goods to a struggling business twenty days prepetition, the Bankruptcy Code grants that creditor an administrative expense for what would normally be a voidable preference. But, after that claim has been repaid in full, does the Code then also allow that same creditor to come back and ask the court to re-use the value of those same *paid-for* goods in attempting to further offset its preference liability?

II. Section 365(d) of the Bankruptcy Code requires a Trustee to timely perform the post-petition obligations of a debtor under an unexpired nonresidential lease until the date of the lease's rejection or assumption. When a Debtor rejects a lease and ceases occupancy five days after the first of the month, must a Trustee continue to pay for unoccupied space for the remaining twenty-six days post-rejection?

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The Thirteenth Circuit Court of Appeals' Decision is available at No. 20-0803. The bankruptcy court decided in favor of the Trustee. On direct appeal, the United States District Court for the District of Moot affirmed. On further appeal, the United State Court of Appeals for the Thirteenth Circuit affirmed.

STATEMENT OF JURISDICTION

The formal statement of jurisdiction is waived pursuant to Competition Rule VIII.

STATEMENT OF CONSTITUTIONAL AND STATUTORY PROVISIONS

The constitutional and statutory provisions listed below are relevant to determine the present case, and selected statutes are reproduced in Appendix A.

U.S. Const. art. I § 8, cl. 4;

11 U.S.C. §§ 365, 503, 507, 547, 549 (2020).

STATEMENT OF THE FACTS

Relationship and History of the Parties. Terrapin Station, LLC ("Debtor") is a small, local coffeehouse established in 2005 in Terrapin, Moot. R. at 3. By 2009, the Debtor had a loyal customer base. *Id*. Touch of Grey Roasters, Inc. ("Touch of Grey") is a giant coffee corporation with hundreds of retail outlets around the world. *Id*. In 2017, Touch of Grey began soliciting independent coffeehouses in an attempt to further expand its market share by profiting off of local coffeehouses' reputations. R. at 4. Touch of Grey contacted the Debtor and proposed a franchise and lease agreement, under which the Debtor would exclusively sell Touch of Grey products. *Id.* The Debtor was persuaded that this would be a good opportunity and agreed to an arrangement with Touch of Grey whereby Touch of Grey would purchase and renovate a retail space (the "Premises") and lease the Premises to Debtor. *Id*. The new retail space opened in December of 2018. R. at 5.

The Road to Bankruptcy. The Debtor encountered challenges right away that would ultimately lead to the bankruptcy filing. R. at 5. The terms of the lease ("Lease") were less than ideal. The twenty-year lease included "triple-net"[1] conditions, as well as above-market rent in the amount of $25,000 "due in advance on the first day of each month." R. at 4-5. In short, the business was not as wildly successful as anticipated. R. at 5. By September of 2019, the Debtor was cash-flow insolvent. *Id*. The Debtor owed Touch of Grey over $700,000 for coffeehouse goods supplied on credit. *Id*. On December 5, 2019, Touch of Grey sent the Debtor a notice of default and threatened to terminate the franchise agreement. *Id*.

[1] A "triple-net" lease is "[a] lease in which the lessee pays all the expenses, including mortgage interest and amortization, leaving the lessor with an amount free of all claims." Lease Definition, *Black's Law Dictionary* (11th ed. 2019), *available at* Westlaw.

The Preference Window Opens. On December 7, 2019, the Debtor transferred $250,000 to Touch of Grey in partial payment of outstanding invoices for supplied goods. *Id.* This payment occurred within 90 days of the bankruptcy filing, and the parties stipulated that all elements of a voidable preference were met. R. at 9 n.3. Touch of Grey extended new credit, $200,000 worth of goods provided in the Invoice, within twenty days prepetition. R. at 5.

The Bankruptcy, COVID-19, and the Current Disputes. On January 5, 2020 (the "Petition Date"), the Debtor filed for Chapter 11 in the hopes of saving the business. R. at 6. On this date, the Debtor was still current on rent but owed Touch of Grey over $650,000 for supplied goods. *Id*. The Debtor does not have any secured debt but does have other unsecured debts accounting for $500,000. *Id*. On January 19, 2020, the Debtor filed a motion to repay Touch of Grey the $200,000 as an administrative expense. *Id*. After a hearing, the bankruptcy court allowed the $200,000 payment. R. at 7.

In March of 2020, the COVID-19 Pandemic forced the Debtor to temporarily close its doors. *Id*. The Debtor was able to reopen in April of 2020, but most customers stayed home. *Id*. Four months post-petition, the Debtor permanently ceased operations, vacated the Premises, and returned the keys to Touch of Grey on May 5, 2020. *Id*. Rent had not been paid for May. *Id.*

On May 29, 2020, the bankruptcy court held a combined hearing on two motions to determine the date of rejection and the amount of rent owed for May. R. at 8. The court granted the Debtor's motion to reject the lease, effective May 5, 2020. *Id*. The court converted the Debtor's case to a Chapter 7 and appointed a Trustee. *Id*. The court ordered additional briefing on whether the Debtor is liable for the full month's rent, or only the pre-rejection rent. *Id*.

The Trustee filed an adversary proceeding to recover the December 7, 2019 payment of $250,000 as a preference. *Id*. In response, Touch of Grey asserted the "subsequent new value"

defense to offset its preference liability with the $200,000 of provided goods to the Debtor. *Id*. This appeal follows decisions in the lower courts granting and affirming the Trustee's motions. R. at 9.

STANDARD OF REVIEW

This case only presents questions of law since the facts are undisputed. R. at 9. This Court reviews *de novo* issues of law originating in bankruptcy cases. *Texas v. Soileau* (*In re Soileau*), 488 F.3d 302, 305 (5th Cir. 2007). With a *de novo* standard of review, this Court must make fresh determinations on questions of law without deference to the lower courts' conclusions. *See Razavi v. Comm'r of Internal Revenue*, 74 F.3d 125, 127 (6th Cir. 1996).

SUMMARY OF THE ARGUMENT

With careful dissection of the United States Bankruptcy Code (hereinafter the "Code") and policy-based motivations, the Thirteenth Circuit Court of Appeals properly affirmed the bankruptcy court's rulings on both issues before the Court today. First, a seller of goods is not entitled to a reduction in preference exposure by asserting the "subsequent new value" defense when a debtor repays the seller with a court-approved administrative expense. Second, a trustee does not have any obligations to pay rent after rejecting the lease, and, as a result, rent should be prorated for the days the leased premises were occupied. These judgments reinforce the fundamental goals of the Bankruptcy Code.

First, in a preference action, the trustee has the burden of proof to establish a preferential transfer, which the Trustee in this case has done. Then, the burden shifts to the defendant-creditor to assert any affirmative defenses that may apply. The parties stipulated that the only defense that may apply in this case is the "subsequent new value" approach listed in section 547(c)(4). For a creditor to successfully raise this defense, the creditor must show that (1) new value was given

after the preferential transfer, (2) the new value was unsecured, and (3) the debtor did not make an otherwise unavoidable transfer for the benefit of the creditor on account of the new value. The facts show that the new value was given after the preferential transfer, and that the new value was unsecured. The first issue of this case arises out of the third element of the subsequent new value defense. While a double negative in a statute may seem complex at first glance, this element can be reworded as a positive to express the same intent. In other words, a debtor must make a voidable transfer as repayment for the new value for the creditor to establish this defense.

As evidenced in this case, the Debtor repaid the new value with a court-approved administrative expense under section 503(b)(9). Section 549 does not allow a trustee to avoid this repayment of new value. Thus, the Debtor repaid the creditor with an *unavoidable* transfer. The unavoidable transfer wrecks Touch of Grey's subsequent new value defense. Without this defense, Touch of Grey cannot reduce its preference exposure pursuant to section 547(c)(4).

Second, a debtor should only bear the obligation to pay rent for the days actually occupied under an unexpired nonresidential lease. When there is an unexpired nonresidential lease agreement, the debtor has the option to either assume or reject the lease. Under section 365(d)(3), the lease must be assumed or rejected within a timely manner, and the obligations arising from this lease terminate when the lease is rejected. Therefore, the trustee does not have a duty to perform these obligations after the lease is rejected.

In addition to the plain language of section 365(d)(3), context and policy rationales unite to fight for the well-established proration approach. The proration approach allows bankruptcy courts to prorate rent because the lease obligations accrue over time, and debtors should only pay for what they used. In this case, the debtor rejected the lease five days into May and immediately vacated the premises. The debtor should only pay for the five days occupied in May because

paying a whole month's rent for five days would result in a windfall to the landlord. The proration approach is most consistent with the policy goals of the Code by balancing the landlord's rights with those of the estate and its creditors.

ARGUMENT

This Court should AFFIRM the Thirteenth Circuit Court of Appeal's decision that section 547(c)(4) precludes a defendant from asserting the "subsequent new value" affirmative defense given a satisfied administrative expense under section 503(b)(9). Further, this Court should also AFFIRM that section 365(d)(3) does not require the trustee to satisfy obligations after the lease has been rejected and prorate the rent accordingly.

I. A SUPPLIER OF GOODS CANNOT REDUCE ITS PREFERENCE EXPOSURE WITH THE "SUBSEQUENT NEW VALUE" DEFENSE BECAUSE IT HAS ALREADY BEEN PAID.

A seller of goods cannot decrease the preferential transfer claim amount by asserting the "subsequent new value" defense when that seller receives an "otherwise unavoidable" transfer from the debtor. 11 U.S.C. § 547(c)(4). A preferential transfer occurs when a debtor satisfies an old debt to a creditor for the full value of its claim while the debtor was insolvent within ninety days prior to filing a bankruptcy petition. *Miller v. JNJ Logistics*, (*In re Proliance Int'l, Inc.*), 514 B.R. 426, 430 (Bankr. D. Del. 2014). The exact requirements of a preference can be found at 11 U.S.C. § 547(b). Here, the parties stipulated that the Trustee has established all the elements of a preference for a transfer that occurred on December 7, 2019, about one month prior to the Petition Date. R. at 5, 9 n.3. A preference is avoidable by the trustee. 11 U.S.C. § 547(b).

Once a preference has been established, the creditor has affirmative defenses which may apply and are found in 11 U.S.C. § 547(c). The parties have stipulated that the only defense available is the "subsequent new value defense." 11 U.S.C. § 547(c)(4); R. at 9 n.3. The preference defendant

carries the burden of proof upon asserting an affirmative defense. *Wiscovitch-Rentas v. PDCM Assocs.*, (*In re PMC Mktg. Corp.*) 518 B.R. 150, 156 (B.A.P. 1st Cir. 2014).

Here, Touch of Grey must prove three elements of the subsequent new value defense. *See id.* at 157. First, the creditor must give new value to or for the benefit of a debtor after a preferential transfer. 11 U.S.C. § 547(c)(4). Second, the new value must be unsecured. 11 U.S.C. § 547(c)(4)(A). Lastly, the debtor must not have made "an otherwise unavoidable transfer to or for the benefit" of the creditor asserting the defense. 11 U.S.C. § 547(c)(4)(B).

"New value" is defined in section 547 as money's worth in goods, services, new credit, or the release of property that is neither void nor voidable. 11 U.S.C. § 547(a)(2). On the Petition Date, the Debtor did not have any secured debt. R. at 6. The record reflects Touch of Grey giving the Debtor unsecured "new value" after a preferential transfer but before the Petition Date. *See* R. at 5-6. Later, the bankruptcy court approved an administrative expense payment to repay Touch of Grey for the goods delivered in the Invoice. R. at 9. Thus, there was not a benefit incurred by the debtor's estate.

The issue here is whether the Debtor made an "otherwise unavoidable" transfer when the Debtor paid for that new value with a court-approved administrative expense. "In other words, payment by a debtor for new value only neutralizes the creditor's new value defense if that payment is unavoidable." *In re PMC Mktg. Corp.*, 518 B.R. at 158. The record reflects that the Debtor in fact made an unavoidable transfer when the court approved an administrative expense to Touch of Grey for goods provided in the Invoice.

A. Section 547(c)(4)(B) does not include any temporal limitations that would confine repayment of new value to prepetition only.

Under section 547(c)(4), a creditor is entitled to reduce its preference exposure by providing "new value" to the debtor. The exception provided in section 547(c)(4)(B) states "after

such [preferential] transfer, such creditor gave new value to or for the benefit of the debtor… on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." In other words, a creditor can offset its preference payments with the new value provided to the debtor so long as the debtor does not make an unavoidable transfer on account of the new value. *Hall v. Chrysler Credit Corp.* (*In re JKJ Chevrolet*), 412 F.3d 545, 552 (4th Cir. 2005). Thus, the creditor can assert the new value defense only if the debtor's payment can be recovered as an avoidable transfer. *Phoenix Rest. Grp. v. Ajilon Pro. Staffing*, (*In re Phoenix Rest. Grp.*), 317 B.R. 491, 495 (Bankr. M.D. Tenn. 2004).

The courts have wrestled with two issues that arise concurrently under section 547(c)(4)(B), and their decisions caused a circuit split. *PMCM 2 v. Fabric Sources*, (*In re Beaulieu Grp.*), 616 B.R. 857, 869 (Bankr. N.D. Ga. 2020). The first issue is whether the transfer is avoidable or unavoidable. The second issue looks at the timing of the transfer, either prepetition or post-petition, to decide whether the transfer affects a creditor's assertion of a subsequent new value defense. *Id.*

While its plain language is confusing with a double negative, many courts have undertaken countless hours to carefully understand the drafters' intent. *See Boyd v. The Water Doctor*, (*In re Check Reporting Servs.*), 140 B.R. 425, 430 (Bankr. W.D. Mich. 1992). Where two negatives create a positive, "not otherwise unavoidable" can also be interpreted as otherwise *avoidable*. 11 U.S.C. § 547(c)(4)(B); *Id.* at 431-32. However, a more correct alternative, positive phrasing is "the debtor made an otherwise *unavoidable* transfer to the creditor," which includes situations where the debtor does not make a transfer after the new value is given. *In re Check Reporting Servs.*, 140 B.R. at 435 (emphasis added). Either interpretation makes the statute seemingly complicated but not ambiguous. *Id.* at 434.

In addition to the double negative, courts have grappled with the placement and meaning of the word "otherwise." *Id.* at 436. In *In re Phoenix Rest. Grp.*, "otherwise" means a transfer is unavoidable for reasons other than those specified in this section. 317 B.R. at 499. To figure out whether a transfer is unavoidable, the placement and meaning of "otherwise" requires courts to look at other sections of the Code to see if any of those apply to protect the debtor's transfer. *Id.* at 499-500. With this code section being unambiguous, there is no need to turn to the legislative history or other interpretive aids because the statutory language itself is sufficient. *In re Check Reporting Servs.*, 140 B.R. at 436.

Nothing in section 547(c)(4) expresses that debtors' subsequent payments on account for new value must occur prepetition to eliminate creditors' defenses. *Friedman's Liquidating Trust v. Roth Staffing Cos.*, (*In re Friedman's Inc.*), 738 F.3d 547, 553 (3d Cir. 2013). There is a substantial body of caselaw that holds a defendant in a preference action may not assert the new value defense for the new value provided to the debtor's estate after the petition date. *Miller v. A & M Oil Company*, (*In re Smith Min. & Material*), 405 B.R. 589, 594 (Bankr. W.D. Ky. 2009). Regarding a preference analysis, section 547 clearly states the preference window begins ninety days prior to the petition date and ends on the petition date. 11 U.S.C. § 547(b)(4)(A). The new value must be provided during the preference window in response to a prior preference transfer for a creditor to offset its preference exposure. *In re Smith Min. & Material*, 405 B.R. at 594. With that much detail in the prior section, there are not any time limitations imposed on a debtor's repayment of new value. *TI Acquisition LLC v. Southern Polymer Inc.*, (*In re TI Acquisition*), 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010). As indicated in this section of the Code, Congress knows how to create and impose temporal limitations. By not adding any constraint on when the

"otherwise unavoidable" transfer in section 547(c)(4)(B) must occur, Congress left a window open wide enough for debtors to repay the new value either pre- or post-petition.

Some courts have not allowed post-petition repayments of new value, and their reasoning distinguishes "to or for the benefit of the debtor" from the debtor's estate because the debtor's estate is created on the petition date. *In re PMC Mktg. Corp.*, 518 B.R. at 157. Under this view, new value advances to the debtor are separate and distinct from post-petition payments to the creditor. *In re Beaulieu Grp.*, 616 B.R. at 876. However, this view is unpersuasive because it violates the policy of equitable distribution among creditors and ignores other Code sections. *Id.* at 877. If a debtor's post-petition repayment of new value cannot apply to the creditor's defense, then the creditor will receive a double benefit. *See id*. The creditor can keep the administrative expense while also offsetting its preference liability. *Id.* When the debtor pays administrative expenses, the debtor's estate is reduced. *Id.* The debtor's estate is further diminished when the creditor's preference liability is offset against the new value provided. *In re Beaulieu Grp.*, 616 B.R. at 877. While the creditor is paid twice, the debtor's estate and other unsecured creditors suffer exponentially. *See id.* Congress could not have intended a result that contravenes a fundamental goal of bankruptcy—equality of distribution among creditors.

By diligently working through section 547(c)(4), the broad issue can be narrowed down to apply to the facts of the case to reach a single, correct result. *In re Check Reporting Servs.*, 140 B.R. at 434. The broad issue is whether the Debtor's transfer is "otherwise unavoidable." At the outset, the word "otherwise" triggers an expansive analysis of the entire Code looking for a section that enables a trustee to avoid transfers. *In re Phoenix Rest. Grp.*, 317 B.R. at 499-500. As predetermined by the facts of this case and lower courts, the only other section that applies is section 549. 11 U.S.C. § 549; R. at 13. This section allows a trustee to avoid a transfer that was

made after the petition date and not approved by the bankruptcy court. 11 U.S.C. § 549(a). By applying section 549 to determine whether the transfer at issue is avoidable or not, the analysis looks at transfers that occur post-petition. Consequently, a post-petition transfer does affect a creditor's subsequent new value defense when the transfer is unavoidable.

Here, the bankruptcy court approved the Debtor's transfer of an administrative expense for $200,000 on account of new value for goods listed in the Invoice. R. at 7. So, the trustee may not avoid this transfer because section 549 prevents avoidance of court-approved transfers. The Debtor's transfer is unavoidable. These facts do not track the plain language in section 547(c)(4)(B). The Debtor did in fact make an "otherwise unavoidable" transfer to the creditor which does not satisfy the last element necessary for a new value defense. By not satisfying this element, Touch of Grey cannot assert the subsequent new value defense. Without this defense, Touch of Grey cannot lower its preference exposure by the amount of the administrative expense.

This analysis achieves and aligns with the twin policy concerns expressed by the drafters. *In re Check Reporting Servs.*, 140 B.R. at 437. Section 547(c)(4) triggers policy rationales to treat creditors equally and to encourage creditors to continue business with struggling debtors. *Id.* In other words, stated so eloquently:

> …[T]he risk to the creditor of continuing to do business with a struggling debtor is reduced, but that risk reduction depends upon the creditor continually replenishing the estate with something of value, such as goods or services, all to the benefit of both the struggling debtor and its other creditors. At bottom, that is a fair result.

Bogdanov v. Avnet, Inc., No. 10-CV-543-SM, 2011 WL 4625698, at *7 (D. N.H. Sept. 30, 2011). In the end, courts rely on policy considerations to ensure a fair, just, and equitable result.

B. An administrative expense payment overcomes the seller's new value defense because the court-approved administrative payment is an unavoidable transfer.

With a punch, shirk, and an uppercut, the Trustee ultimately prevails against Touch of Grey's new value defense because the court-approved administrative expense payment of $200,000 to Touch of Grey was an unavoidable transfer. Under section 547(c)(4), Touch of Grey has the opportunity to offset its preference liability with the "new value" amount. Under section 503(b)(9), Touch of Grey can also receive an administrative expense payment for goods provided twenty days prepetition. When both situations arise and are related, the question becomes whether Touch of Grey can be paid by an administrative expense and use that *same value* to offset its preference liability. *See In re Beaulieu Grp.*, 616 B.R. at 865-66. The answer is no.

These two Code sections work against each other where a creditor asserts the new value defense, and the debtor makes an "otherwise unavoidable" transfer on account of that new value. *Id.* at 866. The new value is expected to enhance the debtor's estate, and the new value defense allows an unsecured creditor to offset its preference liability from a previous transfer. This defense is only available if the creditor, or supplier, has credit remaining in the debtor's estate. *In re Check Reporting Servs.*, 140 B.R. at 437. If the supplier is repaid, in full, with an *unavoidable* transfer, then the supplier does not have any credit leftover to apply to a preferential claim offset. If the supplier is repaid, in full, with an *avoidable* transfer, then it is like the supplier never received repayment because the trustee can recover an avoidable transfer, and the supplier still has credit in the debtor's estate. The key to this analysis is whether that repayment of new value is an avoidable transfer or an unavoidable transfer.

The Eleventh Circuit has clearly stated that administrative expense payments under section 503(b)(9) are not avoidable, i.e., unavoidable. *Id.* at 869. Since the Code and the bankruptcy court authorizes administrative expense payments, they are not avoidable under section 549 or any other

section of the Code. *Id*. Therefore, the new value defense cannot be used to offset creditors' preference liability when that same amount is represented by the section 503(b)(9) claim. *Id.* at 878.

The policy considerations of the new value defense encourage creditors to continue lending to distressed debtors and promote equality among creditors. *TI Acquisition v. Southern Polymer*, (*In re TI Acquisition*), 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010). "[Section] 503(b)(9) claims deny the debtor and the debtor's estate the uninhibited use of new value." *Id.* The new value defense limits the claim amount to the extent the bankruptcy estate has been enhanced by the creditor's actions. *Id.* "If the estate is not enlarged, [then] no new value has been given." *Id.*

Here, Touch of Grey enlarged the Debtor's estate upon delivery of goods prepetition. When the Debtor later paid Touch of Grey in full with the court-approved administrative expense payment, the Debtor's estate is no longer enlarged by the delivery. Therefore, Touch of Grey has not given any new value for which it has yet to receive full credit and should not be entitled to the new value defense.

C. Where a debtor's estate is no longer enhanced by "new value," a creditor can no longer assert the new value defense.

Section 547(c)(4) has never been amended since its enactment in 1978. *In re Check Reporting Servs.*, 140 B.R. at 430. Without any changes to the statute, the policy considerations remain steadfast. The first policy consideration realizes the risk creditors bear when providing a distressed debtor with more unsecured liabilities. *In re TI Acquisition*, 429 B.R. at 384. The drafters wanted to encourage these creditors to continue lending to these debtors and discourage a "race to the courthouse" to recoup their monies. *Id.* The new value defense protects these creditors up to the amount of the prior preferential transfers and provides security through strict statutory language. *Id.* Creditors aware of the new value defense understand their risks but also consider the safeguard

this defense allows. *Id.* With some of the risk taken out of the equation, more creditors continue lending to debtors in arrears. *Id.* The availability of this defense depends on the ultimate impact on the debtor's estate. *Kroh Bros. Dev. Co. v. Continental Constr. Eng'rs*, (*Matter of Kroh Bros. Dev. Co.*), 930 F.2d 648, 654 (8th Cir. 1991).

However, a creditor cannot know when exactly a debtor will file for bankruptcy. *In re TI Acquisition*, 429 B.R. at 385. Without this knowledge, a creditor will not know whether it is operating within the preference window or not. *Id.* While the preference window occurs pre-petition, there are other protections for creditors post-petition. *Id.* An administrative expense has priority over other unsecured creditors; those get paid out second in priority. 11 U.S.C. § 507(a)(2). The administrative expense at issue here is found in section 503(b)(9). This section allows a creditor to get paid for goods provided to the debtor within twenty days prior to the petition date. 11 U.S.C. § 503(b)(9). But a creditor will not know to assert this administrative expense claim until after a bankruptcy case is filed. "From the creditor's pre-petition perspective, there is no difference in incentive if the new value defense the creditor may have relied on is lost as a result of a [section] 503(b)(9) claim." *In re TI Acquisition*, 429 B.R. at 385. Either the creditor may offset its preference exposure through the new value defense for pre-petition transfers, or the creditor will get paid in full with the priority of an administrative expense. Ultimately, creditors want to be repaid dollar for dollar rather than pennies on the dollar. *Id.* These two options for creditors allow them to be repaid in full which encourages creditors to continue doing business with debtors. *Id.* But the main policy rationale focuses on similarly-situated creditors being treated equally. *Id.*

Here, policy considerations align with the Trustee. Touch of Grey does not have a new value defense because the administrative expense payment is unavoidable. Policy reasons go against

allowing a creditor to use the same value twice, to get paid in two different ways—such as Touch of Grey keeping the administrative expense of $200,000, and reducing its preference exposure by that same amount too. The only way to maintain equality is to allow an administrative expense for a creditor to be repaid in full and reject the new value defense when both are at issue. Thus, plain statutory interpretation and policy bolsters the Trustee's position that Touch of Grey cannot offset its preference exposure with the re-use value of those same paid-for goods.

II. A TRUSTEE'S DUTY TO PERFORM UNDER LEASE OBLIGATIONS ENDS WHEN THE LEASE IS REJECTED.

Section 365(d)(3) mandates a trustee to "timely perform all obligations of the debtor… arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title." 11 U.S.C. § 365(d)(3). Many courts have wrestled with the language of this section. *See El Paso Props. Corp. v. Gonzales*, (*In re Furr's Supermarkets, Inc.*), 283 B.R. 60, 66 (B.A.P. 10th Cir. 2002). As with many other sections of the Bankruptcy Code, there are layers to peel back and policy reasons to consider when applying section 365(d)(3) to a trustee, or debtor-in-possession, who ultimately rejects their unexpired lease of nonresidential real property. *See Matter of Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1128 (7th Cir. 1998). The main issue under this section concerns timing and context surrounding a debtor's decision to reject the lease. *Id.*

Every bankruptcy case is unique, and bankruptcy courts across the nation bring distinct and nuanced perspectives to the bench when analyzing Code sections and applying them to the facts of the case. Over time, these differences cause circuit splits. Victoria Kothari, *11 U.S.C. § 365(d)(3): A Conceptual Status Argument for Proration*, 13 Am. Bankr. Inst. L. Rev. 297, 297 (2005). Since 1984, the enactment year of section 365(d)(3), the courts have yet to come to an agreement on the seemingly simple "when and how much" questions relating to the timing of the

assumption or rejection of the lease and the rent amount in dispute. *Id.* at 297-98. Without consensus, the courts have created a few approaches in interpreting and applying this section of the Code. *Id.* at 298. However, there is only one method that began prior to 1984 and continues in most courts today. *Id.* at 304; *In re Door to Door Storage, Inc.*, No. C17-1385RSM, 2018 WL 1899361, at *1 (W.D. Wash. Apr. 20, 2018). This approach, the "proration" approach, is the correct application because it benefits the debtor's estate while treating creditors equally.

Here, the Debtor and Touch of Grey have an unexpired lease of nonresidential real property, i.e., "Terrapin Station Coffeehouse." R. at 5. Within the first year, 2019, the Debtor experienced low sales and began to worry about paying the high monthly rent of $25,000. R. at 4-5. Rent was due on the first day of each month. R. at 4. Through the struggles, the Debtor remained current on the lease obligations. R. at 5. Eventually, the Debtor filed for bankruptcy on January 5, 2020. R. at 6. Over the next few months, the Debtor and Touch of Grey continued working together. R. at 7. When the COVID-19 pandemic hit in March 2020, the Debtor had to close temporarily. R. at 7. The following April, the world shutdown, and people were not visiting businesses as often as they used to. *See* R. at 7. By May, the Debtor could not afford rent payments. R. at 7. The Debtor closed its coffee shop, rejected the lease, returned the keys, and vacated the premises on May 5, 2020. R. at 7. Amid these unforeseen circumstances, Touch of Grey sued the Debtor for the full amount of May's rent, $25,000. R. at 7. The court hearing held on May 29, 2020 confirmed the lease rejection date of May 5, 2020, but did not rule on the amount of rent that is due. R. at 8. Because the Debtor only occupied the building for five days in May, Touch of Grey does not have a claim for rent after the Debtor rejected the lease because the Debtor's obligation to pay future rent ended on the date of rejection. The lower courts correctly agreed that the Debtor should only

pay a prorated rent amount for the five days prior to rejection instead of a full month's rent. R. at 9.

A. Conforming to the Code as a whole, section 365(d)(3) treats unperformed post-petition lease obligations on a pro-rata basis as they accrue.

By dissecting the language of section 365(d)(3) with key policy considerations in mind, the single, correct answer leads to applying the proration approach when a debtor rejects a lease five days into the month and immediately vacates the premises. Beginning with a statutory text analysis, the words are important, but where the words could have multiple interpretations, the statute becomes ambiguous. *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 68 (Bankr. S.D.N.Y. 2004). Where a statute is deemed ambiguous, courts turn to the legislative history to provide context behind the meaning of the statute. *Id.* Ultimately, policy rationales tip the scales in favor of the Debtor.

As the Supreme Court frequently reminds lower courts, statutory interpretation is a "holistic endeavor" which analyzes Code sections as part of a whole that aligns with its object and policy. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988); *In re Friedman's Inc.*, 738 F.3d at 554. Courts normally start with the language in the specific section before analyzing how other sections may work together. *See In re Furr's Supermarkets, Inc.*, 283 B.R. at 69; *In re Simbaki, Ltd.*, No. 13-36878, 2015 WL 1593888, at *2 (Bankr. S.D. Tex. Apr. 3, 2015).

The first phrase under section 365(d)(3) states "a trustee shall timely perform all of the obligations of the debtor…." While some courts think this part is clear, other courts have questioned the meaning of "timely." *Compare In re Simbaki, Ltd.*, 2015 WL at *2, *with In re Rhodes, Inc.*, 321 B.R. 80, 87 (Bankr. N.D. Ga. 2005). The courts who think this section is unambiguous have a strict, narrow view. *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 364

(Bankr. S.D.N.Y. 2008). These courts track the lease language precisely by forcing debtors to pay rent in full on the first of every month, as their lease requires, regardless of how many days of that month the debtor is occupying and using the premises. *See Koenig Sporting Goods, Inc. v. Morse Road Co.*, (*In re Koenig Sporting Goods, Inc.*), 203 F.3d 986, 989 (6th Cir. 2000). Other courts are sympathetic to distressed debtors with a broader interpretation of this phrase. *In re Rhodes, Inc.*, 321 B.R. at 87. One court held that "timely" does not mean "on time" but means "at an appropriate time." *Id.* In other words, an obligation for rent that occurs every first day of the month does not have to be paid on the same day for the payment to be considered "timely." *Id.*

The second and most contested phrase under section 365(d)(3) uses the language "…arising from and after the order of relief…." The word "arise" could refer to one snapshot in time or could insinuate increasing on an accrual basis. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 67. The strict, narrow viewers of this section deem an obligation arises by the terms of the lease. *In re Koenig Sporting Goods, Inc.*, 203 F.3d at 989. These courts fault the debtor for not rejecting the lease prior to the first of the month since they are the ones "in control." *Id.* Yet, there are other courts that recognize circumstances where a debtor does not have control like scheduling hearings or auctions. *See In re Stone Barn Manhattan LLC*, 398 B.R. at 368.

However, more forgiving courts analyze "arising" in an accrual fashion. *In re NETtel Corp.*, 289 B.R. 486, 490 (Bankr. D.D.C. 2002). Rather, rent can be accumulated daily by a measured amount and is not solely limited to the once-a-month payment. *In re Stone Barn Manhattan LLC*, 398 B.R. at 365. Upon a bankruptcy filing, the relationship between the now-debtor and landlord changes. *Id.* The post-petition, pre-rejection period gives the debtor time to decide whether to assume or reject the lease while the landlord continues to perform. *Id.* Within this time, the agreement is not immediately enforceable, and has a high likelihood of terminating

forever upon rejection. *Id.* Section 365(d)(3) promotes timeliness and sets the possible rent amount as provided in the lease, instead of establishing market rent rates. *Id.* at 362.

Another important phrase of this section sets a temporal limitation with "… until such lease is assumed or rejected…." While somewhat helpful, the confusion arises when trying to figure out whether this phrase refers to the word "perform" or "obligations," which are both in the first phrase. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 67. If the phrase modifies "perform," then it would support an absolutist view. *Id.* If the phrase modifies "obligations," then there is support for prorating rent payments. *Id.* Because obligations accrue over time, the obligations end when the lease is rejected and triggers prorated rent calculations.

This section ends with "notwithstanding section 503(b)(1) of this title," which gives landlords post-petition administrative expense claims. *In re Rhodes, Inc.*, 321 B.R. at 88. With this phrase, Congress intended to give landlords the right to collect rent during the post-petition, pre-rejection period. *Matter of Handy Andy Home Improvement Ctrs, Inc.*, 144 F.3d at 1128. There is no indication that Congress wanted landlords to have super priority over other unsecured creditors. *See id.*; *In re NETtel Corp.*, 289 B.R. at 488.

Ultimately, with this many variations in one subsection, the section is ambiguous, but with the help of legislative history and policy, the drafters' intent becomes clear. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 68. Section 365(d)(3) was added to the Code to resolve landlords' concerns. *Id.* Landlords dealt with the risk of waiting until conformation to possibly recover their administrative claims for post-petition rent. *Id.* Landlords had to provide the debtor with the property throughout the bankruptcy case which could go on for many months, possibly years. *Id.* Over this time, most landlords also had issues with losing the benefit of their bargain. *Id.* Prior to section 365(d)(3), rent was calculated at the fair market rental value and often dropped below the

originally bargained-for rent. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 68. Senator Hatch addressed the landlords' worries in an often-cited statement about section 365(d)(3)'s purpose—to encourage timely performance and fix the rent rate to the lease rather than the market. 130 CONG. REC. (1984), *as reprinted in* 1984 U.S.C.C.A.N. 576, 598-99 (statement of Sen. Hatch). Congress intended this section to put landlords on equal footing by removing prejudicial treatment but not award them a windfall at other creditors' expense. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 70.

Before section 365(d)(3), the landlords' hands were tied. *See Matter of Handy Andy Home Improvement Ctrs, Inc.*, 144 F.3d at 1128. They were not allowed to evict their tenants because of the automatic stay bankruptcy provides. *Id.* They previously had to prove their "actual, necessary" administrative expenses under section 503(b)(1). *Id.* They were unsure whether they would ever get repaid. *Id.* Now, with section 365(d)(3), landlords automatically obtain administrative expense claims for post-petition rents and require constant rent payments. *Id.*

It is important to give the statute some context. *Matter of Handy Andy Home Improvement Ctrs, Inc.*, 144 F.3d at 1128. Context gives life to the meaning behind the words. *Id.* With the split between the circuits, there are two main approaches the courts have applied section 365(d)(3) to. *In re Furr's Supermarkets, Inc.*, 283 B.R. at 66. One is the "proration" approach, and the other is known as the "billing date" approach. *Center Point Props. v. Montgomery Ward Holding Corp.*, (*In re Montgomery Ward Holding Corp.*), 268 F.3d 205, 214 (3d Cir. 2001) (Mansmann, dissenting).

1. *The "proration" approach applies the statutory language broadly and accommodates debtors.*

The proration approach, also known as the "accrual" approach, recognizes obligations that accumulate during the post-petition, pre-rejection period without any emphasis on the billing date.

In re GCP CT Sch. Acquisition, LLC, 443 B.R. 243, 255 (Bankr. D. Mass. 2010). A majority of courts prefer this approach because this rule is well-established by its application prior to the enactment of section 365(d)(3). *In re Montgomery Ward Holding Corp.*, 268 F.3d at 214. There is not any legislative history that suggests Congress intended to replace the proration approach with the billing date approach. *Id.* at 215. The proration approach aligns with the current statute and continues to provide landlords payment when their services are provided—no more and no less. *Id.* This approach supports earlier practice and better serves fundamental bankruptcy policies. *Id.* "Once a court has ordered a lease rejected in the midst of the month, neither the language of [section] 365(d)(3) nor its legislative history mandate the allowance of the full monthly rent as an administrative claim." *In re NETtel Corp.*, 289 B.R. at 497.

The key to the proration approach is to provide landlords payment for their current services in fair amount to the debtor while the debtor is occupying and using the leased property. *In re Stone Barn Manhattan LLC*, 398 B.R. at 364. Once the debtor vacates the property, the debtor is no longer using services provided which is why the debtor should not have to pay for unused services. *See id.* Usually dates in the lease are clear, and dates within a bankruptcy case are given high importance because the Code applies a multitude of temporal limitations. Therefore, it is likely that the date of rejection will be undisputed, as it is here. With these known dates, the proration approach is easy to apply. *Id.*

Here, the Debtor rejected the lease on May 5, 2020. R. at 7. Touch of Grey did not oppose rejection of the lease. R. at 8. Under the proration approach, the Debtor is only liable for the five days of the month the leased premises were occupied. The calculation would take the rent amount from the lease, $25,000, and divide it by the number of days in that month. Under these facts, $25,000 divided by thirty-one equals $806.45. Thus, rent of $806.45 accrues each day the Debtor

uses Touch of Grey's services. The Debtor used the premises for five days of the month, and $806.45 multiplied by five equals $4,032.25. Therefore, the Debtor should only be liable to Touch of Grey for $4,032.25 for May's rent—which the lower courts correctly held. Failure to prorate rent would lead to an absurd result. *In re Stone Barn Manhattan LLC*, 398 B.R. at 366.

2. The "billing date" approach harms debtors by harshly and narrowly applying the statutory language.

The billing date approach, also called the "performance rule," strictly and narrowly applies section 365(d)(3) by entitling landlords to rent payments on the exact due date. *In re Furr's Supermarkets, Inc.*, 283 B.R. at 67. The date the lease agreement makes rent due is the "billing date." *In Montgomery Ward Holding Corp.*, 268 F.3d at 212. To use the language in the statute, which is clear and ambiguous to those who use this approach, the debtor incurs an obligation to pay the full amount of rent on the date it arises under an unexpired lease of nonresidential property. *Id.* This rule aligns with what section 365(d)(3) literally says, without any context. *See In re Stone Barn Manhattan LLC*, 398 B.R. at 364.

Under this approach, courts believe debtors are in total control and plan when they will reject a lease. *In re Koenig Sporting Goods, Inc.*, 203 F.3d at 989. Therefore, if a debtor knows the date to pay rent is coming up, then the debtor should also know to reject the lease before the rent payment becomes due (so, the debtor should have known better since they know it all.) *Id.* However, allowing landlords to collect rent payments for a full month when a debtor vacates the property within the first week of the month creates a windfall for the landlord. *In Montgomery Ward Holding Corp.*, 268 F.3d at 214. The landlord would get paid for services that the debtor never used. Usually, rent payments are one of the largest debts owed, especially for a retail debtor. Thus, requiring a full rent payment for the use of one week would greatly diminish the debtor's estate and treat other creditors unfairly. *In re NETtel Corp.*, 289 B.R. at 490.

If the "billing date" applied to the facts of Touch of Grey's lease, the full amount of rent, $25,000, would be due May 1, 2020, without taking into consideration that the Debtor only remained on the premises for five days. Disregarding context around the Debtor's situation, especially during a global pandemic, is inhumane. Congress did not enact section 365(d)(3) to give additional cushions to the concerned landlords, instead this section brings all unsecured creditors to an equal, level playing field and protects the debtor from absurd results.

B. The proration approach is most consistent with the policy goals of the Bankruptcy Code by balancing the landlord's rights with those of the estate and its creditors.

A few common themes among most courts which apply the proration approach are the simple application, equality between creditors, and the history prior to section 365(d)(3) amendment. *Id.* With the statutory language, lease obligations "arise" as the obligations accrue, not when the bill is due. *In re Furr's Supermarkets, Inc.*, 283 B.R. at 70. These lease obligations accrue post-petition and pre-rejection. *Id.* While these landlords may find themselves as "involuntary" creditors, the purpose of section 365(d)(3) is to provide them with reasonable relief that does not supersede well-established bankruptcy principles. *Id.* at 68.

The proration approach protects both debtors and creditors simultaneously. Recalculating rent saves the debtor's estate money while paying creditors exactly what they have earned. As applied earlier, the numbers needed to follow this approach are easily found. With basic math, any court can effectively prorate rent to an amount that is fair, just, and equitable. *In re Stone Barn Manhattan LLC*, 398 B.R. at 366.

By paying obligations as they become due, the debtor's estate is only liable for current obligations. The billing date approach would inappropriately put all of debtor's eggs in one basket. With a monthly rent of $25,000, the Debtor's estate would be greatly depleted if the full amount

were required to be paid to Touch of Grey. If the landlord gets paid more than what it is owed, other unsecured creditors will receive less than their fair share—assuming there are any funds left to distribute. The proration approach is the only approach that aligns with the policy of protecting debtors and creditors equally. *Id.* at 367.

Protecting the debtor's estate is one side of the scales of bankruptcy justice, while fair and equal treatment of similarly-situated creditors is the other side. The billing date approach tips the scales in favor of one creditor. While this one creditor is detrimental for debtor's continued business life throughout a bankruptcy case, the creditor is not entitled to a windfall recovery under section 365(d)(3). *In re Ames Dep't Stores, Inc.*, 306 B.R. at 70. With the proration approach, the scales are evenly balanced because the debtor pays its current liabilities and creditors receive payment for exactly the amount of services provided.

The proration approach is the only approach that leads to an equitable result between debtor and creditors while preserving the Code's main policy of favoring debtor reorganization and rehabilitation. *In re Stone Barn Manhattan LLC*, 398 B.R. at 367. Because timing is everything in bankruptcy, when a debtor decides to reject a lease, the debtor's estate is relieved of any future, post-rejection obligations immediately. *In re NETtel Corp.*, 289 B.R. at 491. "Accordingly, there ought not be any administrative claim attributable to the estate's nonexistent right of occupancy during the post-rejection period, otherwise the estate will be saddled with a burden that rejection is designed to avoid." *Id.* at 492.

Reading section 365(d)(3) with context, legislative history, and policy rationales in mind, this section deals with obligations arising under an unexpired nonresidential lease for the debtor's right to continue using the leased premises for the time after the petition date and until the lease is ultimately rejected. *Id.* Additionally, the rent amount is what is listed in the lease and not what

the market rent rate is. *See id.* The proration approach is in the best interest of the estate. Because the proration approach is the only one that matches statutory interpretation and aligns with policy considerations, this Court should join the majority of courts which continue to apply prorated rent calculations for debtors, regardless of the billing date. Thus, this analysis leans in favor of Trustee and validates the lower courts' rulings.

CONCLUSION

For the foregoing reasons, this Court should AFFIRM the Thirteenth Circuit Court of Appeal's decision that section 547(c)(4) precludes a defendant from asserting the "new value" affirmative defense given a satisfied administrative expense under section 503(b)(9). Further, this Court should also AFFIRM that section 365(d)(3) does not require the liquidating trustee to satisfy lease obligations after the lease has been rejected and prorate the rent accordingly. Respondent requests that this Court affirm both decisions of the Thirteenth Circuit.

Respectfully submitted,

Team R42
Counsel for Respondent
DATED: January 20, 2022

APPENDIX A: Selected Sections from Title 11 of the U.S. Code

§ 365. Executory Contracts and Unexpired Leases

(d)(3)

The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period, except as provided in subparagraph (B). This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

§ 503. Allowance of Administrative Expenses

(b)(1)

After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—

(A) the actual, necessary costs and expenses of preserving the estate including--

(i) wages, salaries, and commissions for services rendered after the commencement of the case; and

(ii) wages and benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board as back pay attributable to any period of time occurring after commencement of the case under this title, as a result of a violation of Federal or State law by the debtor, without regard to the time of the occurrence of unlawful conduct on which such award is based or to whether any services were rendered, if the court determines that payment of wages and benefits by reason of the operation of this clause will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations, during the case under this title;

(B) any tax--

(i) incurred by the estate, whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, except a tax of a kind specified in section 507(a)(8) of this title; or

(ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case;

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph; and

(D) notwithstanding the requirements of subsection (a), a governmental unit shall not be required to file a request for the payment of an expense described in subparagraph (B) or (C), as a condition of its being an allowed administrative expense;

(b)(9)

the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

§ 507. Priorities

(a)(2)

The following expenses and claims have priority in the following order: …
Second, administrative expenses allowed under section 503(b) of this title, unsecured claims of any Federal reserve bank related to loans made through programs or facilities authorized under section 13(3) of the Federal Reserve Act (12 U.S.C. 343), and any fees and charges assessed against the estate under chapter 123 of title 28.

§ 547. Preferences

(a)(2)

In this section— …
"new value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation;

(c)(4)

The trustee may not avoid under this section a transfer—
to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--
(A) not secured by an otherwise unavoidable security interest; and
(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of
such creditor;

§ 549. Postpetition Transactions

(a)

Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate--
(1) that occurs after the commencement of the case; and
(2)(A) that is authorized only under section 303(f) or 542(c) of this title; or
(B) that is not authorized under this title or by the court.