N O T E S O N

DEBTOR/CREDITOR

R E L A T I O N S

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Bankruptcy Sale Extinguishes Lease

The federal bankruptcy statute permits the sale of a debtor's property "free and clear of any interest in such property." Presumably, this includes the interest of a tenant under a lease. However, if the debtor/landlord seeks to "reject" the lease, another section of the statute permits the tenant to pay the rent and remain on the leased premises for the duration of the term of the lease. Can the sale of the premises accomplish what the rejection cannot – dispossession of the tenant?

A federal appeals court in Chicago recently decided that protection of the tenant's right of possession must give way before the debtor's right to sell the property without the lease. The debtor, however, must provide "adequate protection" of the tenant's leasehold interest. In most cases, this means that the landlord must pay the tenant the value (determined by the court) of the lease from the sale proceeds of the property.

Although the case before the court involved a sale to an unrelated party, a debtor may be able to reach the same result by setting up its own new entity to act as purchaser. In this way, a debtor could buy out a lease at a price determined by a judge, rather than by a recalcitrant tenant.
Precision Industries v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.), 327 F.3d 537 (7th Cir. 2003).

Insider Loans Not Subordinated

Bankruptcy courts do not always look favorably on the repayment of loans that controlling shareholders make to their own corporations. Particularly where the corporation is insolvent and cannot borrow from any other source, courts have treated these "loans" as disguised equity contributions. In practical terms, this means that the insiders do not share in any distribution made to creditors from the assets of the bankrupt corporation.

In contrast, a recent Delaware case rejected creditor attempts to recharacterize insider loans as equity contributions, even though the corporations were insolvent and could not have borrowed from a disinterested lender.

The court reasoned that all of the proper formalities had been observed to document the loans. The loans did not contain unusual or unreasonable terms. There was no inequitable conduct. As a matter of policy, the court did not wish to discourage insider loans, "because it is the shareholders who are most likely to have the motivation to salvage a floundering company."
Cohen v. The KB Mezzanine Fund II (In re Submicron Systems Corp.), 291 B.R. 314 (Bankr. D. Del. 2003).

Withdrawal of Claim Unsuccessful

There can be a downside to filing a claim in a bankruptcy case. Sometimes a bankruptcy court will entertain certain suits by a debtor against a creditor only because the creditor voluntary participated in the case by filing the claim.

When this scenario occurred in a Florida bankruptcy court, the creditor sought to withdraw its claim in order to dismiss a counter suit that the debtor brought in the bankruptcy court. The court allowed the creditor to withdraw the claims, but determined that the withdrawal did not preclude the court from continuing to entertain the debtor's suit against the creditor.
The Academy, Inc. v. James, Hoyer, Newcomer & Smiljanich, P.A., 289 B.R. 230 (Bankr. D. Fla. 2003).

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