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## Administrative Expense Priority of Post-Petition Lease Payments

A recent decision, *Kimzey v. Premium Casing Equipment LLC*,<sup>1</sup> reveals growing tension over the appropriate post-petition treatment of a lessor's administrative expense claim if the debtor rejects the lease. *Kimzey* also highlights a circuit split over whether actual post-petition use of leased equipment is a condition precedent to the allowance of an administrative expense claim under § 503(b)(1)(A).

### Kimzey and the TransAmerican Test

The specialized oilfield equipment leased by the debtor in *Kimzey* was not used post-petition, but the debtor's principals decided to retain the equipment due to potential future use, the higher cost of renting similar equipment and a desire to protect the value of the company pending a potential § 363 sale, among other factors.<sup>2</sup> The § 363 sale was held, but the leased equipment was not sold, so the debtor moved to reject the lease after the sale.<sup>3</sup>

The lessor, Premium Casing Equipment LLC, asserted an administrative expense claim for the amounts owed under the lease between the petition date and the rejection (approximately \$58,000). The request was granted by the bankruptcy court for two primary reasons.<sup>4</sup> First, the bankruptcy court ruled that the leased equipment did not have to be used by the debtor to be "necessary" in the context of § 503(b)(1)(A) "if the business derived some other benefit from its retention."<sup>5</sup> Second, the bankruptcy court relied heavily on the exercise of the debtor's business judgment in deciding to retain the equipment (even though it was not used post-petition) and elected not to "second-guess that business judgment."<sup>6</sup>

The decision was upheld on appeal. The district court began by analyzing whether Premium had established a *prima facie* case for an administrative expense claim under § 503(b)(1)(A)<sup>7</sup> using a two-pronged test established by *In re TransAmerican*

*Natural Gas Corp.*<sup>8</sup> The first prong examines whether "the claim arises from a transaction with the debtor-in-possession."<sup>9</sup> Citing "[c]ase law throughout the country" and noting that an equipment lease represents "an ongoing exchange of benefits and obligations between the lessor and lessee," the district court concluded that pre-petition equipment leases are a form of post-petition transaction between the lessor/creditor and debtor.<sup>10</sup>

The second prong of the *TransAmerican* test is whether the leased equipment "enhanced the ability of the debtor in possession's business to function as a going concern."<sup>11</sup> The appellants in *Kimzey* (who were creditors) argued that it did not because no revenue was produced that enhanced the estate due to the lack of post-petition use of the equipment, and because the asset-purchaser did not purchase or assume the lease.<sup>12</sup> The appellants therefore asserted that there could be no benefit to the estate under the "plain meaning of the terms 'actual' and 'necessary'" in § 503(b)(1)(A).<sup>13</sup> In response, Premium argued that the debtor's continued post-petition access to the leased equipment was a "real benefit" to the estate, provided the debtor with additional capacity to serve customers, and enhanced the value of the company prior to the sale because renting similar equipment would have been more expensive.<sup>14</sup>

While the district court had no problem concluding that the first *TransAmerican* prong was satisfied, the court was forced to confront "[t]wo divergent lines of cases" in addressing the second *TransAmerican* prong and the fundamental question of whether actual use of the leased equipment was a prerequisite for an administrative expense claim.<sup>15</sup>

### Equitable Considerations Favor Lessor's Right to § 503(b)(1)(A) Claim

The first line of cases generally hold that a lessor is entitled to a post-petition administrative expense



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1 *Kimzey v. Premium Casing Equip. LLC*, 2018 WL 1321971 (W.D. La. March 14, 2018), appeal dismissed by *Matter of Kimzey Casing Serv. LLC*, 2018 WL 4870861 (5th Cir. June 1, 2018).

2 *Id.* at \*1-2.

3 *Id.*

4 *Id.* at \*3.

5 *Id.* (internal citation omitted).

6 *Id.* (internal citation omitted).

7 Section 503(b)(1)(A) provides in pertinent part as follows:

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

(1)(A) the actual, necessary costs and expenses of preserving the estate...."

8 *In re TransAm. Natural Gas Corp.*, 978 F.2d 1409 (5th Cir. 1992); *Kimzey*, 2018 WL 1321971, at \*3.

9 *Id.* at \*4.

10 *Id.* (internal citations omitted).

11 *Id.* at \*5. Compare to *In re Double G Trucking of the Arlatex Inc.*, 442 B.R. 684 (Bankr. W.D. Ark. 2010), in which the second prong of the *prima facie* test requires the claimant to show that the expense "benefited the estate in a demonstrable way." *Id.* at 687 (internal citations omitted).

12 *Kimzey*, 2018 WL 1321971, at \*5.

13 *Id.*

14 *Id.*

15 *Id.*

claim under § 503(b)(1)(A) for pre-rejection rent regardless of the debtor's actual use of the equipment.<sup>16</sup> This avoids the lessor being compelled to protect its position under, for example, § 362(d) by moving for relief from stay or under § 365(d)(2) by moving to require the debtor, within a specified period of time, to assume or reject the lease.<sup>17</sup> The court noted that a "creditor should have the right to assume that the debtor is utilizing the leased property for its intended purpose until the trustee rejects the lease."<sup>18</sup>

A foundational case in the first line of cases is *In re Sturgis Iron & Metal Co. Inc.*<sup>19</sup> In that case, the debtor leased a shredder "large enough to accommodate a school bus" for use in its business of recycling metal from scrapped vehicles.<sup>20</sup> Despite rejecting the lease just two months into the bankruptcy case, two post-petition lease payments had accrued in the amount of \$404,000, for which the lessor sought administrative expense treatment under § 503(b)(1)(A).<sup>21</sup> The creditors' committee objected, claiming that only a nominal administrative claim amount might be appropriate due to the minimal, if any, post-petition use of the shredder.<sup>22</sup> After a particularly thorough analysis, the bankruptcy court made the following conclusion:

[T]he bankruptcy estate, being now the recognized successor to the debtor's leasehold rights immediately upon the commencement of the case, must also now pay under Section 503(b)(1)(A) the agreed-upon rent due the lessor as an actual and necessary expense of preserving the estate's rights under the lease. Therefore, this court has no compunction in departing from what had been prior practice under the former Act to now award [the lessor] an administrative rent claim on this basis.<sup>23</sup>

Other examples cited in *Kimzey* as first-line cases include *In re Fred Sanders Co.*<sup>24</sup> and *In re Curry Printers Inc.*<sup>25</sup> *Kimzey* then contrasted the first line of cases with the second line of cases, including cases out of the Fourth and Tenth Circuits.

## Actual Use of the Leased Property Is a Condition Precedent to Assert a Claim

The second line of cases require actual use of the equipment and a concrete benefit to the estate, with "mere potential benefit to the estate" deemed to be insufficient grounds for an administrative expense claim.<sup>26</sup> In these cases, the rationale is to "minimize the overall administrative expenses of the estate to

protect the interests of all unsecured creditors."<sup>27</sup> One such case is *In re Mid Region Petroleum Inc.*<sup>28</sup> In that case, the debtor leased 70 railcars and retained possession of them after filing for chapter 11.<sup>29</sup> About seven months after the case was filed, the bankruptcy court granted the trustee's motion to reject the leases.<sup>30</sup> None of the railcars were returned to the lessor prior to rejection, and none of the railcars were used post-petition.<sup>31</sup>

The lessor sought an administrative expense claim for post-petition rents due under the leases.<sup>32</sup> The bankruptcy court disallowed the claim, and the district court affirmed.<sup>33</sup> The lessor argued that the estate received a benefit from the retention of the railcars because it was "spared the trouble and expense of deciding whether to reject or allow the lease early in the case," thus facilitating the resumption of business operations or the sale of the company with the leases still existing.<sup>34</sup> This argument was unpersuasive to the court of appeals in the absence of the debtor's actual use of the railcars, and it declined to award administrative expense status for "mere possession," noting that one of the goals of chapter 11 is to minimize administrative costs in order to preserve a debtor's resources.<sup>35</sup> Moreover, the court of appeals was wary of "creating tremendous pressure upon debtors to reject as many contracts as quickly as possible" to avoid being saddled with full contract obligations before acceptance or rejection.<sup>36</sup>

*Ford Motor Credit v. Dobbins*,<sup>37</sup> which featured a contested administrative expense claim based on the decrease in value of real estate,<sup>38</sup> is also cited in *Kimzey* as a second-line/actual-use case. In *Ford Motor Credit*, the court concluded *inter alia* that the terms "actual" and "necessary" in § 503(b) "must be observed with scrupulous care," declared that a narrow construction of the statute was necessary, and concluded that there is a "critical distinction between an actual benefit to the estate resulting from the actual post-petition use of collateral and a potential benefit to the estate resulting from a debtor's mere possession of [the] collateral."<sup>39</sup>

## Lessor Can Have an Administrative Expense Claim Without the Debtor's Actual Use of the Leased Property

*Kimzey* sided with the first line of cases and affirmed the bankruptcy court's allowance of Premium's administrative expense claim in the absence of a "bright-line rule" on the issue in the Fifth Circuit.<sup>40</sup> The court determined that certain "intangible benefits" to the estate were present in the form of increased capacity to use the equipment to respond to customer demand and the ability to use the equipment should other equipment experience problems, notwithstanding the

16 *Id.*

17 *Id.*

18 *Id.* (internal citations omitted).

19 420 B.R. 716 (Bankr. W.D. Mich. 2009). This case is notable due to the substantial historical perspective of the Bankruptcy Code, statutory history and pre-Code case law relating to § 503(b)(1)(A). It is also notable for the inclusion of an extensive footnote on plate tectonics ("the now widely recognized theory that involves the gradual drift of continents over the Earth's subsurface") in a bankruptcy opinion. *See id.* at 748 n.62.

20 *Id.* at 718.

21 *Id.*

22 *Id.* at 718-19.

23 *Id.* at 756.

24 22 B.R. 902, 906 (Bankr. E.D. Mich. 1982) ("To permit a debtor to deprive a lessor of the use of his property and unilaterally dictate the amount of the lessor's claim does not comport with elementary notions of justice.").

25 135 B.R. 564, 584 (Bankr. N.D. Ind. 1991) (allowing administrative expense claim for post-petition, pre-rejection payments, but expressly limiting its holding to "a Chapter 11 case, involving rental equipment, where the Debtor either uses or actually physically possesses the equipment"). *Compare with In re Carmichael*, 109 B.R. 849 (Bankr. N.D. Ill. 1990) (actual-use case contrary to the holding in *Curry*).

26 *Kimzey*, 2018 WL 1321971, at \*6 (internal citations omitted); *see also In re Bridgeport Plumbing Prods. Inc.*, 178 B.R. 563, 567 (Bankr. M.D. Ga. 1994) (referring to adoption by Eleventh Circuit of "actual use/resulting benefit method" of determining lessor's claim).

27 *Kimzey*, 2018 WL 1321971, at \*6.

28 1 F.3d 1130 (10th Cir. 1993).

29 *Id.* at 1131-32.

30 *Id.* at 1132.

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.* at 1133.

35 *Id.* at 1133-34.

36 *Id.* at 1134.

37 35 F.3d 860 (4th Cir. 1994).

38 *Id.* at 863-64.

39 *Id.* at 866-67 (internal citations omitted).

40 *Kimzey*, 2018 WL 1321971, at \*6.

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# On the Edge: Administrative Expense Priority of Post-Petition Lease Payments

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lack of use of the equipment.<sup>41</sup> A notable characteristic of *Kimzey* is the district court's deference to the debtor's business judgment<sup>42</sup> in retaining the equipment, which deference was likewise shown earlier by the bankruptcy court:

[Kimzey Casing Service LLC] made an affirmative business decision at the highest level of the company to retain the two pieces of equipment so that [Kimzey Casing Service LLC] would have unfettered access to the equipment to maintain their business after filing for bankruptcy. [The debtor's president and post-petition interim CEO] presumably were in the best position to know whether the equipment would benefit the estate, and they felt that it would.<sup>43</sup>

To bolster its intangible-benefit analysis, the district court also noted that administrative-expense claims can be approved in the absence of a direct financial benefit to the estate in other contexts.<sup>44</sup>

## Conclusion

Under *Kimzey*, the *potential* benefit that unused leased equipment could have to an estate is sufficient to justify an administrative expense claim for post-petition rent *if* that potential benefit is recognized by the debtor's decision-makers. Actual use of the equipment producing a measurable benefit to the estate is not required. Debtors in the Fifth Circuit (and probably the Sixth Circuit in light of *Sturgis*) should be decisive early on regarding the assumption or rejection of equipment leases, lest their reorganization efforts be upended by potentially large administrative expense claims. Lessors in these circuits have greater leverage to obtain administrative expense status for unpaid, pre-rejection rent.

Courts in the Fourth, Tenth and Eleventh Circuits focus primarily on the terms "actual" and "necessary" in § 503(b)(1)(A) and require actual use of the leased equipment as a condition for an administrative expense claim. The lessor should inquire early (*e.g.*, at the § 341 meeting of creditors) whether the debtor is using the equipment. If not, then lessors should seriously consider filing a motion under §§ 362(d) or 365(d)(2) to make the debtor admit that it is using the equipment, or force the debtor into an earlier assumption or rejection decision. **abi**

<sup>41</sup> *Id.* at \*6.

<sup>42</sup> Bankruptcy courts employ the business-judgment standard when reviewing a debtor's decision to assume or reject an executory contract. *See, e.g., In re Penn Traffic Co.*, 524 F.3d 373, 383 (2d Cir. 2008).

<sup>43</sup> *Kimzey*, 2018 WL 1321971, at \*7.

<sup>44</sup> *Id.* (citing *In re H.L.S. Energy Co.*, 151 F.3d 434 (5th Cir. 1998) (involving legal obligation of trustee to incur cost to plug inactive oil wells); *In re ATP Oil & Gas Corp.*, 2014 WL 1047818 (Bankr. S.D. Tex. March 18, 2014) (involving post-petition repair and maintenance work on shuttered oil production platform performed under contract with debtor allowed as administrative expense)). *ATP Oil* is another example in the Fifth Circuit where the bankruptcy court refused to second-guess the debtor's business judgment and awarded administrative expense status to almost \$650,000 owed for post-petition service work. *Id.* at \*6.

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