

# FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

SAN FERNANDO VALLEY DIVISION

FILED & ENTERED

JUL 09 2012

In re:

The Leather Factory Inc

Case No.: 1:05-bk-18708-GM  
UNITED STATES BANKRUPTCY COURT  
Central District of California  
BY gasparia DEPUTY CLERK

Chapter 7

Debtor(s).

**MEMORANDUM OF OPINION  
DENYING MOTION TO DISALLOW CLAIM  
NUMBER 211-1 OF VARLOW  
ENTERPRISES AND CLAIM NUMBER  
60 OF CREDITOR HARRY ROSS  
INDUSTRIES AND DENYING SANCTIONS**

Date: June 19, 2012

Time: 10:00 a.m.

Courtroom: 303

On October 12, 2005, the Leather Factory filed its chapter 11 petition. At the time that it filed, the Leather Factory was a vertically integrated company that manufactured and sold custom leather furniture built in its Montebello, California factory and sold in its twelve retail stores located throughout California. The schedules showed \$22,000+ in secured claims, \$269,000+ in unsecured priority claims, and \$4.6+ million in unsecured claims (of which about \$2 million was owed to non-insiders). The assets (all personal property) were valued at \$2.3 million.

A creditors' committee was appointed and the debtor was immediately subject to a series of motions for relief from stay by the landlords. It rejected some leases as early as December 2005 and continued to operate as a debtor-in-possession until its case was converted to chapter 7 on March 9, 2007. David Seror was appointed as the trustee and he continued to oversee a series of avoidance power actions as well as carry out the other duties required of the trustee.

1 As of February 2012, the trustee had \$236,000 in cash. He anticipated that the  
2 chapter 7 costs of administration would be about \$74,000. After reviewing the  
3 administrative claims, he determined that the case was administratively insolvent and  
4 that the chapter 11 administrative claimants would be paid only about 13.5% of their  
5 claims. The trustee accordingly sought disgorgement from chapter 11 professionals  
6 who had previously received interim payments in excess of 13.5% of their allowed  
7 administrative claims. One of the firms from which disgorgement is sought is the  
8 Friedman Law Group, P.C. ("Friedman"), chapter 11 counsel to the debtor.  
9

10 The trustee concluded that, other than some duplicates, the chapter 11  
11 administrative claims appeared to be legitimate and that he would not be filing  
12 objections. However, the trustee did not oppose Friedman filing objections to claims,  
13 since Friedman is an interested party who is trying to reduce the amount of the required  
14 disgorgement.  
15

16 In January 2012, Friedman filed a series of objections to the chapter 11  
17 administrative claims of the former landlords, on a variety of grounds. All except two of  
18 these objections have been resolved, and the facts of these two remaining claims –  
19 those of Harry Ross Industries ("HRI") and Andrew Varlow dba Varlow Enterprise  
20 ("Varlow") – are substantially similar. These last two objections focus on whether rent  
21 for the period immediately after the petition date until the first post-petition lease  
22 payment came due ("stub rent") is a pre-petition unsecured claim or an administrative  
23 claim, whether the security deposit must be applied toward the landlord's unsecured  
24 claim or its administrative one, and whether the landlord is entitled to its attorneys' fees  
25 and the amount of those fees. The landlords have responded to Friedman's objections  
26 and also sought sanctions.  
27  
28

STUB RENT

The bankruptcy was filed on October 12, 2005 and the next rent payment under the leases was due on or after November 1, 2005. Neither HRI nor Varlow had been paid the October rent prior to bankruptcy. The issue is whether the unpaid rent for the post-petition portion of October 2005 is a pre-petition obligation or whether it is entitled to an administrative priority. Bankruptcy Code §365(d)(3) requires the trustee to perform all lease obligations “arising” post-petition and grants such obligations administrative claim status, but there is a split between Circuit Courts of Appeals over whether leasehold obligations “arise” under §365(d)(3) when they are due (in this case on October 1, making them pre-petition) or when they accrue (in this case, over the month of October, making rent from October 12-31 post-petition and entitled to administrative status).

This split between circuit courts is over a single sentence in 11 U.S.C. §365(d)(3), which states that the “trustee shall timely perform all the obligations of the debtor, except those specified in §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.”<sup>1</sup> Prior to the amendment of the Bankruptcy Code adding this section, although landlords were entitled to post-petition rent, etc. as an administrative expense, the burden was on the landlord to seek collection rather than on the debtor to make the payments. Payments could be delayed at the discretion of the bankruptcy judge and could be less than the contract amount. While it is universally agreed that §365(d)(3) was intended to alleviate the landlord’s burden and risk regarding post-petition lease

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<sup>1</sup> All statutory citations are to 11 United States Code, unless otherwise noted.

1 payments by shifting it to the trustee or debtor-in-possession,<sup>2</sup> the Third and Seventh  
2 Circuits (and a number of lower courts) have disagreed on the standard for whether a  
3 lease obligation “arises” post petition. This split follows an ongoing debate as to  
4 whether the language of §365(d)(3) is ambiguous or not.

5  
6 A number of courts, led by the Third Circuit, have found the language of  
7 §365(d)(3) to be unambiguous and to compel the result that obligations must be paid at  
8 the time they are due under the lease. Concluding that the obligation “arises under a  
9 lease for the purposes of §365(d)(3) when the legally enforceable duty to perform arises  
10 under the lease,” the Third Circuit reluctantly adopted the billing approach rather than  
11 the pre-Code proration approach. Centerpoint Props. v. Montgomery Ward Holding  
12 Corp. (In re Montgomery Ward Holding Corp.), 268 F.3d 205, 211 (3d Cir. 2001); see  
13 also, e.g., Burival v. Creditor Comm. (In re Burival), 406 B.R. 548, 553 (B.A.P. 8th Cir.  
14 2009)(rent); In re Krystal Co., 194 B.R. 161, 163-64 (Bankr. E.D. Tenn. 1996)(property  
15 tax obligations).

16  
17 On the other hand, those courts who find §365(d)(3) to be ambiguous look to the  
18 issues of equity and of bankruptcy policy and generally apply the “accrual” method to  
19 the question of when rent and tax obligations arise post-petition. See, e.g., Heathcon  
20 Holdings v. Dunn Indus. (In re Dunn Indus.), 320 B.R. 86, 89-90 (Bankr. D. Md. 2005);  
21 (property tax obligations); In re Travel 2000, Inc., 264 B.R. 444 (Bankr. W.D. Mich.  
22 2001)(rent). In the context of a tax obligation that had already accrued but which the  
23 debtor was not obligated to pay to the landlord until it was actually billed, the Seventh  
24 Circuit held that the  
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<sup>2</sup> For ease, the term “trustee” is used throughout this opinion even though duties of a trustee are placed on a debtor-in-possession. § 1107(a).

1 'billing date' approach is a possible reading of section 365(d)(3), but it is neither  
2 inevitable nor sensible. It is true that Handy Andy's obligation to National to pay  
3 (or reimburse National for paying) the real estate taxes did not crystallize until the  
4 rental due date after the taxes were paid. But since death and taxes are  
5 inevitable and Handy Andy's obligation under the lease to pay the taxes was  
6 clear, that obligation could realistically be said to have arisen piecemeal every  
7 day of 1994 and to have become fixed irrevocably when, the last day of the year  
8 having come and gone, the lease was still in force. . . .

9 . . . .  
10 . . . Handy Andy's debt to National for 1994 and earlier 1995 taxes relates  
11 entirely to an earlier period, and is thus no different from its debts to trade  
12 creditors for supplies that it bought in 1994 but never paid for. . . .

13 In re Handy Andy Home Improvement Ctrs., 144 F.3d 1125, 1127 (7th Cir. 1998). The  
14 court found the accrual approach more sensible than the billing date approach because  
15 it tracks the purpose of the Bankruptcy Code by giving post-petition creditors a high  
16 priority so as to keep the debtor operating for as long as possible. Id.

17 Timing is crucial and increases the complexity of this interpretation issue. In  
18 Handy Andy the estate was benefitted under the accrual method because it classified  
19 the landlord's claim for taxes as pre-petition, even though it was contractually billed to  
20 the debtor post-petition. The facts of this case would work in an exactly opposite  
21 manner: the estate would benefit under the billing date method since the entire October  
22 rent payment would be classified as pre-petition.

23 At the back-end of the §365(d)(3) period, Courts of Appeals have used a more  
24 uniform approach: they have denied the trustee's request to prorate rent that comes  
25 due immediately before the rejection, but actually covers a period beyond the rejection.  
26 The courts find no ambiguity in the language of §365(d)(3) on this point. Although this  
27 rule provides a windfall to the landlord at the expense of other creditors, the statute is  
28 clear and the control of the date of rejection is in the hands of the trustee, not of the  
landlord. For example, in HA-LO Industries v. CenterPoint Properties Trust, 342 F.3d  
794 (7th Cir. 2003), the rent was due on November 1 and the rejection took place on

1 November 2. The Seventh Circuit required the debtor to pay its November rent in full  
2 and distinguished its Handy Andy opinion by limiting Handy Andy to non-rent "sunk  
3 costs" that relate to a time before the bankruptcy case, as opposed to rent arising wholly  
4 post-petition, which is the consumption of a resource during the administration of the  
5 case.  
6

7 The Sixth Circuit reached the same result on similar facts in Koenig Sporting  
8 Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.), 203 F.3d 986 (6th  
9 Cir. 2000)(rejection on second day of month, rent due on first). Citing legislative history,  
10 the court noted that the purpose of §365(d) was to "to relieve the burden placed on  
11 nonresidential real property landlords (or 'landlords') during the period between a  
12 tenant's bankruptcy petition and assumption or rejection of a lease." Id. at 989. The  
13 Koenig court found that the debtor or trustee was in control of the landlord's right to  
14 payment of the December rent since it could have rejected the lease two days earlier  
15 and would not have been obligated to pay for December. Thus equity as well as the  
16 statute favored the landlord.  
17

18 Because the courts are split on the issue of stub rent, I specifically asked for  
19 Ninth Circuit authority, which Friedman failed to provide. The only case in the Ninth  
20 Circuit that Friedman cites, In re Designer Doors, Inc., 389 B.R. 832 (Bankr. Ariz. 2008),  
21 does not deal specifically with stub-rent. Designer Doors notes that there is not yet a  
22 preferred approach in the Ninth Circuit for determining which lease obligations should  
23 be treated as administrative priorities, but gives a well-reasoned analysis on why the  
24 court should only give administrative priority status to payments or performance due  
25 after the petition is filed.  
26  
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1 The only Ninth Circuit appellate opinion anywhere near on point is TreeSource  
2 Indus. v. Midway Engineered Wood Prods. (In re TreeSource Indus.), 363 F.3d 994 (9th  
3 Cir. 2004), which discusses a situation where the obligation did not arise until the lease  
4 was terminated. However the court noted that for tax and rent obligations "the relevant  
5 time to determine whether the obligation is pre- or post-petition is when the obligations  
6 accrue and not necessarily when performance must take place. . . ." Id. at 998.  
7 Although this statement is dicta (and thus ignored by Designer Doors), I believe that it  
8 must be considered in issues of back-end obligations at the end of the lease or on  
9 rejection, though not necessarily in dealing with stub rent.  
10

11 In re Picturesque, L.L.C., 2006 Bankr. LEXIS 3689 (Bankr. D. Ariz. Dec. 22,  
12 2006), never mentions TreeSource, which preceded it by two years, but notes the circuit  
13 split between the Seventh Circuit and the Third Circuit and follows the slight majority of  
14 cases that accept the proration (as opposed to the billing) theory for stub rent.  
15

16 While I agree that there is little or no ambiguity in §365(d)(2) on the rejection end  
17 of the lease and that, as a matter of equity, the date of rejection is solely in the hands of  
18 the debtor and the debtor should have realized the implications of the date chosen, I do  
19 not think the language of §365(d)(3) or the equities are so clear on stub rent at the front  
20 end. Accordingly, it is appropriate to look to the legislative intent. Congress intended to  
21 shift the burden from the landlords for the debtor's use of their property. To allow "stub  
22 rent" to be considered as a pre-petition unsecured claim gives a windfall to the debtor  
23 and its administrative creditors at the expense of the landlord, who has no ability at that  
24 time to evict because of the automatic stay. I find that the rent for the days after the  
25 filing of the petition until the next lease payment is due are an administrative claim  
26 under §365(d)(3) in a prorated amount of a full monthly lease payment, in accord with  
27  
28

1 TreeSource and that slight majority of courts following the accrual rule. To rule  
2 otherwise would reward the estate to the detriment of the landlord, which was not the  
3 intent of Congress.

4 Landlords also argue that the use of the premises during the "stub" period would  
5 be an administrative claim under §503(b), even if §365(d)(3) does not clearly make it so  
6 (since §365(d)(3) only deals with the requirement of the trustee to act and does not  
7 categorize the claim). In re Sportsman's Warehouse, Inc., 436 B.R. 308 (Bankr. D. Del.  
8 2009); see also In re Goody's Family Clothing Inc., 610 F.3d 812 (3d Cir. 2010) ("We  
9 hold that §365(d)(3) does not supplant § 503(b) and the Landlords are entitled to "stub  
10 rent" as an administrative expense."). While this is a very sensible argument, it flies in  
11 the face of Cukierman v. Uecker (In re Cukierman), 265 F.3d 846 (9th Cir. 2001)(citing  
12 Towers v. Chickering & Gregory (In re Pacific-Atlantic Trading Co.), 27 F.3d 401 (9th  
13 Cir. 1994)):

14  
15  
16 We have held that claims arising under §365(d)(3) are entitled to administrative  
17 priority even when they may exceed the reasonable value of the debtor's actual  
18 use of the property. See Pacific-Atlantic, 27 F.3d at 405. We did so because the  
19 "notwithstanding section 503(b)(1)" proviso exempts the amount of lease  
20 obligations that a trustee must timely pay under §365(d)(3) from §503(b)(1)'s  
21 limitation of administrative expenses to the fair value of the debtor's use of the  
22 property. Id. When the trustee fails to pay an obligation, the amount accorded  
23 administrative priority is similarly not subject to the §503(b)(1) limitation. Id. We  
24 reasoned that to hold otherwise would reward trustees for failing to perform lease  
25 obligations, a result entirely at odds with §365(d)(3)'s purpose of ensuring prompt  
26 payment for landlords. Id.

27 Cukierman, 265 F.3d at 850. Even though post-petition lease claims seem to fall under  
28 the definition of an administrative claim in §503(b), these claims are granted priority  
under §365(d)(3) and it is questionable whether a post-petition use of the premises can  
qualify under §503(b) if it is disqualified under §365(d)(3). But since I find that the  
landlords are entitled to their stub rent as an administrative priority under §365(d)(3), I  
need not analyze the §503(b) issue at this time.



SECURITY DEPOSIT

Friedman argues that HRI's security deposit should be applied against HRI's administrative claim for post-petition rent, rather than the unsecured claims for pre-petition arrearages and lease rejection pursuant to Bankruptcy Code §502(b)(6). (Varlow had applied its security deposit prior to the petition date and thus the issue is moot since it already reduced the pre-petition claim and the security deposit never became property of the estate.) HRI does not dispute that the security deposit can reduce the amount of its claims, but argues that it is the pre-petition arrearages or rejection claims that are affected, not the administrative claim.

The application of the security deposit is governed by the terms of the lease. The applicable provision, paragraph 5 of the HRI lease, provides that the security deposit may be applied by the landlord if the lessee fails to pay rent, or otherwise defaults under the lease.<sup>3</sup> There is no requirement that it be applied at all, although at the termination or expiration of the lease it must be either applied or returned to the lessee. The security deposit is not in trust and is property of the estate, but is clearly meant to be used to protect the landlord against a default.

Without the bankruptcy, there would be no issue since there would be a single claim for default under the lease. But the bankruptcy actually creates three separate categories of claims (a general unsecured claim for pre-petition arrearages, a general unsecured claim for rejection damages under §502(b)(6), and an administrative claim for post-petition damages). The lease does not deal with how to apply the security deposit in case of a bankruptcy filing by the tenant. Without direction from the lease, the Court considers applicable law.

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<sup>3</sup> Legible copies of this portion of the lease has been filed as Exhibit 1 to Amended Claim #60-2 (HRI).

1 Section 502(b)(6) Cases

2 Most cases decided under Bankruptcy Code §502(b)(6) are not directly relevant  
3 to the question at hand. A number of cases have applied security deposits to reduce  
4 §502(b)(6) rejection damages, but they start from the premise that the security deposit  
5 will be applied against rejection damages. The issue in those cases is whether the  
6 deposit should be applied against the rejection claim (i) prior to limiting the claim under  
7 the §502(b)(6) cap or (ii) after the rejection claim is capped, having the effect of  
8 reducing the statutory rejection claim. They have not explicitly considered the rights of  
9 the landlord to apply the deposit to the rejection damages claim (or other pre-petition  
10 claims) *as opposed to* applying it to an administrative claim for post-petition rent.  
11

12 Oldden v. Toronto, 143 F.2d 916 (2d Cir. 1944), a pre-Code case, is the model  
13 for the post-Code holdings. It considers whether a security deposit should be deducted  
14 from the total claim or from the “allowable” claim for damages due to the post-petition  
15 rejection of the lease (calculated under then 11 U.S.C. §63, sub. A(9), which limits the  
16 claim for future rents). Oldden holds that the landlord must apply the security deposit to  
17 the “allowable claim” as capped by §63, as it would be unfair to give the landlord the  
18 large rejection claim without taking into consideration and applying the security deposit  
19 to it.  
20

21  
22 Legislative history indicates that Congress intended to uphold Oldden when it  
23 enacted §502(b)(6). The House and Senate Reports read in relevant part:

24 The history of this provision is set out at length in Oldden v. Tonto Realty Co. . . .  
25 It is designed to compensate the landlord for his loss while not permitting a claim  
26 so large (based on a long-term lease) as to prevent other general unsecured  
27 creditors from recovering a dividend from the estate. The damages a landlord  
28 may assert from termination of a lease are limited to the rent reserved for the  
greater of one year or ten percent of the remaining lease term, not to exceed  
three years . . . . This subsection does not apply to limit administrative expense  
claims for use of the leased premises to which the landlord is otherwise entitled.

1 This paragraph will not overrule Oldden, or the proposition for which it has  
2 been read to stand: To the extent that a landlord has a security deposit in excess  
3 of his claim allowed under this paragraph, the excess comes into the estate. . . .  
4 As under Oldden, he will not be permitted to offset his actual damages against  
5 his security deposit and then claim for the balance under this paragraph. Rather,  
6 his security deposit will be applied in satisfaction of the claim that is allowed  
7 under this paragraph.

8 H. Rep. No. 95-595, 95th Cong., 1st Sess. 353-54 (1977); S. Rep. No. 95-989, 95th  
9 Cong., 2d Sess. 63-64 (1978).

10 Post-Code cases have generally followed Oldden: when applying security  
11 deposits to rejection damages claims, they have done so after the §502(b)(6) cap has  
12 been applied, essentially reducing the amount of statutory damages under §502(b)(6).  
13 See, e.g., AMB Prop. v. Official Creditors Committee of AB Liquidating Corp. (In re AB  
14 Liquidating Corp.), 416 F.3d 961 (9<sup>th</sup> Cir. 2005); In re All for a Dollar, 191 B.R. 262, 264  
15 (Bankr. D. Mass. 1996)(quoting legislative history at length); Redback Networks, Inc. v.  
16 Mayan Networks Corp. (In re Mayan Networks Corp.), 306 B.R. 295 (9th Cir. BAP 2004)  
17 (deducting not only cash security deposits but also draws on letters of credit against the  
18 statutory rejection claim, so long as the letter of credit draw had the effect of reducing  
19 estate assets). In Mayan, although the landlord had filed an administrative priority claim  
20 for over \$50,000, neither the parties nor the court dealt with the possibility that the  
21 security deposit should be credited toward that portion of the claim.

22 The second paragraph of the legislative history quoted above arguably extends  
23 the meaning of Oldden beyond both its original holding and the holdings of this line of  
24 cases: not only *how* security deposits should be applied against §502(b)(6) rejection  
25 claim, but also *that* security deposits should be applied against §502(b)(6) rejection  
26 claims.

#### 27 Section 365(d)(3) Cases

28 Several cases under Bankruptcy Code §365(d)(3) offer more guidance and  
explicitly consider whether a security deposit should be applied against administrative

1 claims for post-petition rent under §365(d)(3) or against pre-petition claims (whether  
2 pre-petition arrearages or rejection claims). These cases have uniformly held that the  
3 security deposits should be applied against the general unsecured claims (whether for  
4 pre-petition arrearages or statutory rejection damages).

5  
6 In re PYXSYS Corp., 288 B.R. 309 (Bankr. D. Mass. 2003) deals with a trustee  
7 who wished to setoff the security deposit against both an administrative claim for post-  
8 petition rent under §365(d)(3) and use and occupancy charges under §503(b). After  
9 determining the amount of the administrative claim, the court held that it was clearly  
10 Congress's intent that the security deposit be applied to the pre-petition arrearages and  
11 lease rejection damages and not to post-petition claims. Id. at 319. The PYXSYS court  
12 read the second paragraph of §502(b)(6)'s legislative history quoted above as authority  
13 not only for applying the security deposit against the capped amount of the rejection  
14 claim, but also for applying the security deposit against the §502(b)(6) rejection  
15 damages in the first place (and not against administrative claims). Id. at 319. See also  
16 In re All for a Dollar, 191 B.R. at 264 ("[T]he legislative history of §502(b)(6) signals  
17 Congress' intention not to reduce the statutory cap by postpetition rentals and not to  
18 categorize security deposits and postpetition rentals together.").

19  
20  
21 In re Far West Corp., 120 B.R. 551 (Bankr. E.D. Cal. 1990) was similar to this  
22 case before the Court because the landlord was seeking post-petition rents, interest and  
23 attorneys' fees as an administrative claim and it concerned the proper application of a  
24 security deposit paid to the landlord at the initiation of the lease over ten years before  
25 the bankruptcy. In that case the parties agreed that generally a security deposit could  
26 not be applied against a post-petition administrative rent claim, but should be applied  
27 against any pre-petition, unsecured claim of the landlord. But the debtor argued that the  
28

1 deposit was really payment of the last two months of rent under the lease and thus  
2 should be offset against the landlord's post-petition claims. The court reviewed the  
3 lease and determined that the security deposit was to be applied to the last two lease  
4 payments only if the debtor was not in default under the lease. Since there were  
5 substantial pre-petition defaults, the option to use the security deposit for the last two  
6 lease payments had lapsed and so it was to be applied to the outstanding pre-petition  
7 rent payments. Id. at 553.

9 Finally, Pereira v. Rich Taubman Assocs. (In re KP Fashion Co.), 2011 U.S. Dist.  
10 LEXIS 96466 (S.D.N.Y. Aug. 26, 2011) concerned a security deposit in the form of a  
11 standby letter of credit. It is factually confusing since it seems that the landlord drew on  
12 the letter of credit (possibly prior to the bankruptcy) and applied it to its pre-petition debt.  
13 The trustee apparently sought to recharacterize this draw so that it would be applied to  
14 the administrative claim. The court, citing to PYXSYS and Far West, held that it was  
15 proper for the landlord to apply this letter of credit draw/security deposit to the pre-  
16 petition claim, rather than the administrative claim.

#### 18 Setoff Cases

19  
20 A different line of cases has analyzed the rights of debtors to setoff security  
21 deposits against landlords' administrative claims. These cases have concluded that the  
22 pre-petition security deposits and post-petition administrative claims lack mutuality of  
23 obligation and cannot be set off. They generally assume or conclude that the security  
24 deposit *can* be set off against pre-petition arrearage claims and rejection damages,  
25 consistent with Colliers. 5 Collier on Bankruptcy ¶ 553.03 [3][c][iii] (“[A] landlord may  
26 offset a security deposit against a claim for pre-petition rent . . .”).  
27

28 In re Genuity Inc., 323 B.R. 79 (Bankr. S.D.N.Y. 2005) involved security deposits

1 under a variety of telecommunications contracts. As the court succinctly stated: “At  
2 issue is whether the Debtors are entitled to use the Pre-Petition Deposits to offset their  
3 post-petition cure obligations. In a word, the answer is no.” Id. at 83. The court noted  
4 that the debtor and debtor in possession are separate and distinct entities, so that there  
5 is no mutuality of obligation between the pre-petition security deposits and the post-  
6 petition cure obligations. The court also felt it would be unfair for the debtor to apply the  
7 deposits to the cure obligations rather than the arrearages; the purpose of the deposits  
8 was to safeguard parties contracting with the debtor against the effect of just such  
9 defaults. The court clearly intended that its decision would enable the  
10 telecommunications providers to apply the deposits against debtors’ pre-petition  
11 arrearages.  
12

13  
14 In In re Telligenix Corp., 436 B.R. 211 (Bankr. M.D. Fla. 2010) the court denied  
15 the debtor’s motion to apply its post-petition rent obligations under a commercial real  
16 estate lease against the security deposit. The court stated that, as both the security  
17 deposit and the rejection damages are pre-petition claims, “bankruptcy courts routinely  
18 allow a landlord to offset rejection damages claims against security deposit funds.” Id.  
19 at 213. The court “stop[ped] short of holding that post-petition administrative priority  
20 claims can *never* be set off against pre-petition debts owed to the debtor.” Id. at 215  
21 (emphasis in the original). But the court did not find any of the “narrow circumstances”  
22 that might justify such a setoff in the instant case and allowed the landlord to setoff the  
23 security deposit against the rejection damages.  
24

25  
26 The court in In re Go Fig, Inc., 2009 Bankr. LEXIS 533 (Bankr. E.D. Mo. Feb. 5,  
27 2009) held that a Chapter 7 trustee could not use recoupment to apply the security  
28 deposit against the landlord’s §365(d)(3) administrative claim. The court distinguished

1 the pre-petition debtor and post-petition debtor as different legal entities, such that the  
2 administrative claim and the security deposit arose out of different transactions. The  
3 court also cited policy considerations: applying the deposit against administrative claims  
4 would effectively strip the landlord of the higher priority treatment that enables debtors  
5 to obtain post-petition services. Although recoupment was at issue, the very same  
6 analysis could be applied to setoff.  
7

8 Finally, in In re Aspen Data Graphics, 109 B.R. 677 (Bankr. E.D. Pa. 1990) in the  
9 context of whether setoff was avoidable under Bankruptcy Code §547 and §553, the  
10 court stated that “a landlord may setoff the amount of a *security deposit* under a lease  
11 against a pre-petition claim for rent and damages owed to the landlord, as these are  
12 mutual, pre-petition obligations.” Id. at 683 (emphasis in original).  
13

#### 14 Conclusion as to the Application of the Security Deposit

15 Precedent under both §365(d)(3) and §553 overwhelmingly holds that pre-  
16 petition security deposits may be applied against pre-petition claims, whether  
17 arrearages or rejection damages, rather than administrative claims. These holdings are  
18 consistent with the legal principle of mutuality of obligation being required for setoff and  
19 the legal distinction between pre-petition and post-petition obligations and legal entities.  
20 They are also consistent with the purpose of §365(d)(3) and fundamental fairness. The  
21 Bankruptcy Code protects the landlord by requiring the trustee to pay the landlord for  
22 use of the premises post-petition until the lease is rejected. Allowing the trustee to use  
23 the premises to benefit the estate and then pay for that use, not with the cash  
24 contemplated by §365(d)(3) but with the security deposit designed to protect the  
25 landlord against defaults, both strips the landlord of the protections of §365(d)(3) and  
26 unfairly benefits the estate at the expense of the landlord. (This conclusion is also  
27  
28

1 consistent with case law interpreting the legislative history of §502(b)(6) as requiring  
2 application of security deposits to rejection claims.) Accordingly, this Court rules that  
3 HRI's security deposit should be applied against its pre-petition claims, both arrearage  
4 and rejection damages, not its administrative claims.  
5

6 HRI argues that even if the security deposit was applied to debtor's obligations  
7 under §365(d)(3), that draw down on the security deposit triggers debtor's lease  
8 obligation to refresh the security deposit, which would be an administrative claim under  
9 the logic of Cukierman (that the debtor must fulfill all lease obligations under §365(d)(3)  
10 and all such obligations become administrative claims). Hence, applying the security  
11 deposit against HRI's §365(d)(3) administrative claim, would simply create a new  
12 administrative claim (to refresh the deposit) in the same amount. Because I am ruling in  
13 favor of HRI by concluding that the deposit should be applied against HRI's pre-petition  
14 arrearages and rejection claim, I will not devote further attention to this argument.  
15  
16

#### 17 ATTORNEY'S FEES

18  
19 HRI is not claiming attorneys' fees as part of its administrative claim. In his  
20 original response to the objection, Varlow asserted a request for attorneys' fees for  
21 defending this objection to his claim. Since then he has revised his request, limiting it to  
22 the fees and costs incurred in defending the motion to reject the lease. Varlow is  
23 entitled to attorneys' fees from the date of the petition to the time of surrender, but not  
24 after that. Cukierman makes it clear that under §365(d)(3), the court is to follow the  
25 lease and not use the measure of reasonableness, etc. unless that is part of the lease.  
26 Paragraph 31 of the Varlow lease does require that the fees be reasonable and that  
27 they will be allowed to the prevailing party on any action to enforce the terms of the  
28



1 lease, whether such action or proceeding is pursued to judgment. The landlord is also  
2 entitled to fees and costs incurred in preparing notices of default, whether or not a legal  
3 action is taken.<sup>4</sup>

4 Varlow asserts that the amount actually incurred through to the defense of the  
5 Motion to Reject the Lease was \$1,225 for Mr. Goodman and \$3,165.25 for Ms. Nelson.  
6 No back-up documentation has been given.<sup>5</sup> The docket reveals that Varlow filed a  
7 limited opposition and objection to the motion to reject the lease, based on a lack of  
8 notice and timing, and demanded a hearing.<sup>6</sup> The content of that opposition shows that  
9 there were multiple contacts and attempts to contact debtor and its counsel in the period  
10 leading up to the rejection and that the lease was in pre-petition and post-petition  
11 default. Replies to the opposition were filed and a short hearing was held on February  
12 8, 2006. The court granted the motion to reject, but deemed this to be effective on  
13 January 8, 2006 (rather than on December 1, 2005, as requested in the motion). Thus  
14 Varlow was the prevailing party. Although there is no breakdown, the total fees and  
15 costs requested appear to be reasonable for the amount of work that was done. And  
16 these are entitled to an administrative priority. In re Multiple Allied Servs., 2010 Bankr.  
17 LEXIS 3895 (Bankr. N.D. Cal. Oct. 15, 2010).

#### 21 SANCTIONS

22 Although I am not happy about the failure of Friedman to just admit that there is  
23 little or no authority for its statement that many courts in the Ninth Circuit use the billing  
24 date approach, this is not a frivolous motion, but rather it deals with an unclear area of  
25 law, as can be seen by my long analysis. Sanctions are denied.  
26

27  
28 <sup>4</sup> A legible copy of this portion of the lease has been filed as doc. #406.

<sup>5</sup> Doc. #385.

<sup>6</sup> Doc. #46.

CONCLUSION

HRI's administrative claim is \$70,558, its claim for pre-petition arrearages is \$115,174 and its rejection claim under 11 USC §502(b)(6) is \$245,343. The security deposit is \$24,000 and is to be applied to the pre-petition arrearage claim, reducing it to \$91,174.

Varlow's administrative claim is \$45,236.85. This is calculated by apportioning the month of January 2006 between an administrative claim (though January 8, 2006) and a rejection claim for the balance of the month. As stated above, Varlow appears to be entitled to an administrative claim for the rent for the full month of January 2006, but that has not been requested.<sup>7</sup> The Varlow unsecured claim of \$98,108.64 is not affected by this ruling.

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DATED: July 9, 2012

  
United States Bankruptcy Judge

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<sup>7</sup> Doc. #385.

## NOTICE OF ENTERED ORDER AND SERVICE LIST

Notice is given by the court that a judgment or order entitled (*specify*): **MEMORANDUM OF OPINION REGARDING DENYING MOTION TO DISALLOW CLAIM NUMBER 211-1 OF VARLOW ENTERPRISES AND CLAIM NUMBER 60 OF CREDITOR HARRY ROSS INDUSTRIES AND DENYING SANCTIONS**

was entered on the date indicated as "Entered" on the first page of this judgment or order and will be served in the manner stated below:

**1. SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING (NEF)** – Pursuant to controlling General Orders and LBRs, the foregoing document was served on the following persons by the court via NEF and hyperlink to the judgment or order. As of (*date*)\_\_\_\_\_, the following persons are currently on the Electronic Mail Notice List for this bankruptcy case or adversary proceeding to receive NEF transmission at the email addresses stated below.

Gregory Abrams Email: [jbothell@askfinancial.com](mailto:jbothell@askfinancial.com)  
Jerome Friedman Email: [jfriedman@jbflawfirm.com](mailto:jfriedman@jbflawfirm.com)  
David Seror Email: [kpscion@ebq-law.com](mailto:kpscion@ebq-law.com)  
Sheila Nelson Email: [shedoesbklaw@aol.com](mailto:shedoesbklaw@aol.com)  
Michael Greger Email: [mgreger@allenmatkins.com](mailto:mgreger@allenmatkins.com)  
Richard Dinets Email: [rdinets@allenmatkins.com](mailto:rdinets@allenmatkins.com)

☐ Service information continued on attached page

**2. SERVED BY THE COURT VIA UNITED STATES MAIL:** A copy of this notice and a true copy of this judgment or order was sent by United States mail, first class, postage prepaid, to the following persons and/or entities at the addresses indicated below:

The Leather Factory Inc.  
c/o Larry Katz  
5776 Lindero Canyon Road  
Westlake Village, CA 91362

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**3. TO BE SERVED BY THE LODGING PARTY:** Within 72 hours after receipt of a copy of this judgment or order which bears an "Entered" stamp, the party lodging the judgment or order will serve a complete copy bearing an "Entered" stamp by United States mail, overnight mail, facsimile transmission or email and file a proof of service of the entered order on the following persons and/or entities at the addresses, facsimile transmission numbers, and/or email addresses stated below:

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