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Administrative Priority Status Given to Indemnification Obligation Claim

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In *WM Inland Adjacent LLC v. Mervyn's LLC*, Adv. Pro. No. 09-50920 (KG) (Del. Bankr. Jan. 8, 2013), the U.S. Bankruptcy Court for the District of Delaware faced a question of first impression: whether a claim arising from an indemnification provision in a nonresidential commercial lease with the debtor, which the debtor rejected post-petition, was entitled to administrative priority under §365(d)(3), or was a pre-petition, general unsecured claim under §502(g).

The facts of the case, as related by the court, were straightforward and not disputed. In January 2008, the debtors executed a lease on a commercial property owned by WM Inland. The lease included a construction agreement related to prospective property improvements. Together, the lease and construction agreement required the debtor to indemnify Inland for various liabilities prior to, during and after the term of the lease, including a duty to keep the premises free of mechanic's liens and to pay Inland as additional rent all amounts and charges due under the lease, including attorney fees. The lease provided that the debtor would be liable to Inland for any lien or claim that may be alleged to have arisen out of work performed by the debtor.

Subsequent to the execution of the lease, the debtor entered into a contract with Fisher Development to provide labor and materials for building improvements to the premises. In July 2008, the debtor filed a voluntary petition for relief under Chapter 11. As of the petition date, the improvements to the property were approximately 90 percent complete. Fisher then stopped work on the premises and, in September and October 2008, recorded two mechanic's liens against the property totaling approximately \$5.5 million. Fisher then filed suit against Inland in October 2008 to foreclose on the liens; the suit was settled in February 2010 with Inland paying Fisher \$1.8 million, including attorney fees and costs.

In April 2009, after the liens and suit were filed by Fisher but before the suit was settled, the bankruptcy court entered an order approving the debtor's rejection of the lease effective November 21, 2008. As of the rejection date, the condition of the premises was such that Inland was not obligated to purchase the building improvements from the debtor. Inland filed two proofs of claim, including an administrative post-petition priority claim for indemnification under the lease for the amounts Inland paid to settle the Fisher litigation. The debtor sought to treat this claim as a pre-petition, general unsecured claim under §502(g) of the Bankruptcy Code, thus raising the issue that the court characterized as one of first impression.

Inland argued that under §365(d)(3) and the lease, the indemnification obligation claim arose post-petition and prior to the rejection of the lease so as to be entitled to administrative priority. Inland contended that the claim arose either in September 2008, when the mechanic's liens were recorded, or October 2008, when Fisher sued Inland to foreclose on the liens. The debtor, on the other hand, argued that the claim arose pre-petition because it either arose from the rejection of the lease or derived from improvements to the property occurring pre-petition.

The court rejected both of the debtor's scenarios. First, the court said the damages giving rise to the claim did not arise from the rejection of the lease, but from the filing of the mechanic's liens, a matter entirely separate from the rejection of the lease. Second, the court said that although the conduct giving rise to the indemnification claim (i.e., the construction of the improvements to the property) arose pre-petition, the obligation to pay did not arise until after Fisher recorded the liens and sued Inland, both of which occurred post-petition. It was not until these events transpired that the debtor became obligated to indemnify Inland under the lease.

The debtor also argued that the filing of the liens and institution of the lawsuit did not trigger the indemnification obligation because the obligation was "speculative, unmatured, contingent and unliquidated" until after the lease was rejected, when Inland and Fisher reached an agreement regarding the value of Fisher's claims. The court rejected this argument as well. The court said that in the context of §365(d)(3), the relevant time is when the "obligation" arises, which is different from when a "claim" arises. The court

noted that in *Centerpoint Properties v. Montgomery Ward Holding*, 268 F.3d 205 (3d Cir. 2001), the U.S. Court of Appeals for the Third Circuit distinguished a "claim," which is "an unmatured right to payment," from an "obligation," which is "something one is legally required to perform under the terms of the lease." Here, while the lease and the conduct giving rise to the indemnification obligation claim took place pre-petition, the actual obligation arose when Fisher filed its mechanic's liens and sued to foreclose upon them. Therefore, the indemnification obligation claim arose post-petition and pre-rejection.

The debtor also argued that even if the claims arose post-petition, they were not entitled to administrative priority because the incurred expenses and damages did not confer a substantial benefit on the debtor's estate as required by §503 of the Bankruptcy Code. The court explained, however, that §365(d)(3) requires the debtor to perform all obligations under the lease "notwithstanding Section 503(b)(1)." The provision "notwithstanding Section 503(b)(1)" means that aside from administrative expenses provided for in §503(b)(1), §365(d)(3) creates a new and different obligation that does not necessarily rest on the administrative expense concept. Because the indemnification obligation claim stems from post-petition obligations under §365(d)(3), Section 503(d)(1) is inapplicable.

Finally, the debtor argued that when Inland settled with Fisher, it stood in Fisher's shoes as an unsecured creditor of the debtor. Elevating Inland's claim to administrative status "simply by conspiring with a third-party plaintiff" would encourage "a wait-and-see hedging of bets" regarding an anticipated bankruptcy. The court again disagreed, reiterating its conclusion that the obligation in question only arose post-petition and pre-rejection, and did not involve any gamesmanship on the part of Fisher or Inland. Although not mentioned by the court, Fisher and Inland were in fact adversaries in the matter of the mechanic's liens, money actually changed hands between them to settle the Fisher lawsuit, and Inland was left with an uncertain claim against the debtor, regardless of whether the claim was entitled to administrative priority. Moreover, the indemnification obligation was triggered by the action of a third party in making a claim against an indemnitee of the debtor, not by any action of the indemnitee itself. It is hard to see how the court's decision to accord the claim administrative priority would create the type of perverse incentive that the debtor feared.

In fact, the court's decision should not open the floodgates to the conversion of unsecured claims into administrative priority claims. Most significantly, the decision recognizes and gives effect to the distinction between the underlying events that created the initial claim and the subsequent events that created the indemnity obligation.

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