

Dated: January 18, 2018



*Scott H. Gan*  
Scott H. Gan, Bankruptcy Judge

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UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF ARIZONA

	)	
	)	Chapter 11
	)	
In re:	)	Cases No. 4:16-bk-12285-SHG
	)	
<b>ARTHUR W. GRIMM,</b>	)	
	)	<b>MEMORANDUM DECISION</b>
<b>CYNTHIA GRIMM,</b>	)	<b>OVERRULING OBJECTION TO</b>
	)	<b>LEASE ASSUMPTION FOR</b>
Debtor.	)	<b>PREPETITION TERMINATION OF</b>
	)	<b>LEASE</b>
_____	)	

Pending before the Court is the Debtor’s motion to assume a commercial lease on nonresidential real property. The Court set an evidentiary hearing on the motion. The parties orally stipulated that whether the lease was terminated prepetition should be determined before the determination of all other issues relevant to the Debtors’ assumption of the lease. At the conclusion of the initial hearing, including the admission of documentary evidence and arguments of counsel, the Court took the matter under submission. Based on the arguments of the parties, the record and the law, the Court finds Mastick failed to terminate the lease prepetition. Mastick’s objection to lease assumption based on lease termination is overruled. The Court will consider all other issues regarding the lease assumption at the next scheduled evidentiary hearing.

1 **I. JURISDICTION**

2 Jurisdiction is proper under 28 U.S.C. §§ 1334 and 157(b)(2)(J).<sup>1</sup>

3 **II. PROCEDURAL HISTORY**

4 On October 26, 2016, Arthur W. Grimm and Cynthia Grimm (collectively, the  
5 “Debtors”) filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code  
6 (DE 1). On March 20, 2017, the Debtors filed a motion to assume a ground lease (the  
7 “Lease”) as tenants of nonresidential real property owned by the Annette Suzy Mastick  
8 Revocable Living Trust (“Mastick”) (DE 63).<sup>2</sup> On April 6, 2017, Mastick filed an  
9 objection to the Debtors’ Lease assumption (DE 69).

10 On January 17, 2017, Mastick filed a motion to convert the Chapter 13 case to  
11 Chapter 7 (DE 33). On March 7, 2017, the Debtors filed an objection to Mastick’s  
12 conversion motion, to which Mastick filed a reply on March 18, 2017 (DE 57, 59, 60).  
13 On May 9, 2017, the Debtors filed a motion to convert the case from Chapter 13 to  
14 Chapter 11 (DE 79). On June 4, 2017, Mastick filed an opposition to the Debtors’  
15 conversion of the case from Chapter 13 to Chapter 11 (DE 87). On August 2, 2017,  
16 Mastick withdrew their opposition by stipulation and, on Aug 15, 2017, the Court entered  
17 an order converting the case to Chapter 11 (DE 101, 106).

18 On May 16, 2017, the Court set an evidentiary hearing (the “Trial”) on the  
19 Debtors’ motion to assume the Lease and Mastick’s motion to convert the case to Chapter  
20 7 (DE 85, 91).<sup>3</sup> On January 10, 2017, the Court conducted the Trial (DE 212).<sup>4</sup> On the  
21 eve of the Trial, Mastick—in their pre-trial statement—raised for the first time the  
22 argument that the Lease was terminated prepetition (DE 210 at 2). At the Trial, both  
23 parties agreed that the issue of the alleged Lease’s termination is functionally dispositive

24 \_\_\_\_\_  
25 <sup>1</sup> Unless otherwise indicated, all chapter and section references are to the Bankruptcy  
26 Code, 11 U.S.C. § 101-1532. “Rule” references are to the Federal Rules of Bankruptcy  
27 Procedure Rules 1001-9037.

28 <sup>2</sup> The parties previously stipulated to an extension of the deadline (DE 53, 56).

<sup>3</sup> After the conversion, the Court treated Mastick’s motion to convert the Chapter 13 case  
as a motion to convert the Chapter 11 case.

<sup>4</sup> The parties stipulated to continue the Trial numerous times (DE 104, 151, 173, 188).

1 of the others issues and orally stipulated to continue their evidentiary presentations on the  
2 other issues until a subsequently scheduled evidentiary hearing (DE 212).

### 3 **III. FACTS**

4 The Debtors own and operate a motor fuel filling station and attached convenient  
5 store (the “Gas Station”) in Nogales, Arizona. In 1983, the Debtors leased the  
6 nonresidential real property owned by Mastick for the purpose of building and operating  
7 the Gas Station (Ex. 2.2 at 2). The Debtors built the Gas Station at their own expense and  
8 retained ownership all of the improvements on the leased land (Id. at 4).

9 The Gas Station generates revenue through the retail sale of motor fuel and  
10 merchandise. The Gas Station has at times also generated rents by subleasing space on  
11 its premises to at least one third-party fast food operation. The Debtors’ rent obligation is  
12 comprised of a base monthly rent as well as additional rents (the “Additional Rents”) tied  
13 Gas Station’s sales (Id. at 3). The Lease provides that the Debtors must pay Mastick  
14 Additional Rents of: (1) two cents (\$0.02) for every gallon of fuel sold in a rental month  
15 over forty-thousand (40,000) gallons; and (2) three percent (3%) of gross revenue of all  
16 merchandise sold other than fuel (Id.).

17 At some time prior to December 2015, the Debtors ceased the operation of one of  
18 the Gas Station’s fuel pumps and its accompanying underground fuel tank (the “Pump”).<sup>5</sup>  
19 On July 16, 2015, the Arizona Department of Environmental Quality (the “ADEQ”)  
20 conducted an inspection of the Gas Station and found two (2) violations of Arizona  
21 regulations relating to the Pump (Ex. 2.5 at 3). The ADEQ noted that the Pump’s “shear  
22 valves were not properly anchored . . . to protect against spills[,]” and that “the spill  
23 bucket on the [pump] was cracked or broken” (Id.).

24 The ADEQ noted these violations and instructed the Debtors to deliver proof of  
25 their correction as well as proofs of various required maintenance certifications (Id. at 3–  
26 5). On December 22, 2015, the ADEQ issued the Stop-Use Order (the “Stop-Use

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27 <sup>5</sup> The record contains no evidence to determine the date of—nor reason for—the  
28 cessation of the Pump.

1 Order”) requiring the Debtors to halt the sale of any fuel, empty all of the fuel tanks, and  
2 comply with all of the maintenance certification requirements cited under Arizona law  
3 (Id. at 5). The ADEQ stated it would lift the Stop-Use Order once it found the Gas  
4 Station was in compliance with the relevant Arizona laws (Id.).

5 On January 20, 2016, Mastick served the Debtors with the Notice of Default and  
6 Termination of Lease (the “Default Letter”) (Ex. 2.6).<sup>6</sup> The Default Letter provided:

7 I have been informed that all sales of motor fuels from the leased  
8 premises have ceased. A primary purpose of the Lease was that there be  
9 payments of the agreed upon percentage from the sales of motor fuels as  
10 part of the rent . . . The cessation of the sale of motor fuels constitutes a  
11 material breach by you and your obligations under the Lease. If your  
12 breach of the lease is not cured within the fifteen day notice provision  
provided by . . . the Lease, Notice of Default and Termination of the Lease  
is hereby given

13 (Id. at 2).<sup>7</sup> On January 27, 2016, the Debtors responded to the Default Letter in writing  
14 with an assurance of their intention to cure any alleged defaults under the Lease (Ex. 2.7).  
15 On January 28, 2017, the Debtors wrote the ADEQ to request a reexamination of the Gas  
16 Station after asserting their full compliance with the requirements of the Stop-Use Order  
17 (Ex. 2.8).

18 On February 8, 2016, Mastick filed a verified complaint (the “Complaint”),  
19 initiating an action against the Debtors in the Superior Court of Arizona for, *inter alia*,  
20 forcible entry and detainer (Ex. 2.11). The Complaint alleges that the Debtors “did not  
21 cure their default [on the Lease] by recommencing the operation of the service station and  
22 the sale of motor fuels within the 15 day period” (Ex. 2.11 at 5).

23 On February 11, 2016—twenty-two (22) days after Mastick’s service of the

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24 <sup>6</sup> Under the Lease, Mastick may declare a default for Debtors’ “failure to perform any  
25 condition or covenant of this lease . . . [if] said failure shall have continued for fifteen (15)  
26 days after notice in writing requiring the performance or such condition or covenant” (Ex.  
2.2 at 22).

27 <sup>7</sup> Although Mastick originally argued that Debtors’ nonpayment of taxes formed a basis  
28 for default, the Default Letter does not raise the taxes as a basis. As a result, Mastick  
abandoned the Debtors’ failure to pay the taxes as a basis for termination of the Lease.

1 Default Letter and three (3) days after filing the Complaint—the ADEQ issued the  
2 Consent Order (the “Consent Order”), allowing the Gas Station resume the sale of fuel  
3 operations including the Pump (Ex. 2.13). The Consent Order provides only one  
4 restriction; the Debtors were to provide the ADEQ with three consecutive months of  
5 results from environmental testing (Id. at 4).

6 Mastick now objects the Debtors’ assumption of the Lease, arguing the filing of  
7 the Complaint in conjunction with the Default Letter terminated the Lease prior to the  
8 petition date under Arizona law. Mastick’s argument relies on the Debtors’ failure to  
9 continuously sell fuel—resulting in a failure to generate a portion of the Additional  
10 Rents—thereby establishing the Debtors’ default under the terms of the Lease. Mastick  
11 contends that the Debtors’ failure to cure the alleged default within fifteen (15) days of  
12 Default Letter—as provided by the Lease—established legal grounds for terminating the  
13 Lease upon Mastick’s filing of the Complaint.

#### 14 **IV. DISCUSSION**

##### 15 **A. The Effect Termination**

16 “It is undisputed that only an executory contract or unexpired lease of the debtor  
17 existing at the time of petition is capable of being assumed.” *In re Gentile Family Indus.*,  
18 No. BAP CC-13-1563-KITAD, 2014 WL 4091001, at \*3 (B.A.P. 9th Cir. Aug. 19,  
19 2014). To determine whether Mastick successfully terminated the Lease prepetition the  
20 Court must look to Arizona law. *In re Qintex Entm't, Inc.*, 950 F.2d 1492, 1497 (9th Cir.  
21 1991) (“State law controls both the question of breach and construction of a contract.  
22 Whether one party's actions constitute a material breach must be determined by  
23 applicable state contract law.”) (citations omitted); *Lemon v. Harlem Globetrotters Int'l,*  
24 *Inc.*, 437 F. Supp. 2d 1089, 1102 (D. Ariz. 2006).

25 Mastick argues that the Debtors’ failure to sell fuel constituted a material breach  
26 of the Lease and upon the Debtors’ failure to timely resume fuels sales after service of the  
27 Default Letter, the Lease terminated upon the filing of the Complaint. In Arizona, once a  
28 lessee has defaulted on a lease for real property, the lease terminates upon the lessor’s

1 filing of a complaint seeking recovery of the property. *In re Bricker*, 43 B.R. 344, 346  
2 (Bankr. D. Ariz. 1984) (citing *DVM Co. v. Bricker*, 137 Ariz. 589, 592 (1983)).  
3 Termination upon the filing of a complaint under A.R.S. § 33–361, however, is not  
4 absolute. *Found. Dev. Corp. v. Loehmann's, Inc.*, 163 Ariz. 438, 443, (1990). A Court  
5 must weigh the lessee’s potential forfeiture by lease termination against the alleged  
6 “trivial, inadvertent, non-prejudicial, or technical” nature of the alleged breach. *Id.* To do  
7 otherwise is to allow a lessor the ability to terminate any lease by simply providing the  
8 lessee notice of default and initiating an action under A.R.S. § 33–361 “for any breach no  
9 matter how inconsequential.” *Id.* Thus, the filing of the Complaint was not legally  
10 sufficient to terminate the Lease if at the time the Debtors’ breach was “trivial or  
11 immaterial.” *Id.*

## 12 **B. Nature of the Alleged Breach**

13 Mastick acknowledges that the Lease’s plain language imposes no obligation on  
14 the Debtors to: (1) sell fuel; (2) generate a minimum amount revenue from fuel sales;<sup>8</sup> or  
15 (3) pay a minimum amount of Additional Rent, regardless of revenue. Instead, Mastick  
16 argues that Arizona law imposes an implied duty on the Debtors to continuously operate  
17 all revenue streams forming the basis of their express right to the Additional Rents.

18 Mastick’s argument, however, is unsupported by the case law upon which they  
19 rely. It has been held that a “percentage lease . . . reasonably implies that [the lessee] will  
20 use good faith in insuring the continuation of [the] sales” from which lessor derives rents.  
21 Nevertheless, “it is clear that even in percentage leases, that if the minimum fixed  
22 monthly rental is adequate to compensate the lessor for the use of the premises, *the fact*  
23 *that additional compensation may be forthcoming by way of percentage of sales does not*  
24 *give rise to an implied covenant of continuous occupancy.”<sup>9</sup> *Walgreen Arizona Drug Co.**

25 \_\_\_\_\_  
26 <sup>8</sup> Whether in gallons or dollars.

27 <sup>9</sup> Mastick has neither raised, argued, nor presented evidence on the question of whether  
28 the base rent provides “adequate compensation” for use of the premises despite having  
the burden of establishing the Debtors’ breach. *Thomas v. Montelucia Villas, LLC*, 232  
Ariz. 92, 96 (2013).

1 v. *Plaza Ctr. Corp.*, 132 Ariz. 512, 516 (Ct. App. 1982) (emphasis added). In other  
2 words, Mastick’s argument that a covenant of continuous operation arose by operation of  
3 law—due to the Additional Rents provision—fails. *Id. see Carter v. Safeway Stores, Inc.*,  
4 154 Ariz. 546, 549 (Ct. App. 1987); *First Am. Bank & Tr. Co. v. Safeway Stores, Inc.*,  
5 151 Ariz. 584, 586 (Ct. App. 1986).

6 The test in *Walgreen*—overlooked by Mastick—to determine whether a lease  
7 imposes a covenant of continuous operation requires the trial court consider five separate  
8 factors:

9 (1) The implication must arise from the language used ...; (2) it must appear  
10 from the language used that it was so clearly within the contemplation of  
11 the parties that they deemed it unnecessary to express it; (3) implied  
12 covenants can only be justified on the grounds of legal necessity; (4) a  
13 promise can be implied only where it can be rightfully assumed that it  
would have been made if attention had been called to it; (5) there can be no  
implied covenant where the subject is completely covered by the contract.

14 *Walgreen*, 132 Ariz. at 515.

15 With respect to the *Walgreen* test, the only language Mastick identifies as  
16 implying a covenant reads: “Lessee shall have the right during its occupancy of the leased  
17 premises to use such premises for the primary purpose of conducting thereon a service  
18 station business . . . .” (Ex. 2.11 at 4).<sup>10</sup> The *Walgreen* court expressly rejected this  
19 argument, finding that it “overlooks the well-established rule that a statement as to the  
20 use of the leased premises *does not imply a covenant* that the lessee may not cease to use  
21 the premises for any purpose.” *Walgreen*, 132 Ariz. at 517.

22 Factors two, four and five of the *Walgreen* test weigh in favor of the Debtors. By  
23 providing the sale of forty-thousand (40,000) gallons per month is a condition precedent  
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25 <sup>10</sup> Mastick failed to satisfy their burden of establishing a material breach by failing to  
26 demonstrate that a covenant arises by operation of law argument. Although Mastick does  
27 not address the *Walgreen* factors in their brief or at Trial, the Court considers them *sua*  
28 *sponte*.

1 to the Debtors' duty to pay Mastick Additional Rents—arising out of fuel sales—the  
2 parties contemplated and agreed to rental periods when no rents on fuel sales would be  
3 due. This conclusion is further supported by the fact that Additional Rents of three  
4 percent (3%)—on all sales of merchandise other than fuel—are due without any such  
5 minimum benchmark. Similarly, there is no legal necessity presented in this case to  
6 justify the imposition of a covenant. Thus, the Court finds no grounds to impose a  
7 covenant of continuous operation under the terms of the Lease.

### 8 **C. Failure to Terminate the Lease**

9 Having found no covenant of continuous operation arising out of the Lease, the  
10 Court finds that Mastick provided no grounds sufficient for termination of the Lease in  
11 the Default Letter.<sup>11</sup> Accordingly, Mastick failed to give the Debtors notice and  
12 opportunity cure a material default giving rise to prepetition termination of the Lease.  
13 Thus, Mastick's filing of the Complaint in conjunction with the Default Letter was not  
14 legally sufficient to terminate the Lease under Arizona law. *Loehmann's, Inc.*, 163 Ariz.  
15 at 443. The Lease having not been terminated prepetition, may be assumed if the Debtors  
16 can satisfy the remaining requirements of 11 U.S.C. § 365.

### 17 **V. CONCLUSION**

18 **IT IS HEREBY ORDERED** that Mastick's objection to the Debtors' assumption  
19 of the Lease for prepetition termination is **OVERRULED**.

20 **IT IS FURTHER ORDERED** that Mastick's objection to the Debtors' motion to  
21 assume the Lease on all other grounds remaining will be addressed at subsequent  
22 evidentiary hearings on this matter.

23 Dated and signed above.

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27 <sup>11</sup> Although other grounds for termination of the Lease may have existed, the Debtors  
28 were only given notice and opportunity to cure default based on the failure to  
continuously sell fuel.



1 Notice to be sent through the  
2 Bankruptcy Noticing Center "BNC"  
3 to the following:

4 **CHARLES R HYDE**  
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9 **ROBERT F. KUHN**  
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11 P.O. Box 13312  
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13 *Counsel for Creditor*

14 ALSO notice to all on MML  
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