

## WHEN THE TENANT FILES BANKRUPTCY

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There are two basic types of bankruptcy proceedings, liquidations and reorganizations. In a liquidation (called a chapter 7 filing) a trustee is appointed to collect the non-exempt property of the debtor, sell it and distribute the proceeds to the creditors. With a reorganization (chapter 11 for corporations and 13 for individuals) a debtor seeks to rehabilitate itself to allow it to use future earnings to pay off creditors. A trustee is used in chapter 13 proceedings and in some chapter 11 actions.

### *A. The Effect of a Bankruptcy Stay and What You Can Do*

Once a bankruptcy is filed, Section 362 of the United States Bankruptcy Code (11 U.S.C. §362) provides for an automatic stay of any action by creditors which has the purpose and result of collecting a debt or taking possession of property or assets of the debtor. The purpose of the stay is to preserve the status quo.

Generally, any activity against a debtor, such as the filing of any legal proceeding or the collection of a judgment is stayed by the filing of a bankruptcy. The stay also bars actions to create or enforce any liens or efforts to create set-offs of any debts owing to the debtor. Although the stay is broad, the stay does not apply to post-petition transactions, the commencement of criminal proceedings against a debtor, the collection of alimony or child support that occurs post petition or actions by the government to enforce police or regulatory power.

Commonly there is found in commercial leases provisions that state that bankruptcy is a basis for default and ultimately termination. These clauses appear as follows:

*Default.* (1) If Tenant or the Guarantor shall commence or institute any case, proceeding or other action (i) seeking relief on its behalf as debtor, or to adjudicate it as bankrupt, insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition, or other relief with respect to it or its debts under any existing or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization, or relief of debtors, or (ii) seeking appointment of a receiver, trustee, custodian, or other similar official for it or for all or any substantial part

of its property. (2) If any case, proceeding or other action shall be commenced or instituted against Tenant or the Guarantor (i) seeking to have an order for relief entered against it as debtor or to adjudicate it as bankrupt, insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition, or other relief with respect to it or its debts under any existing or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization, or relief of debtors, or (ii) seeking appointment of a receiver, trustee, custodian, or other similar official for it or for all or any substantial part of its property, which either: (i) results in any such entry of an order for relief, adjudication of bankruptcy, or insolvency, or such an appointment or the issuance or entry of any other order having a similar effect and such order shall not have been vacated, discharged, or stayed within a period of ten (10) days; or (ii) remains un-dismissed or is not stayed for a period of sixty (60) days.

*Rights In the Event of Tenant's Bankruptcy.* Nothing contained in this Lease shall limit or prejudice the right of Landlord to prove for and obtain in proceedings for the termination of this Lease by reason of bankruptcy or insolvency, an amount equal to the maximum allowed by any statute or rule of law in effect at the time when and governing the proceedings in which the damages are to be proved, whether or not the amount be greater, equal to, or less than the amount of the loss or damages referred to above.

Executory (or existing and on-going) contracts like commercial leases receive specific treatment under the bankruptcy code. First and foremost, bankruptcy termination clauses which seek to end a lease if a bankruptcy is filed (like those provisions above), have been found to be unenforceable. See, *In re 48th St. Steakhouse*, 835 F. 2d 427 (2nd Cir 1988). Based upon the bankruptcy law, Section 365 (e) (paragraph 1) a lease cannot be terminated solely because of a provision in the lease that provides for termination based upon the filing of a bankruptcy. *In re Joshua Slocum, Ltd.* 922 F.2d 1081 (3rd Cir. 1990). However, if the contract has been terminated before the bankruptcy, the pre-petition termination is binding on the trustee. *In re Coast Cities Truck Sales, Inc.* 147 B.R. 674 (D. N.J. 1992).

Paragraph 2 of the same Code section states that paragraph 1 does not apply where "applicable law excuses" the landlord "from accepting performance from or rendering performance to, the trustee or to an assignee of such...lease." It has been interpreted that this exception may apply where the tenant's lease is based upon personal services and those services cannot be delegated (or assigned). Based upon some conflicting interpretations concerning these different code

sections, although the termination provisions may not be readily enforceable, it is recommended that they remain in the lease.

Generally, bankruptcy filings will not bar actions against separate entities, partners or guarantors, except in "unusual cases." See, *A.H. Robins Co. v. Piccinin*, 788 F. 2d 994 (4th Cir. 1986). There have been different conclusions reached as to whether a stay is violated if a creditor seizes property pre-petition and fails to return it post petition. Some courts have found that the failure to return the property violates the stay (see, *Knaus v. Concordia Lumber Co.* 889 F. 2d 773 (8th Cir. 1989)) while other courts have held that the stay applies only to creditor acts taken after the bankruptcy case is commenced. See, *United States v. Inslaw, Inc.* 932 F. 2d 1467 (D.C. Cir. 1991). It has been held that when the debtor lost his interest in real estate through pre-petition foreclosure the creditor's commencement of a postpetition unlawful detainer action did not violate the stay. *In re Crawley* 117 B.R. 457 (Bankr. D. Minn. 1990).

An automatic stay continues until the bankruptcy case is closed, the case is dismissed, a plan is confirmed (Chapter 11 cases) or the debtor is discharged (individual bankruptcies). The stay also concludes when the court orders that the stay is to be lifted for the benefit of certain creditors. Any actions taken in violation of the stay are considered void. If a violation occurs with respect to a company, the creditor can be fined and assessed with costs and fees. If a violation occurs against an individual, punitive damages may be awarded. In the case of *Pettit v. Baker*, 876 F.2d 456 (5th Cir. 1989), the Court assessed damages against both the creditor and its lawyer for violating the stay.

### ***B. Lifting the Automatic Stay and Regaining Possession***

Commonly a debtor who is a lessee will remain in possession of the leased premises (so-called "debtor-in-possession") while decisions are made whether to terminate the lease or continue with the lease post-petition. Un-expired leasehold interests (including subleases) constitute estate property and efforts to terminate those leases once a bankruptcy has been filed constitutes a violation of the automatic stay.

According to Bankruptcy Rule 4001, an action for relief from stay is a contested matter. Once the motion is filed, the debtor has an opportunity for hearing. Within 30 days after relief from the automatic stay is requested, the stay will terminate unless the Court orders the stay continued pending the court's ruling. Relief from an automatic stay will be granted if the moving party can show that there is no value in the property or that the debtor is unable to show that there is adequate protection for the creditor's claim. The term

"adequate protection" is not specifically defined in the Code. Adequate protection may be a showing that the debtor can make periodic payments on its debt or that the value of the creditor's collateral exceeds the amount of the outstanding debt. If it turns out that the adequate protection becomes inadequate, a creditor can file a new motion for relief or may be able to renew its previous motion. The courts have held that a secured creditor who is entitled to adequate protection has a first priority claim to the extent that the protection has not been adequate. See, *In re Clark at Center Leasing Co., Inc.*, 991 F. 2d 682 (11th Cir. 1993).

If the lease term ends either before the bankruptcy is filed or during the bankruptcy, the bankruptcy court has the right to order the debtor to vacate the premises. The Court in *In re Convenient Food Mart No. 144, Inc.*, 968 F. 2d 592 (6th Cir. 1992) held that a landlord had the right to evict a tenant who filed bankruptcy when the lease term ended.

### ***C. Tenant's Duty to Pay Rent During the Pending Bankruptcy***

The debtor in possession or the trustee for the bankruptcy case must continue to pay rent during the post petition period. The trustee must perform all of the obligations of the tenant under the lease until assumption or rejection of the lease occurs. The landlord is entitled to adequate protection during this post petition period and is entitled to receive payment of all rent falling due under the lease during the post-petition period. See, *In re DeSantis*, 66 B.R. 998 (E.D. Pa. 1986). Creditor/landlords can claim post petition rent as an administrative expense if there is a post-petition benefit conferred on the debtor with regard to the operation of its business. See, *In re Mid Region Petroleum, Inc.*, 1 F.3d 1130 (10th Cir 1993).

### ***D. Assumption and Rejection of the Lease***

An executory contract remains in effect pending assumption or rejection by the trustee. If the lease expires by its own terms during post-petition, the trustee has nothing to assume or reject. Upon the filing of the bankruptcy, the debtor/tenant will need to make the decision to assume the lease going forward or to reject the lease allowing cancellation. The Bankruptcy Code addresses this choice under U.S.C. 365 (d) (4) and provides that the trustee may assume or reject executory contracts and unexpired leases of the debtor. If the tenant's goal is to avoid the lease, the tenant may surrender the property to the landlord upon the filing of its bankruptcy. If there is a delay in the surrender, the trustee must pay the administrative rent for the days the space is used.

The standard to be applied by the court in determining whether to approve the trustee's decision to assume an executory contract is a "business judgment" standard or whether the performance of the contract will be advantageous to the estate and whether the estate will be able to perform. See, *In re Orion Pictures Corp.* 4 F. 3d 1095 (2nd Cir. 1993). The trustee's position must be "unequivocal". The trustee must assume or reject an executory contract in its entirety and cannot assume part and reject part. *Department of Air Force v. Carolina Parachute Corp.* 907 F. 2d 1469 (4th Cir. 1990).

If the tenant wants to stay in the lease, the tenant must cure all past defaults, make ongoing payments and give the landlord adequate assurance of future performance under the lease. The Code provides that the debtor must make the decision to assume or reject within 60 days after the filing of the petition. A remedy for a party to an executory contract who wishes to force a trustee to act is to move for an order compelling the trustee to determine whether to assume or reject. See, *In re Greenpoint Metallic Bed Corp.*, 113 F.2d 881 (2nd Cir 1940).

If the debtor does not make the required rent payments during the 60 day period the courts have allowed an administrative expense claim for post-petition unpaid pre-assumption rents. See, *In re Wingspread Corp.* 116 B.R. 915 (Bankr. S.D.N.Y. 1990). An administrative expense claim does not constitute adequate protection. Further adequate protection may even be different from the actual contractual lease payments and the payments may need to be greater than the money actually due. Previous courts have held that adequate protection of a lessor's interest may include payment of rent and the establishment of a sufficient security deposit. See, *City Stores Co. A.L.S., Inc.* 3 B.R. 107 (Bankr. E.D. Pa. 1980).

### *Assumption*

If the debtor-tenant has not defaulted under the lease the court will likely allow the assumption. If there is a default, the code provides that the lease may not be assumed without a cure and a showing of future adequate assurance to the landlord. 11 U.S.C. §365 (b)(1)(B). Generally, if there are pre-petition defaults they cannot become assumed post-petition obligations without the trustee curing the default and giving adequate assurance of future performance. *NCL Corp. v. Lone Star Building Centers, Inc.* 144 B.R. 170 (S.D. Fla. 1992). Commonly the time for making the decision to assume or reject is extended based upon cause, since many times the decision to assume or reject may be central to the debtor's plan of reorganization. The Court is willing to allow the

debtor additional time to analyze its assets and financial situation to determine whether the debtor's interests (and those of its creditors) are properly considered.

Where a lease has already been terminated pre-petition the opportunity to reinstate the lease will have already passed and the tenant will only have possession of the leased space. In that instance, the lessor can seek a relief from the stay to enforce a writ of possession. *In re Couture*, 202 B.R. 837 (Bankr D. Vt. 1996). The trustee can also enter into a new contract that supercedes the old contract. *In re F.H. Lawson Co.*, 97 B.R. 895 (Bankr. S.D. Ohio 1989).

On assumption, the rental obligation would continue at the contractual rate. The debtor's rights under the lease continue as property of the estate. The lease is given full force and effect. The expenses and liabilities incurred by a debtor in connection with an assumed lease are given priority administrative expense status. This is found to include unpaid rent during any gap period before the assumption occurred. *In re Pacific-Atlantic Trading Co.*, 27 F. 3d 401 (9th Cir. 1994).

The trustee can assign an assumed lease but before doing so must provide adequate assurance of future performance by the assignee. *In re Sunrise Restaurants, Inc.* 135 B.R. 149 (Bankr. M.D. Fla. 1991). Section 365 of the Code allows assignment by the trustee whether or not there has been a default and notwithstanding a provision prohibiting assignment. Yet in order to assign, the trustee must meet the requirements of Section 365 which requires that adequate assurance must be given for future performance whether or not there has been a default. Assumption of an executory contract is subject to Court approval. See, 11 U.S.C. §365(a). Notice is required to assume a lease but if there is no objection, no hearing is required. No notice or hearing is required when the trustee automatically rejects a contract by failing to act within 60 days of an order for relief in a chapter 7 case.

### *Rejection*

A debtor may reject any unexpired lease of real property, based generally on whether the rejection would be advantageous to the debtor. If the decision is made to reject, the Code provides that the trustee shall automatically surrender the leased property back to the lessor. There are few statutory exceptions to the trustee's power to reject executory contracts.

The rejection of a lease is effectively a breach of the executory contract, giving the other party a claim for damages. *Sharon Steel Corp. v. National Fuel Gas*

Distribution Corp. 872 F. 2d 36 (3rd Cir. 1989). The creditor maintains its claim in the bankruptcy court after a contract is rejected and its claim (although technically arising AFTER the petition) is considered an allowable claim. Yet the holder of the claim is not entitled to any priority. The claim ends up as a general unsecured claim.

The calculation of the damages can be found under section 502 (b) (6) of the Code. If no action is taken to assume the lease within 60 days after the order for relief (date of commencement of bankruptcy) (or no extension is granted) then an automatic rejection of the lease will occur. This applies to Chapter 7 cases. Under Section 365 (d) if a case is filed under Chapter 11 or 13, the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan, but the Court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

If the tenant continues to make monthly payments after the bankruptcy and the landlord accepts them, this will likely not be considered a waiver by the landlord to presume automatic rejection if no action is taken within the 60 days. See, U.S.C. §364 (d) (3).

### *Damages*

If rejected, the landlord is granted an unsecured claim for actual damages or a formula amount whichever is less. The formula is based upon the greater of the rent owed for one year or 15% of the remaining term (not in excess of three years). The limitation only applies in the case of a rejection of a lease of real property. 11 U.S.C. §502 (b)(6). If the lease was terminated before the petition was filed, the starting period for the one year/three years is not the date of the petition but the date the landlord repossessed or the tenant surrendered the premises.

### *E. Proofs of Claim*

The filing of proofs of claim are covered under Section 501 of the Bankruptcy Code. Proofs of claim are filed by creditors to establish from the creditor's perspective the value of the their claim. It is commonly asked whether the lessor has a secured claim (as compared to an unsecured claim) concerning the property in the leased space pursuant to the terms of the lease. The answer may depend on whether a security interest was created and whether there is an adequate description given for the property. The Bankruptcy Code has established certain time limitations or "bar dates" regarding the filing of proof

of claims. These dates act similar to a statute of limitations. If the proof of claim is filed after the allowed bar date, the claim may not be considered valid.

Rule 3002 (c) of the Federal Rules of Bankruptcy Procedure governs the time for filing proofs of claim in Chapter 7 cases. It requires that a creditor wishing to file a proof of claim must do so within ninety (90) days after the first date set for the meeting of creditors pursuant to Section 341 of the code. No such deadlines exist for Chapter 11 cases. Instead, Rule 3003 (c) leaves it to the court to set the time within such claims must be filed.

If a creditor fails to meet a bar date on the filing of a proof of claim, generally the creditor will be prohibited from participating in the distribution of the estate's assets. In Chapter 7 cases a creditor need only to receive notice or have knowledge of the commencement of the case before it will be penalized for missing this deadline. In Chapter 11 cases the creditor must receive proper adequate notice of the bar date before it can be precluded from submitting its claim. Under bankruptcy Rule 9006 (b) the court has discretionary power to extend bar dates in Chapter 7 and Chapter 11 cases for cause shown.

In submitting a proof of claim, a landlord can include in its claim: 1) the pre-bankruptcy rent claim (rent plus CAM charges, insurance, etc.) and 2) the administrative rent claim (post filing - date lease payments). There have been conflicting interpretations as to whether a lessor is entitled to an administrative expense claim to the extent the leased property is used during the 60 days before the lease was accepted. In the recent case of *In re Russell Case Company*, 247 B.R. 656 (Bankr. E.D. Kent. 2000), the court held that where a debtor uses leased property in the first 60 days of a bankruptcy case and receives a benefit from the use of the property, the lessor is entitled to an administrative expense claim for that period of time. After the 60 day period, a showing is not required by the lessor and the lessor is entitled to its rent claim whether or not the property is being used for the debtor's benefit. A sample proof of claim has been provided with these materials.