

## **Representing Commercial and Residential Landlords in Tenant Bankruptcies: The Impact of BAPCPA**

### **A. Basic Principles Applicable to All Leases**

1. A debtor/tenant's leasehold interest is "property of the [debtor's] estate," and is protected by the "automatic stay" triggered by the debtor's bankruptcy filing - § 362(a).

2. No matter what a lease provides, once a bankruptcy case has been filed by or against a tenant, the lease cannot be terminated or modified solely because of an "ipso facto" default, *i.e.*, a default triggered by:

(a) "The insolvency or financial condition of the debtor at any time before the closing of the case"

(b) The commencement of the case, or

(c) The appointment of or taking possession by (i) a trustee in the case, or (ii) a receiver or similar officer before the case is filed - § 365(e).

3. A trustee (including a "debtor in possession" in a Chapter 11 case) "may assume or reject any ... unexpired lease of the debtor" - § 365(a).

(a) If tenant is in default (other than an ipso facto default), assumption requires:

(i) cure, or "adequate assurance" of the prompt cure, of payment defaults,

(ii) compensation for "any actual pecuniary loss" resulting from any tenant default, and

(iii) "adequate assurance of future performance under such ... lease" - § 365(b)(1).

(b) "[O]nly unexpired leases may be assumed ...". *In re Stoltz*, 315 F.3d 80, 84 (2d Cir. 2002)

4. If (and only if) a lease is assumed, it can be assigned - § 365(f).

5. Rejection of a lease constitutes a breach of the lease.

(a) If the lease has not previously been assumed, the breach is deemed to have occurred "immediately before the date of the filing of the petition" commencing the bankruptcy case - § 365(g)(1).

(b) If the lease was previously assumed, the breach will be deemed to have occurred:

(i) at the time of rejection if the case has not previously been converted to a liquidation case under 7, or if conversion occurred prior to assumption, and

(ii) Immediately prior to the conversion, if the case is converted after assumption - § 365(g)(2).

6. In practical terms this means that the lessor's damage claim resulting from the breach

(a) will be treated as a pre-petition claim without priority if the lease was not previously assumed in the case - § 502(g).

(b) will, at least to some extent, be entitled to priority as an administrative expense if the lease was previously assumed - § 503(b)(7), discussed below.

7. The lessor's pre-petition damage claim may be disallowed to the extent it exceeds

(a) unpaid rent due (without acceleration) on the earlier of the bankruptcy petition date and the date of surrender or repossession of the property, plus

(b) the rent reserved (without acceleration) for the greater of one year, or 15%, not exceeding three years, of the remaining term following the earlier of such dates - § 502(b)(6).

8. Rejection of the lease is merely a breach of the lease; it is not the same as termination of the lease. *In re Stoltz*, 315 F.3d 80, 85 n.1 (2d Cir. 2002); *In re Miller*, 282 F.3d 874, 878 (6<sup>th</sup> Cir. 2002).

9. "A rejected lease is abandoned and no longer property of the estate." *Stoltz, supra*, at 85, n.1 If the tenant is still in possession, the landlord may invoke state law remedies to recover possession. The automatic stay will no longer prevent eviction.

## **B. Commercial Leases**

1. The automatic stay

(a) Once a "lease of nonresidential real property" has been "terminated by the expiration of [its] stated term," whether before or during the case, actions by the landlord to take possession of the property are no longer stayed - § 362(b)(10).

(b) Likewise, any interest of the debtor tenant in a commercial lease that has expired by its terms is excluded from the estate - § 541(b)(2).

2. Assumption and rejection of unexpired leases

(a) BAPCPA has extended the time for assumption/rejection from 60 days to 120 days after the date of the order for relief. If no decision made within 120 days, the lease is deemed rejected and the property must be immediately surrendered to the landlord - § 365(d)(4)(A).

(b) Under the old law the court was permitted to grant unlimited extensions “for cause.” BAPCPA provides only *one* opportunity to extend the assumption/rejection period, for 90 days upon a motion “for cause” - § 365(d)(4)(B)(i).

(i) The court may grant a further extension only upon prior written consent of the lessor - § 365(d)(4)(B)(ii).

3. Result of changes: although the initial assumption/rejection period has been enlarged, the 90 day limit on subsequent non-consensual extensions shifts enormous economic leverage to landlords.

4. The shorter time within which to make a decision may cause the trustee or DIP to assume a marginally promising lease, which it may later be forced to reject if it is unable to meet its lease obligations.

(a) If this happens, the lessor is entitled to an administrative expense claim equal to all monetary obligations due under the lease for the period of *two years* following the later of the rejection date or the date of actual turnover of the premises - § 503(b)(7).

(i) Prior to BAPCPA, courts typically allowed administrative expense claims on a dollar-for-dollar basis, so that a trustee or DIP was obligated to the lessor for the full sum remaining due under the lease.

(b) Under BAPCPA, the lessor is also entitled to a general unsecured “claim under § 502(b)(6)” for sums due for the balance of the lease term. This claim is limited to the reserved rent under the lease for the greater of one year or 15% (not to exceed three years) of the remaining term of such lease, following the earlier of the petition date or the date on which the lessor repossessed the property or the lessee surrendered it.

5. The trustee (or Chapter 11 debtor in possession) must “timely perform all the obligations of the debtor arising from and after the order for relief ... until lease is assumed or rejected” (except for penalty obligations triggered by a debtor’s default) - § 365(d)(3).

### **C. Residential Leases**

#### 1. Automatic stay exceptions

(a) The automatic stay will not bar the continuation of an eviction, unlawful detainer or similar action by a lessor against a debtor involving residential property, provided that the lessor obtained a judgment for possession prior to the petition date - § 362(b)(22).

(i) This section does not go into effect until 30 days after the petition date if the debtor files with its petition a certification that applicable nonbankruptcy law permits the debtor to cure the default that gave rise to the judgment for possession - § 362(l).

(1) If the debtor files (within this 30 day period) an additional certification that it has cured the default, § 362(b)(22) will not apply.

(ii) If one of these certifications is not filed, § 362(b)(22) goes into effect immediately.

(iii) In Pennsylvania, a tenant will generally be able to make the initial certification in good faith “[a]t any time before actual delivery of the real property is made in execution of the order for possession” issued by a magisterial district judge. Rule 518, Pennsylvania Rules of Conduct, Office Standards and Civil Procedure for Magisterial District Judges. In general, the District Judges Rules provide for (i) entry of “judgment against the defendant that the real property be delivered up to the plaintiff” at the hearing on the landlord’s complaint for possession (Rule 514); (ii) in the case of a residential lease, issuance of an “order for possession” on written request of the landlord made after the “10<sup>th</sup> day ... following the entry of the judgment” (Rule 515.B); (iii) service of the order of possession on the tenant by the sheriff or constable (Rule 517); and (iv) a subsequent 10 day grace period before the tenant can be evicted by force and possession of the premises can be delivered to the landlord (Rule 519B) Rule 518 provides in full:

At any time before actual delivery of the real property is made in execution of the order for possession, the defendant may, in a case for the recovery of possession solely because of failure to pay rent, satisfy the order for possession by paying to the executing officer the rent actually in arrears and the costs of the proceedings. The executing officer shall give the defendant a signed receipt for any such payment.

(b) The automatic stay will not bar an eviction action that seeks possession of residential property in which the debtor resides as a tenant under a lease, based on endangerment of the property or illegal use of controlled substances. However, in order for this exception to apply, the lessor must file and serve a certification that an eviction action has been filed, or that the debtor endangered the property or illegally used a controlled substance on the property during the 30-day period preceding the date the certification is filed - § 362(b)(23).

(i) This section does not go into effect until 15 days after the lessor files the certification, to give the debtor an opportunity to object to the truth or legal sufficiency of the certification - § 362(m).

2. Assumption and rejection of unexpired leases

(a) Chapter 7 - § 365(d)(1)

(i) The trustee has 60 days in which to assume or reject, but time for assumption/rejection can be extended indefinitely “for cause” – no change from prior law.

(ii) “[I]n virtually every Chapter 7 no-asset case, the trustee realizes no benefit from assuming the debtor’s residential lease, and thus in virtually every Chapter 7 no-asset case, the residential lease is deemed rejected ...”. *In re Sheard*, 1995 WL 454260 at \*3 (Bankr. E.D. Pa. 1999).

(iii) The debtor has no statutory authority to assume or reject the lease. *In re Stoltz*, 315 F.3d 80, 95 n.1 (2<sup>nd</sup> Cir. 2002).

(iv) In theory, if the tenant wants to remain in possession and is current on the rent (or is willing to use exempt assets or post-petition income to cure any defaults) the trustee could assume the lease and assign it to the debtor, but this almost never happens. In most cases, if the tenant wishes to remain in possession, the parties simply ignore the bankruptcy – the debtor continues making rental payments and the lessor accepts them.

(v) For greater certainty, the lessor may want the debtor to enter into a reaffirmation agreement with respect to the lease – in effect, a lease assumption under another name - § 524(c).

(vi) *In re Casserino*, 379 F.3d 1069 (9th Cir. 2004): If the lease is claimed as exempt property, the lease is removed from the estate and is not subject to assumption or rejection by the trustee. Moreover, tenant deposits are “an integral part of the leasehold” and therefore can be claimed by the debtor as part of the exemption. *Id.* at 1074 (construing Oregon’s homestead exemption).

(b) Chapters 11, 12 and 13 - § 365(d)(2)

(i) The trustee may assume or reject an unexpired lease *at any time* before the confirmation of a plan, but the court may set an earlier deadline on the request of the lessor – no change from prior law - § 365(d)(2).

(ii) Unlike § 365(d)(1), which provides that a lease not timely assumed in a Chapter 7 case is “deemed rejected,” § 365(d)(2) does not say what happens to a lease that is not assumed at or before plan confirmation in a Chapter 11, 12, or 13 case. However, the necessary implication seems to be that the lease will be deemed rejected.

(iii) While a Chapter 12 debtor or a Chapter 11 debtor in possession clearly has the power to assume a lease, the statutory basis for a Chapter 13 debtor’s assumption of a lease is less clear. The powers of a trustee

that a Chapter 13 debtor can exercise are enumerated in § 1303. They include the power to “lease ... property of the estate” under § 363(b). However, the trustee’s power to assume or reject leases under § 365(d)(2) is conspicuously absent from the list.

(iv) Nonetheless, the prevailing assumption seems to be that a Chapter 13 debtor can assume a lease. In the Western District of Pennsylvania, the official “Chapter 13 Plan” form (Local Bankruptcy Form No. 10) expressly provides for lease assumption.

(c) What can the lessor do if the debtor is in default and is unable or unwilling to cure?

a. Possession

i. The lessor may seek relief from the automatic stay to commence or continue a state court action to recover possession.

ii. A cooperative trustee may be willing to reject the lease on an expedited basis, particularly if the lessor and its counsel are willing to do all the legwork.

iii. If the trustee is uncooperative, the lessor can ask the court to set a date on which the lease will be deemed rejected if the trustee does not sooner assume it. This procedure is expressly provided for in § 365(d)(2) (applicable to cases under Chapters 9, 11, 12, or 13) and is not expressly prohibited by § 365(d)(1) (applicable to Chapter 7 cases). *See In re Werbinski*, 271 B.R. 514, 516 n.1 (Bankr. E.D. Mich. 2001) (approving this practice in a Chapter 7 case).

b. Unpaid rent

i. Debtor’s personal liability may ultimately be discharged under §§ 727(b), 1141, 1228, or 1328, so an attempt to collect unpaid rent, which will initially be barred by the automatic stay, may eventually be permanently barred by the discharge injunction under § 524(a).

ii. Lessor may be able to recover against the security deposit for unpaid rent (*Casserino*).

(d) What is the status of post-petition, pre-rejection rent claims if a residential lease is not assumed?

(i) Section 365(d)(3) does not apply, and there is no other Code provision that requires either the debtor or the trustee to keep current on lease obligations arising during the post-petition/pre-rejection period.

(ii) The landlord's claim is likely to be deemed merely a part of its pre-petition rejection damages claim. *In re Miller*, 282 F.3d 874, 877-8 (6<sup>th</sup> Cir. 2002). This may be so even if the debtor remains in possession during the post-petition/pre-rejection period. *In re Werbinski*, 271 B.R. 514 (Bankr. E.D. Mich. 2001). Of course the claim may ultimately be discharged, and in a no-asset Chapter 7 case or a Chapter 13 case where the plan pays nothing on general unsecured claims, the lessor's recovery will be nil.

(iii) By contrast, if the debtor holds over after the lease has been rejected, the landlord's claim for rent for post-rejection periods is not discharged, and the landlord "is free to pursue any state court remedies it might have, including eviction or the collection of post-rejection rents." *Id.* at 517.

(1) However, under a Public Housing Authority lease, eviction solely by reason of a holdover tenant's failure to pay rent claims that have been discharged in bankruptcy may be barred by the anti-discrimination provisions of § 525(a). *In re Stoltz*, 315 F.3d 80 (2<sup>nd</sup> cir. 2002).

(iv) The landlord might also consider pursuing an administrative rent claim under § 503(b). This is somewhat problematic in a Chapter 7 case – it is hard to see how post-petition, pre-rejection rent could be viewed as part of the "actual, necessary costs and expenses of preserving the estate." Moreover, in a no-asset case, even a first priority administrative expense claim will be worthless. The argument may have stronger appeal in a Chapter 11, 12, or 13 case, where having a place to live might plausibly be viewed as materially helpful to the debtor in achieving his or her plan.

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