

## Automatic Stays and Administrative Expenses: Rights and Remedies Available to Landlords and Tenants in Bankruptcy Proceedings

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### INTRODUCTION

The Constitution of the United States grants Congress and the federal courts exclusive jurisdiction and power to legislate in and administer the bankruptcy laws of the United States.<sup>1</sup> Congress has exercised its constitutional power on numerous occasions since Ratification, and most recently in October 2005, when extensive revisions contained in the Bankruptcy Abuse Prevention and Consumer Protection Act (the BAPCPA) became effective.<sup>2</sup> Several of these amendments impact and control the landlord-tenant relationship when one of the

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1. U.S. CONST. art. I, § 8, cl. 4.

2. For the legislative history of the BAPCPA, as well as a "red-lined" text of the Bankruptcy Code showing the BAPCPA amendments, see H.R. REP. NO. 109-31, pt. 1 (2005).

parties files for bankruptcy. Bankruptcy court orders preempt contrary provisions of state law by operation of the Supremacy Clause of the Constitution of the United States.<sup>3</sup>

This Article will address the following issues: (1) the rights acquired by and the consequences of a landlord or tenant filing for bankruptcy; (2) the effect of the automatic stay; (3) lifting the automatic stay and regaining possession by a landlord; (4) rent and administrative expense payments during the pendency of bankruptcy proceedings; and (5) the assumption or rejection of the lease.

### I. THE AUTOMATIC STAY<sup>4</sup>

The Bankruptcy Code (the Code) provides a debtor with several different types of relief. The more common actions are Chapter 7,<sup>5</sup> which is a complete liquidation, and Chapters 11<sup>6</sup> and 13,<sup>7</sup> which are debt reorganization proceedings.<sup>8</sup>

Upon the filing of a petition, the bankruptcy estate is established.<sup>9</sup> The estate generally includes “all legal or equitable interests of the debtor in property as of the commencement of the case,” and “[a]ny interest in property that the estate acquires after the commencement of the case.”<sup>10</sup> The filing of the petition commences the case and implements an automatic stay of any collection or other enforcement pro-

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3. U.S. CONST. art. VI, cl. 2.

4. For general information and extensive case citations, see those chapters on bankruptcy contained within Volumes 8A and 8B of *Corpus Juris Secundum* (primarily 8B C.J.S. *Bankruptcy* §§ 908-941 (2006)) and Volumes 9 through 9E of *American Jurisprudence 2d* (primarily 9C AM. JUR. 2D *Bankruptcy* §§ 2326-2387, 2395-2412 (2006)).

5. 11 U.S.C. §§ 701-784 (2006).

6. *Id.* §§ 1101-1174.

7. *Id.* §§ 1301-1330.

8. This Article will not discuss filings under Chapter 9 (municipalities) or Chapter 12 (family farms).

9. *Id.* § 541(a).

10. *Id.* § 541(a)(1), (7). The Code covers and refers to leases under the provisions applicable to executory contracts. *Id.* § 365; see *Gloria Mfg. Corp. v. Int'l Ladies Garment Workers' Union*, 734 F.2d 1020, 1021 (4th Cir. 1984) (“The Bankruptcy Code provides that, with some exceptions and subject to court approval, a trustee ‘may assume or reject any executory contract or unexpired lease of the debtor.’ 11 U.S.C. § 365(a). The Code nowhere defines ‘executory.’ Examination of the Code’s legislative history provides little help. It reveals only that Congress, aware of the imprecision of the term, intended executory contracts generally to include those ‘on which performance remains due to some extent on both sides.’” (quoting H.R. REP. No. 95-595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5844)).

ceedings against the debtor.<sup>11</sup> The automatic stay preempts and prohibits creditors from instituting, maintaining, or proceeding with any action against the debtor, or attempting to collect or enforce judgments or liens against the debtor after the petition is filed.<sup>12</sup>

It is the creditor's duty to verify whether a bankruptcy petition has been filed and whether a stay is in effect.<sup>13</sup> The creditor, or its counsel, acquires a further obligation to bring the debtor's bankruptcy filing to the attention of other courts in which litigation is pending, and to ensure that no further action is taken until the stay is lifted or the bankruptcy proceeding is completed.<sup>14</sup> The creditor's failure to honor the automatic stay may result in the creditor being held in contempt.<sup>15</sup> If the creditor's disregard of the automatic stay is found to be willful and knowing, the creditor may be subject to punitive damages.<sup>16</sup>

Even though a debtor has assigned a lease, the automatic stay protects any retained interest by the debtor.<sup>17</sup> If the debtor is a sub-tenant, the master lease may be protected by the automatic stay from adverse action.<sup>18</sup> Certain property interests of the debtor are not acquired by

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11. 11 U.S.C. § 362(a).

12. *Id.*

13. See *Carter v. Van Buskirk (In re Matter of Carter)*, 691 F.2d 390, 391-92 (8th Cir. 1982) ("Our review of the record convinces us that the district court was correct in concluding Lewis had received actual notice of the bankruptcy court's restraining order and, as indicated, that rather than disregard that order, Lewis was obligated to contact the bankruptcy court to ascertain whether the order had in fact been entered and to obey it." (citing *In re MacDonald*, 6 B.R. 23 (Bankr. N.D. Ohio 1980) (holding that the creditor was notified by debtor's counsel that a bankruptcy filing was imminent, and thus the creditor should have waited to repossess the automobile until creditor contacted the bankruptcy court and ascertained whether a bankruptcy petition had been filed))).

14. See *In re Mims*, 209 B.R. 746, 748 (Bankr. M.D. Fla. 1997) ("A creditor pursuing a garnishment simply cannot sit back and wait for the debtor to act because the effect is to continue to deprive the debtor of property in the possession of the garnishee or the state court in violation of the automatic stay. . . . The creditor and its agents, including its attorney, have an affirmative duty to stop the garnishment proceeding.").

15. 11 U.S.C. § 362(k).

16. *Id.*

17. See *48th St. Steakhouse, Inc. v. Rockefeller Ctr., Inc. (In re 48th St. Steakhouse, Inc.)*, 61 B.R. 182, 189 (Bankr. S.D.N.Y. 1986) ("Viewing the debtor's interest in the premises as that of an equitable owner because of the argued collateral assignment, the automatic stay was in any event violated when [the creditor] served the notices. This is so because a debtor's assignment of property for collateral purposes does not divest the debtor of all interest in the property. Thus, the automatic stay is triggered." (citations omitted)).

18. See *id.* at 188 ("In certain unusual circumstances, a third party may gain protection of the stay as an incidental result of the protection afforded estate property.

the bankruptcy estate. Examples include: (1) “any power that the debtor may exercise solely for the benefit of an entity other than the debtor,” and (2) “any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case.”<sup>19</sup>

## II. LIFTING THE AUTOMATIC STAY AND REGAINING POSSESSION

The bankruptcy estate does not include

any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case under this title, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case[.]<sup>20</sup>

Because the bankruptcy estate has no interest in a terminated lease, the automatic stay does not prevent “any act by a lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property.”<sup>21</sup> This exception to the automatic stay only applies to actual holdover tenants after expiration of the stated lease term and does not include situations where a debtor’s breach of a lease provision constitutes default and allows for termination of the lease.<sup>22</sup> The automatic stay does not toll the time at which the lease will expire in accordance with its stated terms.<sup>23</sup>

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In recognizing this, one court aptly stated: “Where, however, a debtor and a nondebtor are so bound by statute or contract that the liability of the nondebtor is imputed to the debtor by operation of law, then the Congressional intent to provide relief to debtors would be frustrated by permitting indirectly what is expressly prohibited by the Code. . . . Clearly the debtor’s protection must be extended to enjoin litigation against others if the result would be binding upon the debtor’s estate.” (quoting *Plessey Precision Metals, Inc. v. Metal Ctr., Inc.* (*In re Metal Ctr., Inc.*), 31 B.R. 458, 462 (Bankr. D. Conn. 1983)) (citing *Harsh Inv. Corp. v. Bialac* (*In re Bialac*), 712 F.2d 426, 432 (9th Cir. 1983) (“Neither of these interests are within protections afforded by a literal interpretation of section 362, yet they should be protected by the stay if the purposes of the Act, the orderly disposition of all property in which the debtor has some interest, are to be achieved.”))).

19. 11 U.S.C. § 541(b).

20. *Id.* § 541(b)(2).

21. *Id.* § 362(b)(10).

22. *Id.* § 362(a).

23. See *Consol. Energy Corp. v. O’Brien* (*In re Matter of Compass Dev., Inc.*), 55 B.R. 260, 262 (Bankr. D.N.J. 1985) (“It is, therefore, the opinion of this Court that § 362(a) was not intended to act as a toll on leases, contracts and the like, but only as a

The 2005 amendments to the Code allow landlords to evict defaulted or holdover tenants in other situations: (1) when any judgment or writ of possession is obtained by a landlord *prior to* the commencement of a bankruptcy petition, that action may be continued until or enforced after the bankruptcy proceedings are completed, and (2) a landlord may initiate an eviction proceeding during a bankruptcy proceeding if the grounds for the eviction are the tenant's use of controlled substances on the property or "endangerment" of the property.<sup>24</sup>

[T]he statutory language . . . provides no guidance to [a bankruptcy] court in making findings about the truth or legal sufficiency of a lessor's certification that the debtor has "endangered" the property or used or "allowed to be used" a "controlled substance" on the property. These terms and phrases are not defined in the . . . Code and are subject to varying interpretations.<sup>25</sup>

In addition to those limited situations, the landlord retains other options. The landlord may move the court to order or approve post-petition rent payments from the debtor pursuant to 11 U.S.C. § 365(d)(3). If granted, these rental payments are classified as an administrative expense of the estate and gain priority for payment over other subordinate claims until the lease is assumed or rejected.<sup>26</sup> The landlord may also petition the bankruptcy court for relief from the automatic stay pursuant to 11 U.S.C. § 362(d), if the lease expired after the debtor filed for bankruptcy and the debtor is holding over and remains in possession. Relief from the automatic stay may be granted on motion and after notice and hearing under the following circumstances:

- (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
- (2) with respect to a stay of an act against property under subsection (a) of this section, if—
  - (A) the debtor does not have an equity in such property; and
  - (B) such property is not necessary to an effective reorganization[.]<sup>27</sup>

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stay on actual proceedings and similar acts against the debtor. The Court agrees . . . that a lease is subject to expiration at its stated term, notwithstanding the protection of the automatic stay.”)

24. 11 U.S.C. § 362(b)(22)-(23).

25. 3 COLLIER ON BANKRUPTCY ¶ 362.05[21], at 84.4 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2008) (footnote omitted).

26. 11 U.S.C. § 365(d)(3).

27. *Id.* § 362(d).

Relief from the automatic stay in order to evict a debtor-tenant for default on an unexpired lease is rare and difficult to obtain. Repossession of leased premises by a creditor will ordinarily have a significant, if not catastrophic, effect on a debtor. The reluctance of bankruptcy courts to grant relief from the stay especially holds true in Chapter 11 proceedings, where the debtor-in-possession needs to retain the premises, remain open, and continue in business while re-organizing.<sup>28</sup>

The better remedy for the creditor-landlord is to move for the payment of post-petition rent as an administrative expense of the estate pursuant to 11 U.S.C. § 365(d)(3). This motion protects the continued stream of income to the landlord and prevents the debtor-tenant from becoming a free rider at the expense of other tenants, the landlord, and the lender.<sup>29</sup> A motion for allowance of administrative expense is required, unless otherwise provided by the bankruptcy court by a standing order or local rule.<sup>30</sup>

The stay remains in effect until any one of the following events occur: (1) an individual creditor moves for, and receives relief from, the automatic stay; (2) the property is removed from the bankruptcy estate; or (3) the case is closed, dismissed, or discharge is granted or denied.<sup>31</sup> A debtor may not waive the automatic stay, either all together or on a case-by-case basis, through a pre-petition agreement.<sup>32</sup> Any default provisions contained in the lease allowing the landlord to regain possession of the premises or terminate the lease as a default based on the filing of a bankruptcy petition are ineffective.<sup>33</sup>

### III. ASSUMPTION AND REJECTION OF THE LEASE

A bankruptcy trustee or debtor-in-possession can assume or reject only an unexpired lease.<sup>34</sup> In order to determine whether and when the lease term expired, the bankruptcy court reviews the status of the

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28. See *Zagata Fabricators, Inc. v. Superior Air Prods.*, 893 F.2d 624, 627 (3d Cir. 1990) ("Because bankruptcy proceedings are considered to be equitable, however, the landlord's right to collect monetary relief is somewhat curtailed . . ."); *In re Penny*, 52 B.R. 816 (Bankr. E.D.N.C. 1985).

29. 11 U.S.C. § 365(d)(3).

30. See *Mo. Dep't of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neill Shoe Co.)*, 64 F.3d 1146, 1147-48 (8th Cir. 1995).

31. 11 U.S.C. § 362(c)(1)-(2).

32. See *Commerzanstalt v. Telewide Sys., Inc.*, 790 F.2d 206, 207 (2d Cir. 1986) ("Relief from the effect of the automatic stay provisions of section 362(a)(1) must be sought from the bankruptcy court pursuant to section 362(d), and not from this court." (citations omitted)).

33. 11 U.S.C. §§ 365(e)(1), 541(c).

34. *Id.* § 365(a); see also *id.* §§ 362(b)(10), 541(b)(2).

lease on the day the petition was filed.<sup>35</sup> State property law generally determines the status of the parties and whether the lease has expired or has terminated.<sup>36</sup> Even if the lease terminated pre-petition, the debtor may still retain a residual interest, which will be protected by the automatic stay.<sup>37</sup> The unexpired lease must be assumed or rejected by the bankruptcy trustee or debtor-in-possession as a whole.<sup>38</sup>

#### A. *Tenant Files for Bankruptcy*

The Code allows a bankruptcy trustee to recover any “preferential payments” made to any creditors within the ninety days prior to the debtor’s filing for bankruptcy.<sup>39</sup> Payments made “in the ordinary course of business” are not preferential and are not subject to recapture, even if the debtor-tenant paid within ninety days prior to filing for bankruptcy.<sup>40</sup> Rental payments made by the debtor-tenant on or about

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35. See *In re Matter of Dunes Casino Hotel*, 63 B.R. 939, 946 (D.N.J. 1986) (“[A]n executory contract or lease validly terminated prior to the institution of bankruptcy proceedings is not resurrected by the filing of the petition in bankruptcy.” Thus, the court must examine the status of the contract on the date the petition was filed.” (citation omitted) (quoting *Kopelman v. Halvajian (In re Matter of Triangle Labs., Inc.)*, 663 F.2d 463, 467-68 (3d Cir. 1981)) (citing *In re Norquist*, 43 B.R. 224, 230 (Bankr. E.D. Wash. 1984))).

36. See *In re Matter of Escondido W. Travelodge*, 52 B.R. 376, 378 (S.D. Cal. 1985) (“An examination of § 365 reveals that a debtor may not assume a lease once it has expired. Expiration, in turn, has been defined by the case law to include termination under state law prior to the filing of a Chapter 11 petition.” (citations omitted) (citing 11 U.S.C. § 365; *Kearny Mesa Crossroads v. Acorn Invs. (In re Acorn Invs.)*, 8 B.R. 506, 510 (Bankr. S.D. Cal. 1981); Don Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341, 346 (1980))).

37. Protected interests may include options to purchase or renew or leasehold improvements. See *City of Valdez, Alaska v. Waterkist Corp. (In re Waterkist Corp.)*, 775 F.2d 1089, 1092 (9th Cir. 1985) (“Waterkist stands to lose its interest in over one million dollars in improvements. The City, on the other hand, is subject to a default of only \$27,301.52 on a lease in which the cash payments are secondary to the improvements to the leased property and the benefits to the local economy which the City has received. Applying Alaska law, we conclude that Waterkist’s interest in the lease is not forfeited. The bankruptcy court correctly determined that Waterkist could assume the lease as a debtor-in-possession.”).

38. See *In re Morande Enters., Inc.*, 335 B.R. 188, 192 (Bankr. M.D. Fla. 2005) (“The law is clear that an executory contract may not be assumed in part and rejected in part. If a contract is executory, it may be assumed only in whole and not in part. It is black letter law that an executory contract must be either assumed in its entirety, cum onere, or completely rejected.” (citations and internal quotation marks omitted)).

39. 11 U.S.C. § 547(b).

40. *Id.* § 547(c).

the due date are not generally considered a “preferential payment” because they are made “in the ordinary course of business.”<sup>41</sup>

Preferential claims may be asserted if a tenant makes late payments, or agrees to pay past due rent in installments, within the ninety days preceding the debtor’s filing for bankruptcy.<sup>42</sup> Those late payments are no longer made “in the ordinary course of business.”<sup>43</sup> Although late rental payments are not *per se* recoverable by the bankruptcy trustee, the burden of proof rests upon the creditor to establish the payment was “in the ordinary course of business.”<sup>44</sup>

### 1. Residential Leases

In Chapter 7 cases, the Code allows sixty days after the filing of the petition for the bankruptcy trustee to assume or reject an unexpired residential lease.<sup>45</sup> If neither assumption nor rejection occur within the sixty day time limitation, the lease is deemed rejected

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41. *See id.* § 547(b)-(c).

42. *Id.* § 547(c).

43. *See In re Matter of Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993) (stating that a late payment usually will not be in the ordinary course of business and will therefore be an avoidable preference, but acknowledging that a late payment can, under limited circumstances, be in the ordinary course of business).

44. *In re Matter of Xonics Imaging, Inc.*, 837 F.2d 763, 765 (7th Cir. 1988); *see, e.g., Armstrong v. Gen. Growth Dev. Corp. (In re Clothes, Inc.)*, 45 B.R. 419 (Bankr. D.N.D. 1984) (holding payments to be “in the ordinary course of business” where debtor, though in arrears for prior months, made rent payments for two months prior to filing, payments were credited to those months, and commercial lessor had a general policy of accepting current rent payments, while working out prior rental arrearages).

45. 11 U.S.C. § 365(d)(1); *see Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 85-86 n.1 (2d Cir. 2002) (“Whereas the Bankruptcy Code specifically gives a Chapter 11 debtor the authority to assume an unexpired lease, there is no corresponding provision in the code for a chapter 7 debtor. Under Chapter 7, only the bankruptcy trustee may exercise the option to assume or reject a lease. Stoltz’s public housing lease was deemed rejected by the trustee by operation of law under 11 U.S.C. § 365(d)(1). A rejected lease is abandoned and no longer property of the estate. Rejection, however, is not the same as termination. A rejected lease is treated as if the debtor breached it immediately prior to the petition date, and the parties are generally left with the rights and remedies available outside of bankruptcy law.” (citations and internal quotation marks omitted) (quoting *In re Rodall*, 165 B.R. 506, 507 (Bankr. M.D. Fla. 1994)) (citing 11 U.S.C. §§ 365(g), 1107(a); *In re Knight*, 211 B.R. 747, 748 (Bankr. D. Or. 1997); *Blackburn v. Sec. Pac. Credit Corp. (In re Blackburn)*, 88 B.R. 273 (Bankr. S.D. Cal. 1988); *In re Sheard*, No. 98-19627DWS, 1999 WL 454260, at \*3 (Bankr. E.D. Pa. June 24, 1999) (“[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 . . . .”)).

and possession by the tenant-debtor ends.<sup>46</sup> In cases filed under either Chapter 11 or 13, the debtor-in-possession may assume or reject an unexpired residential lease “at any time before the confirmation of a plan, but the court, on the 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.”<sup>47</sup> The bankruptcy trustee or debtor-in-possession must secure approval from the bankruptcy court to assume an unexpired lease.<sup>48</sup> If the lease is assumed, the rent either continues for the same amount previously reserved or at some amount as agreed to by the landlord and the bankruptcy trustee. The post-petition payments are given priority over other unsecured creditors as an administrative expense to the bankruptcy estate.<sup>49</sup>

Once the lease is assumed, the bankruptcy trustee may assign the lease.<sup>50</sup> The bankruptcy trustee may assign the unexpired lease only if: “(A) the trustee assumes such contract or lease in accordance with the provisions of [11 U.S.C. § 365]; and (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.”<sup>51</sup> This assignment can occur even if the lease contains an express provision prohibiting an assignment or sublease.<sup>52</sup>

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46. 11 U.S.C. § 365(d)(1).

47. *Id.* § 365(d)(2).

48. *Id.* § 365(a). All that need be done in the sixty day period is for the trustee to manifest an unequivocal intent to assume the unexpired lease. This manifestation is frequently made through a motion to assume the unexpired lease; however, the initial manifestation is not required to be made by motion. The court’s approval does not have to occur within the sixty day period. *See In re Delta Paper Co.*, 74 B.R. 58, 60 (Bankr. E.D. Tenn. 1987) (“The filing of the motion to assume by the debtor on March 24, 1987, within the 60-day period, was a sufficient manifestation of the debtor’s intention to assume as to meet the 60-day time requirement set forth in § 365(d)(4). This court believes a construction requiring the entire assumption process, including court approval, to occur within 60 days of the commencement of the case, to be unreasonable and out of step with the congressional intent behind the enactment of § 365(d)(4).”). The sixty day period previously proscribed by 11 U.S.C. § 365(d)(4) was replaced with a 120 day period in 2005. *See In re Matter of Burival*, 392 B.R. 793, 796 (Bankr. D. Neb. 2008).

49. *See* 11 U.S.C. § 365(d)(3).

50. *Id.* § 365(f).

51. *Id.* § 365(f)(2).

52. *Id.* § 365(e).

Generally, only the bankruptcy trustee may permit the assumption of a lease. However, an exception to this rule exists.<sup>53</sup> The Code allows an individual debtor to

- (A) . . . notify the creditor in writing that the debtor desires to assume the lease. Upon being so notified, the creditor may, at its option, notify the debtor that it is willing to have the lease assumed by the debtor and may condition such assumption on cure of any outstanding default on terms set by the contract.
- (B) If, not later than 30 days after notice is provided under subparagraph (A), the debtor notifies the lessor in writing that the lease is assumed, the liability under the lease will be assumed by the debtor and not by the estate.
- (C) The stay under section 362 and the injunction under section 524(a)(2) shall not be violated by notification of the debtor and negotiation of cure under this subsection.<sup>54</sup>

When the bankruptcy trustee rejects the unexpired lease, it is deemed to have been rejected immediately prior to filing the petition for bankruptcy.<sup>55</sup> The landlord retains a pre-petition general unsecured claim and should file a proof of claim for damages for breach of the lease.<sup>56</sup> The landlord does not attain the immediate right to possession, but must wait until the property is “abandoned.”<sup>57</sup>

[A]bandonment can occur in one of three ways. First, the trustee can abandon the lease during the pendency of the case by serving a notice of abandonment, and if necessary, obtaining an order of abandonment. This is a common practice where the value of the lease is inconsequential, and poses a risk of future liability to the estate. Second, a party in interest can seek to compel the trustee to abandon the lease.

Third, the trustee can abandon a lease through inaction, analogous to the “deemed rejection” provisions of the Bankruptcy Code. This form of abandonment depends on whether the debtor has identified the lease in her schedules. If the lease is scheduled, and the trus-

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53. *See id.* § 365.

54. *Id.* § 365(p)(2)(A)-(C).

55. *Id.* § 365(g)(1).

56. *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 85-86 n.1 (2d Cir. 2002). Rule 3001 of the Federal Rules of Bankruptcy Procedure sets out the requirements for filing and documenting the proof of claim.

57. *See In re Henderson*, 245 B.R. 449, 453-54 (Bankr. S.D.N.Y. 2000) (“As a rule, the rejection of a lease gives rise to a pre-petition breach, 11 U.S.C. § 365(g)(1), but does not terminate the lease. . . . Where, as here, the lease is residential in nature, the general rule applies. Thus, rejection, without more, does not terminate the lease or immediately divest the estate of its interest in the lease. In this regard, property of the estate ceases to be property of the estate when it is abandoned . . . .” (citation and footnote omitted)).

tee does not administer it, the lease is deemed abandoned to the debtor when the case is closed. If it is not scheduled, it is not abandoned. In either case, the court can order a different result.<sup>58</sup>

The time for filing a proof of claim for rejection damages is normally set by the bankruptcy court in the order approving the motion to reject.<sup>59</sup> The Code limits the claim for damages for breach of the lease to a sum that is the greater of one year's rent or fifteen percent of the rental due for the remaining term of the lease, not to exceed three years' rent.<sup>60</sup>

The same general rules apply to bankruptcies under Chapters 11 and 13 that involve residential leases, with two exceptions: (1) the debtor-in-possession has the authority to assume or reject the lease, and (2) there is no automatic deadline by which the lease must be assumed or rejected.<sup>61</sup> The only requirement is that the assumption or rejection of the lease be accomplished prior to confirmation of the plan.<sup>62</sup> This flexibility provides the debtor-in-possession the time needed to determine whether the unexpired lease is beneficial to the bankruptcy estate.<sup>63</sup> The landlord may move the bankruptcy court to establish a deadline for assumption or rejection of the lease and for the payment of administrative expenses while the debtor-tenant remains in possession.<sup>64</sup>

## 2. Non-Residential Leases

For non-residential leases, the bankruptcy trustee in a Chapter 7 case or debtor-in-possession in a Chapter 11 case must assume or reject the unexpired lease by the earlier of: (1) 120 days<sup>65</sup> after the order for relief is entered, or (2) the time the order confirming a plan is entered.<sup>66</sup> If the lease is rejected, the debtor "shall immediately surren-

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58. *Id.* at 454 (citations and footnotes omitted).

59. 11 U.S.C. § 502(a)-(b).

60. *Id.* § 502(b)(6); *see also* FED. R. BANKR. P. 3001(f).

61. 11 U.S.C. § 365(d)(2); *Stoltz*, 315 F.3d at 85-86 n.1.

62. 11 U.S.C. § 365(d)(2).

63. *See Data-Link Sys., Inc. v. Whitcomb & Keller Mortgage Co. (In re Matter of Whitcomb & Keller Mortgage Co.)*, 715 F.2d 375, 378 n.3 (7th Cir. 1983) ("Since a debtor is in limbo until confirmation of a plan, it is understandably difficult to commit itself to assuming or rejecting a contract much before the time for confirmation of a plan. Thus, the code allows for the debtor to provide for assumption or rejection of the executory contracts in its plan. This procedure insures that the debtor is not in the precarious position of having assumed a contract relying on confirmation of a particular plan, only to find the plan to have been rejected.").

64. *See id.* at 379.

65. Sixty days pre-BAPCPA. 9C AM. JUR. 2D *Bankruptcy* § 2397 (2006).

66. 11 U.S.C. § 365(d)(4)(A).

der that nonresidential real property to the lessor.”<sup>67</sup> The 120 days is a strict deadline and the lease will be rejected by operation of law if the lease is not unequivocally assumed within that time period.<sup>68</sup>

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67. *Id.*; see *In re Tubular Techs., LLC*, 348 B.R. 699, 713-14 (Bankr. D.S.C. 2006) (“Further, the mandate in the Rejection Order, which exactly traces the language of the bankruptcy statute in requiring the immediate surrender of the Leased Premises, is also consistent with the general principals of federalism and supremacy of federal laws. Section 365(d)(4) clearly occupies this area of the law in the context of debtors’ relationships with their landlord, and it requires Debtor, without regard to Debtor’s rights at state law, to surrender the Leased Premise upon the rejection of the Lease. The result produced by the Rejection Order is constitutional and consistent with the Supremacy Clause. Many other courts have reached similar conclusions under the pre-Reform Act version of § 365(d)(4), which also provided for immediate surrender of nonresidential real property upon rejection of a lease.” (citations omitted)).

68. See *In re BDM Corp.*, 71 B.R. 142, 144 (Bankr. N.D. Ill. 1987) (“Based on a reading of section 365 in its entirety, together with the language of Bankruptcy Rules 6006 and 9014, and the analysis of recent authority, this court concludes that the only method of declaring an intention to assume is by filing a formal motion to assume within 60 days[, now 120 days,] of the order for relief and that failure to do so will result in the lease being deemed rejected by operation of law.”).

A debtor may be able to argue waiver or estoppel against the landlord. See *In re Matter of Lew Mark Cleaners Corp.*, 86 B.R. 331, 335 (Bankr. E.D.N.Y. 1988) (“This court is more inclined to follow Judge Buschman’s well-reasoned decision in [*In re T.F.P. Resources*], which concluded that since the 60 day termination rule is for the benefit of lessors, lessors can waive its application. If waiver was not applicable, even in extreme circumstances, harsh results are conceivable. One could imagine the inequities if a landlord accepted rental payments from a debtor/lessee for years during the pendency of a Chapter 11 reorganization, only to pull the rug out from under the debtor if the market value of the lease appreciated. The landlord would essentially reap a windfall and would have all the benefits of the bargain with the ability to terminate the contract at any time. Therefore, waiver should properly be a question of intent as manifested by the lessor’s acts.” (citing *In re T.F.P. Res., Inc.*, 56 B.R. 112 (Bankr. S.D.N.Y. 1983))); *Pier 5 Mgmt. Co. v. Occoquan Riverfront P’ship (In re Pier 5 Mgmt. Co.)*, 83 B.R. 392, 394 (Bankr. E.D. Va. 1988) (“This Court holds that equitable considerations retain their validity in determining whether a lease should be deemed rejected by operation of law under § 365(d)(4). Having promised to provide the information necessary to resolve the rent dispute, the Court finds the Partnership’s subsequent change of position without notice to Pier 5 operates to estop the Partnership from asserting the forfeiture of § 365(d)(4). Therefore, this Court holds that the lease is not deemed rejected and may be assumed by the Chapter 7 Trustee within 60 days of this ruling.” (citations omitted) (citing *In re Matter of Haute Cuisine, Inc.*, 57 B.R. 200 (Bankr. M.D. Fla. 1986); *In re Fosko Mkts., Inc.*, 74 B.R. 384 (Bankr. S.D.N.Y. 1987))).

All that need be done within the sixty day period is the unequivocal expression of intent to assume; court action need not be taken within the time frame. See *In re Delta Paper Co.*, 74 B.R. 58, 60 (Bankr. E.D. Tenn. 1987) (“The filing of the motion to assume by the debtor . . . within the 60-day period, was a sufficient manifestation of the debtor’s intention to assume as to meet the 60-day[, now 120-day,] time

It is common in large-scale Chapter 11 cases for the deadline to accept or reject the lease to be extended for many months or even years into the future. If the bankruptcy court extends the debtor's time period to assume or reject, the creditor should move for the continued payment of rent as an administrative expense pursuant to 11 U.S.C. § 365(d)(3). Failure to do so may jeopardize a sale or financing of the property subject to the lease and place the creditor in default of its loan covenants.

Most bankruptcy courts prefer for the bankruptcy trustee or debtor-in-possession to express by written motion the unequivocal intent to assume the lease.<sup>69</sup> The motion can be included in the debtor-in-possession's bankruptcy plan, so long as it is filed and notice is given within the 120-day time frame.<sup>70</sup> If the lease is rejected by

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requirement set forth in § 365(d)(4). This court believes a construction requiring the entire assumption process, including court approval, to occur within 60 days[, now 120 days,] of the commencement of the case, to be unreasonable and out of step with the congressional intent behind the enactment of § 365(d)(4).”

69. See *Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077, 1079 (9th Cir. 1989) (“Bankruptcy Rule 6006(a) provides that a proceeding to assume or reject a lease is governed by Bankruptcy Rule 9014. Rule 9014 states that relief shall be requested by motion, with reasonable notice and opportunity for a hearing afforded to the opposing party. A motion must state with particularity the grounds therefore, and . . . set forth the relief or order sought. Rule 9013 also specifies that every written motion (except those which may be considered *ex parte*) must be served on the trustee or the debtor in possession and on any entities specified by the Bankruptcy Rules. Thus, these rules plainly specify that a debtor in possession must file a formal motion and provide reasonable notice and an opportunity for a hearing to the opposing party.” (citations and internal quotation marks omitted)).

See *Mut. Life Ins. Co. v. Dublin Pub., Inc. (In re Matter of Dublin Pub., Inc.)*, 81 B.R. 735, 736 (Bankr. N.D. Ga. 1988) (“The Court has carefully reviewed the case law on the issue of whether a debtor can assume an unexpired lease of nonresidential real property by its conduct and has found that the overwhelming majority of cases hold that a debtor must file a formal written motion within the 60-day period.”); see also *Vilas & Sommer Inc. v. Mahony (In re Matter of Steelship Corp.)*, 576 F.2d 128, 132 (8th Cir. 1978) (“While section 70(b) requires the trustee to file a sworn statement showing which of the bankrupt's contracts have been rejected, no such requirement is imposed for an assumption of an executory contract. An assumption may be shown by word or by deed consistent with the conclusion that the trustee intended to assume.” (citations omitted)).

70. See *Riddle v. Aneiro (In re Aneiro)*, 72 B.R. 424, 428 (Bankr. S.D. Cal. 1987) (“[The] [l]essor . . . received notice of th[e] plan's filing on March 12, 1985, 29 days after the debtor's petition was filed. [The] [d]ebtor's motion to assume the lease was 'made' when served on [the lessor]. The liberal policies underlying Chapter 13 relief do not require a separate, formal motion to assume a lease where the debtor communicates an intent to assume pursuant to § 1322(b)(7) under the terms of a plan filed within the § 365(d)(4) time period.”).

operation of law, the landlord is not required to take any further action to have the lease rejected, and the debtor must surrender the property.<sup>71</sup> A split of authority exists among bankruptcy courts regarding whether the landlord must seek relief from the automatic stay before ejecting the debtor.<sup>72</sup>

B. *Landlord Files for Bankruptcy*<sup>73</sup>

The Code's provision allowing the debtor to assume or reject any unexpired lease applies equally to a bankrupt landlord.<sup>74</sup> On its face, 11 U.S.C. § 365 would appear to subject a tenant to undue hardship

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71. See *In re S. Motel Assocs., Ltd.*, 81 B.R. 112, 119 (Bankr. M.D. Fla. 1987) ("Because SMA did not comply with the provisions of § 365(d)(4), the Court finds that the subject leases terminated as a matter of law sixty days after the order for relief in this case. No court order is necessary for the rejection to occur; the rejection occurs automatically and the rejection terminated the leases." (citation omitted) (citing *Ridgeview Lincoln-Mercury, Inc. v. Hurst Lincoln-Mercury, Inc.* (*In re Hurst Lincoln-Mercury, Inc.*), 70 B.R. 815 (Bankr. Ohio 1987))); see also *In re BDM Corp.*, 71 B.R. at 145.

72. Compare *In re Boston Bus. Machs.*, 87 B.R. 867, 871 (Bankr. E.D. Pa. 1988) ("[A] landlord must obtain relief from the automatic stay before seeking to dispossess a tenant irrespective of the debtor-tenant's failure to assume, and hence its implicit rejection of, a lease under § 365(d)(4). We continue to believe that the language of § 365(d)(4) requiring a debtor to 'immediate[ly] surrender' an unassumed leasehold should not be read in such a fashion as to permit a landlord to oust a debtor-tenant without recourse to state-law procedures for conducting an eviction which would otherwise be in place." (citations omitted)), *In re Dial-A-Tire, Inc.*, 78 B.R. 13, 16 (Bankr. W.D.N.Y. 1987), *In re Re-Trac Corp.*, 59 B.R. 251, 259 (Bankr. D. Minn. 1986), and *In re Mead*, 28 B.R. 1000, 1001-02 & n.2 (E.D. Pa. 1983), with *In re Criadores De Yabucoa, Inc.*, 75 B.R. 96, 96-97 (Bankr. D.P.R. 1987) (allowing dispossession of tenant-debtor from the leased premises without an accompanying attempt by landlord to be relieved from the automatic stay).

See *In re Damianopoulos*, 93 B.R. 3, 6 (Bankr. N.D.N.Y. 1988) ("The automatic stay is triggered by the filing of a bankruptcy petition and continues until certain property is no longer property of the estate and the earlier occurrence of the closing or dismissal of the case or the denial or granting of a discharge. Subject to certain exceptions, the stay operates to protect the debtor or the property of the estate from almost any type of formal or informal action. Thus, if the Court concludes that the Debtor has no possessory interest in the Cafe lease or that said lease is not property of the estate, the automatic stay does not affect it. This would be true regardless of whether the lease terminated pre or post-petition and would effectively render HRR's motion moot." (citations omitted)); see also *Town of Islip v. Ne. Int'l Airways, Inc.* (*In re Ne. Int'l Airways, Inc.*), 56 B.R. 247, 249 (S.D. Fla. 1986); *Bregman v. Meehan* (*In re Meehan*), 59 B.R. 380, 382-83 (E.D.N.Y. 1986).

73. The statutes and case law do not appear to differentiate between residential and nonresidential leases, other than the time period within which the lease must be assumed or rejected.

74. 11 U.S.C. § 365 (2006).

when its landlord files for bankruptcy. However, the Code provides the tenant with a remedy under 11 U.S.C. § 365(h)(1):

- (A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—
  - (i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
  - (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.
- (B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.<sup>75</sup>

This provision provides the solvent tenant of a bankrupt landlord with two options: (1) treat the rejection as a termination of the lease, quit the premises, and file a claim for damages against the bankruptcy estate, or (2) remain on the premises and continue to pay rent, withholding whatever amount is necessary to “self-compensate” for damages incurred in performance of obligations that were originally assigned to or assumed by the landlord under the lease.<sup>76</sup> If the solvent tenant chooses to remain on the premises and perform those obligations, further rent payments may be completely offset by the costs of performance of the landlord’s lease obligations. If the tenant’s dam-

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75. *Id.* § 365(h)(1)(A)-(B).

76. *Id.*; see also *Milstead v. Tele Media Broad., Inc. (In re Milstead)*, 197 B.R. 33, 35-36 (Bankr. E.D. Va. 1996) (“Under § 365(g)(1), rejection of an unexpired lease by a debtor constitutes a breach of that lease prepetition. Accordingly, the non-debtor party to the lease becomes the holder of an unsecured prepetition claim.”).

ages exceed the amount that is withheld in rent, those additional damages are not recoverable.<sup>77</sup>

A significant risk that a tenant could be dispossessed may arise if a solvent tenant rests on its 11 U.S.C. § 365(h)(1) laurels, without also paying attention to 11 U.S.C. § 363(f), which states:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.<sup>78</sup>

The use of the coordinating disjunctive “or” shows congressional intent that the existence of and compliance with either of these conditions is sufficient to validate the sale.<sup>79</sup>

This precise situation arose in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)*.<sup>80</sup> Precision, as tenant, entered into a land lease agreement with Qualitech, wherein Qualitech granted Precision exclusive possession of the land for a ten year period.<sup>81</sup> Qualitech filed for Chapter 11 bankruptcy protection one year after the lease had commenced.<sup>82</sup> After notice to all creditors and parties in interest, Qualitech sold all of its assets “free and clear of all liens, claims, encumbrances, and interests.”<sup>83</sup> The purchaser of the property asserted it was not bound by Precision’s lease.<sup>84</sup> The bankruptcy court agreed, but the district court disagreed and held the purchaser was bound by the lease.<sup>85</sup>

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77. 11 U.S.C. § 365(h)(1)(B); *Milstead*, 197 B.R. at 36 (“Under § 365(h)(2), a debtor lessor remains liable for any damages caused by the nonperformance of any obligation of the debtor under the lease, but the lessee’s damages are limited to an offset of the rent due under the lease.”).

78. 11 U.S.C. § 363(f).

79. *Id.*

80. 327 F.3d 537 (7th Cir. 2003).

81. *Id.* at 540.

82. *Id.*

83. *Id.* at 541.

84. *Id.*

85. *Id.* at 542.

The case was appealed to the United States Court of Appeals for the Seventh Circuit. The issue presented before the court was whether “the terms of [11 U.S.C. § 365(h)] conflict with and override those of [11 U.S.C. § 363(f)].”<sup>86</sup> The court of appeals reversed the district court’s ruling and held that Qualitech’s selling of its assets under 11 U.S.C. § 363(f) completely extinguished any right or interest that Precision, as tenant, possessed in the land under its lease.<sup>87</sup> The court of appeals based its decision on Precision’s *failure to object, after it had notice, to the proposed sale of the underlying property*.<sup>88</sup> If Precision had timely objected to the proposed sale by the debtor under 11 U.S.C. § 363, the bankruptcy court would have been required to take steps to protect Precision’s leasehold rights.<sup>89</sup>

The court of appeals stated that the provisions of 11 U.S.C. §§ 363(f) and 365(h) can be harmonized and are not in conflict:

[I]t is apparent that the two statutory provisions can be construed in a way that does not disable section 363(f) vis à vis leasehold interests. Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee’s possessory interest—provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.<sup>90</sup>

Where a solvent tenant is facing a bankrupt landlord, the tenant must be ever vigilant to protect its possessory rights.<sup>91</sup> Otherwise, and particularly in the case of a land lease of unimproved property, a debtor-tenant could lose not only possession, but also the use and value of all leasehold improvements it made on the property. In many

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86. *Id.* at 546.

87. *Id.* at 546-48.

88. *Id.* at 548.

89. *Id.*; *see also* 11 U.S.C. § 363(e)-(f) (2006).

90. *Precision*, 327 F.3d at 548.

91. *See* N.C. GEN. STAT. § 22-2 (2007) (“All . . . contracts for leasing lands exceeding in duration three years from the making thereof, shall be void unless . . . put in writing and signed by the party to be charged therewith . . .”); *id.* § 47-18 (“No . . . lease of land for more than three years shall be valid to pass any property interest . . . but from the time of registration thereof in the county where the land lies . . .”); John M. Tyson, *Drafting, Interpreting, and Enforcing Commercial and Shopping Center Leases*, 14 CAMPBELL L. REV. 275, 277 (1992) (“[The Conner Act, North Carolina’s recordation statute,] has been interpreted to require the party asserting a superior right to be a bona fide purchaser for value.”).

cases, the lost value of the leasehold improvements may far exceed the value of the underlying property.

#### SUMMARY

Exercising simple caution in pending bankruptcy proceedings will prevent major headaches for the solvent landlord or tenant when the other files for bankruptcy. Know the Code's limitations and seek counsel from a knowledgeable bankruptcy attorney. When in doubt, presume the automatic stay applies and affects a creditor's ability to enforce its lease. Not proceeding with enforcement actions after the automatic stay becomes effective may keep a creditor from raising the ire of a bankruptcy judge and from having to pay compensatory and, possibly, punitive damages to the debtor. Note the deadline for the debtor-in-possession or trustee to assume or reject an unexpired lease, and ensure that the bankrupt tenant is not unintentionally dispossessed by operation of law.

To preserve cash flow a landlord should immediately seek payment of post-petition rent through a motion for payment of administrative expenses pursuant to 11 U.S.C. § 365(d)(3). A solvent tenant must preserve the value and continued use of leasehold improvements and ensure that a sale pursuant to 11 U.S.C. § 363 does not "slip through" to deprive the tenant of their 11 U.S.C. § 365(h) options to protect and enforce the terms of the lease.