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REPRESENTING A LANDLORD WHOSE TENANT IS IN A CHAPTER 7 OR 13 BANKRUPTCY

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A CLE Presentation

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1. **Introduction.**

Landlords who have leased real property to tenants who then file a Chapter 7 or 13 bankruptcy generally want their leased property back as quickly as possible with the least amount of hassle as possible. The purpose of this article is to point out ways in which that landlord can quickly and easily terminate the lease with the debtor and recover the leased property.

2. **The Statutory Framework.**

11 U.S.C. § 365 controls leases of real property in a Chapter 7 or 13 bankruptcy.¹ Under § 365(a), a trustee, subject to the court's approval, may assume or reject any unexpired lease of the debtor. Of particular application is § 365(c)(3), under which the trustee may not assume or assign any unexpired lease of the debtor, whether or not such lease prohibits or restricts assignment of rights or delegation of duties, if such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.²

Pursuant to 11 U.S.C. § 541(b)(2) a bankruptcy estate does include a nonresidential lease of real property that has terminated at the expiration of the stated term of such lease before the filing of the bankruptcy petition by the tenant/debtor.³

Pursuant to 11 U.S.C. § 362, the automatic bankruptcy stay protects a tenant/debtor from a landlord initiating or pursuing claims against the tenant/debtor.⁴ However, pursuant to §362(b)(10), the automatic stay does not apply to actions 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 filing of a bankruptcy petition by the tenant/debtor.⁵

3. **Working through Section 365(c)(3)**

A. In General.

Pursuant to § 365(c)(3), a trustee in bankruptcy may not assume or assign an unexpired lease of the debtor, whether or not such lease prohibits or restricts assignment of rights or delegation of duties, if such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief⁶.

If a lease for nonresidential real property terminates before the tenant/debtor files a bankruptcy petition, the bankruptcy trustee for that estate cannot assume, assign or reject the lease because the lease, as an asset, technically never became part of the bankruptcy estate. The critical issue is whether a

¹ 11 U.S.C. § 365 is reprinted in full at Appendix A.

² § 365(c)(3).

³ "Property of the estate does not include—(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 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." 11 U.S.C. § 541 (b)(2).

⁴ Robinson v. Chicago Housing Authority, 54 F.3d 316 (7th Cir. 1995).

⁵ "The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—(10) under subsection (a) of this section, of 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." 11 U.S.C. § 362(b)(10).

⁶ § 365(c)(3).

lease has “terminated” under “applicable nonbankruptcy law prior to the order for relief”. Since an “order for relief” occurs when a bankruptcy petition is filed⁷, and “applicable nonbankruptcy laws” are the laws of the state which govern the case,⁸ a more simple way to state the critical issue is whether, prior to the tenant’s filing for bankruptcy (either under chapter 7 or 13), the lease has terminated under the state’s laws that control in the bankruptcy.⁹

It can be a difficult exercise to prove termination under state law, but at least § 541(b)(2) provides some guidance on termination upon the expiration of a stated term of the lease. According to § 541(b)(2), when a bankruptcy petition is filed by a tenant *after* his lease for *non*-residential real property has terminated, because the stated lease term expired, that lease cannot become part of the estate.¹⁰ Obviously, § 541(b)(2) only covers one specific fact scenario—a rather clear factual scenario at that.

B. Termination/Expiration/Default

“Termination,’ ‘default’ and ‘expired’ are not coextensive; to allow full equation would thwart the Congressional intent that trustees (and Chapter 13 debtors) may cure default for the benefit of the estate pursuant to section 365.”¹¹

There is some confusion regarding the differences between a lease terminating¹², a lease expiring¹³ and a lease being in default¹⁴. When a controversy does arise, it is usually over the scope of the terms “terminated” “expired” and “default”¹⁵. None of the terms are defined in the bankruptcy code. The distinction between termination, expiration and default is important in the §365 context as the above quote notes. Termination is the key concept; defaults can be cured by the trustee and expired non-residential leases are not property of the estate pursuant to § 541(b)(2).

In pedagogical terms, a default can lead to a termination of a lease, but not to an expiration of a lease. An expiration of a lease term is a termination of the lease, but a termination of a lease is not necessarily the result of an expiration of a lease term. If there has been termination of lease either by

⁷ 11 U.S.C. § 301. “The commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter.” 11 U.S.C. § 301.

⁸ See *In re Memphis-Friday’s Associates*, 88 B.R. 830, 834 (Bkrtcy. W.D.Tenn. 1988).

⁹ See e.g., *Ericson v. Polk*, 921 F.2d 200 (8th Cir. 1990); *Vanderpark Props., Inc. v. Buchbinder (In Re Windmill Farms, Inc.)*, 841 F.2d 1467 (9th Cir. 1988); *Norritech v. Geonex Corp.*, 204 B.R. 684 (D.Md. 1997), *aff’d* 120 F.3d 261 (4th Cir. 1998); *Ross v. Metropolitan Dade County*, 142 B.R. 1013 (S.D. Fla. 1992), *aff’d without op.*, 987 F.2d 774 (11th Cir. 1993); *City of Valdez v. Waterkist Corp.*, 775 F.2d 1089 (9th Cir. 1985); *Moody v. Amoco Oil Co.*, 734 F.2d 1200 (7th Cir.), *cert denied*, 469 U.S. 982 (1984); *In re Slim Life Weight Loss Ctrs.*, 182 B.R. 701 (Bankr. D. N.J. 1995); *In re Talley*, 69 B.R. 219 (Bankr. M.D. Tenn. 1986).

¹⁰ Presumably, § 541(b)(2) does add anything that §365(c)(3) does already cover.

¹¹ *Matter of Ross v. Metropolitan Dade County*, 142 B.R. 1013, 1015 (S.D.Fla. 1992 (citing *In re Talley*, 69 B.R. 219, 223 (Bankr. M.D.Tenn.1986)).

¹² “Termination . . . [w]ith respect to a lease or contract, term refers to an ending, usually before the end of the anticipated term of the lease or contract.” 1 Black’s Law Dictionary 1025, 6th ed. 1991.

¹³ “Expiration. Cessatio; termination from mere lapse of time, as the expiration date of a lease.” 1 Black’s Law Dictionary 401, 6th ed. 1991.

¹⁴ “Default. By its derivation, a failure. An omission of that which ought to be done. Specifically, the omission or failure to perform a legal or contractual duty.” 1 Black’s Law Dictionary 288, 6th ed. 1991.

¹⁵ See for example, *Robinson; Hart Envtl. Management Corp. v. Sanshoe Worldwide Corp. (In re Sanshoe Worldwide Corp.)*, 993 F.2d 300 (2nd Cir. 1993); *Vanderpark Props., Inc. v. Buchbinder (In re Windmill Farms, Inc.)*, 841 F.2d 1467 (9th Cir. 1988).

expiration of the term or otherwise, the lease does not become part of the bankruptcy estate of the tenant/debtor. To determine if there has been a termination, courts resort to a two part test.

C. The Two Part Termination Test

To determine if a lease has been terminated: 1) it must be determined whether the lease was terminated prepetition under applicable state law; 2) it must be determined whether the termination would be reversed under the state's nonforfeiture doctrine.¹⁶ This test is controlling in the Seventh Circuit according to Robinson. In Robinson, the Seventh Circuit Court of Appeals, in holding that once a residential lease is terminated under state law, it is therefore expired for § 365(a) purposes, explained the two part termination test as follows:

[f]irst, the landlord must have taken all the necessary procedural steps to repossess the premises . . . [s]econd, the lease may not be considered ended until the tenant herself no longer has legal recourse to revive the lease . . . Thus where there is a viable possibility that the tenant could still take action to preserve the lease, the lease has not been terminated.¹⁷

Addressing the first part of the test in Robinson, the Court looked to Illinois law—the controlling law—regarding residential lease termination. According to Illinois lease termination law, the complete process of evicting a tenant involves five distinct steps. By getting to the fourth step, obtaining a judgment for possession, the landlord had taken the requisite steps to terminate the lease and at that point “there [is not] any recourse left for the tenant to revive the lease.”¹⁸

The second part of the test focuses on anti-forfeiture statutes:

[p]erhaps this should be restated to clarify that until the lease termination process has been completed there has been no “termination subject to reversal”. As long as an asserted or alleged lease termination is still subject to an anti-forfeiture (i.e., anti-termination) proviso of a state statute, or a right to resort to equity for relief to prevent such forfeiture or termination, then, until such time as such anti-forfeiture or anti-termination hurdles are cleared it may be imprecise to say that there has been a forfeiture of (sic) termination; and, somewhat confusing to say that an asserted or alleged forfeiture or termination is subject to reversal when what is intended is that an ultimate termination may still be avoided by a resort to equity or the application of an anti-forfeiture or anti-termination provision under state law. In other words, if the extinguishment of the lease interest is still subject to an existing and available statutory grace proviso or right to resort to equity to prevent a forfeiture or termination then there has not, as yet, been any ultimate or final termination for the purpose of analyzing whether this court has initial jurisdiction, whether the stay of § 362 is applicable, and whether the provisions of § 365 are applicable.¹⁹

D. Residential/Non-Residential Lease Termination Differences.

According to § 365(a) a trustee may only assume or assign an *unexpired* lease of the debtor—this section applies equally to residential and non-residential leases. The Court in Robinson even went so far as to say that there is no distinction between “expired” and “terminated” residential leases. By the structure of § 365(c)(3) and 362(b)(10), there appears to be distinction between the treatment of

¹⁶ In re Masterworks, Inc., 94 B.R. 262, 265 (Bkrtcy. D.Conn. 1988).

¹⁷ Robinson, 54 F.3d at 321.

¹⁸ Id at 322.

¹⁹ Executive Square Office Building v. O'Connor and Associates, 19 B.R. 143, 146 (N.D. Fla 1981).

residential and non-residential leases—only non-residential leases are referenced in § 365 (c)(3) and § 362(b)(10). The difference in treatment between residential and nonresidential leases was explained in the legislative history pursuant to the revisions of § 365(c)(3) as follows:

[i]n 1984, section 365 was amended to prohibit a trustee from assuming nonresidential leases: The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of the right or delegation of duties, if . . . (3) such lease is of nonresidential real property and has been terminated under applicable bankruptcy law prior to the order for relief. 11 U.S.C. § 365(c)(3). Significantly, this prohibition is silent as to residential leases. Congress' different treatment of residential and non-residential leases may be explained by the following statement: A distinction between residential leases is made here and in other provisions of this subtitle. The application of these provisions is limited to non-residential leases in order to avoid depriving residential tenants of whatever consumer protection they may have under applicable non-bankruptcy law." S.Rep. No. 65, 98th Cong., 1st Sess., 37 (1983).

The key difference lies in the body of state consumer law that protects a residential lessee from termination. In other words, there might be two tests for termination of a lease: one for residential real property and one for nonresidential real property.

E. Termination Clauses.

Bankruptcy termination clauses in leases under § 365(e) are not enforceable. Section 365(e) has also been held to preempt contrary provisions of state law which purport to release the non-debtor from a contract upon bankruptcy filing.²⁰

F. Indiana Lease Termination Law.

According to the Indiana law of lease termination, a lease for real property is terminated when any of the following occur: there is a surrender and acceptance, there is an abandonment, the lease term expires, ten (10) days after an I.C. § 32-7-1-6 notice is sent and no rent is received or a proper notice of termination under the lease is sent to the tenant.

G. Emergency Rejection of the Lease

While this article has heretofore described terminating a lease so that it never becomes part of a bankruptcy estate, the purpose of this subsection is to provide a method of rejecting a lease in a case where the lease becomes part of the estate, the tenant wants to return the leased real property to the landlord and the lease is of no value to the estate. In this fact scenario, a "Joint Application of Trustee, Debtor (Lessee) and Lessor for the Immediate 1) Rejection and Termination of Lease for Real Property, 2) Abandonment of Real Property and 3) Modification of Stay" may be filed with the Court.²¹

²⁰ See Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995).

²¹ See Appendix "B".