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HOW DO YOU SCHEDULE AND EFFECT THE TREATMENT OF AN AUTOMOBILE LEASE IN A CHAPTER 7 CASE?

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A CLE Presentation

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Treatment of unexpired lease—dischargeability of debt

Section 365(a) of Bankruptcy Code

(a) Except as provided in §§ 756 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

Section 502(g) of Bankruptcy Code

(g) A claim arising from the rejection, under § 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

Section 524(a) of Bankruptcy Code

(a) A discharge in a case under this title—

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under §§ 727, 944, 1141, or 1328, of this title, whether or not discharge of such debt is waived.

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived; and

(3) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect or recover from, or offset against, property of the debtor of the kind specified in § 541(a)(2) of this title that is acquired after the commencement of the case that is excepted from discharge under §§ 523, 1228(a)(1), or 1328(a)(1) of this title, or that would be so excepted, determined in accordance with the provisions of § 523(c) and 523(d) of this title, in a case concerning the debtor's spouse commenced on the date of the filing of the petition in the case concerning the debtor, whether or not discharge of the debt based on such community claim is waived.

Section 727(b) of Bankruptcy Code

(b) Except as provided in § 523 of this title, a discharge under subsection (a) of this section discharges the debtor from all debts that arose before the date of the order for relief under this chapter, and any liability on a claim that is determined under § 502 of this title as if such claim had arisen before the commencement of the case, whether or not proof of claim based on any such debt or liability is filed under § 501 of this title, and whether or not a claim based on any such debt or liability is allowed under § 502 of this title.

Introduction

According to § 541(a), the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). When a Chapter 7 bankruptcy petition is filed, the trustee takes control of all the assets of the estate, including the debtor's rights under any unexpired lease. According to § 365(a), the trustee may either assume or reject the debtor's interest in an unexpired lease. In a Chapter 7 case, "the debtor has no authority to exercise the option of assuming or rejecting leases." *In re Knight*, 211 B.R. 747, 748 (Bankr. Or. 1997). As part of the debtor's duties as defined by § 521, the debtor is required to list an unexpired auto lease on Schedule G, and also file a statement of intention with respect to the retention or surrender of the property. Shortly after the filing of the Chapter 7 bankruptcy petition, the debtor will obtain a discharge from the vehicle lease payment obligations. The discharge injunction of § 524(a) will enjoin the lessor from any act to collect lease payments from the debtor.

Dischargeability of debt—is claim pre- or post-petition?

One issue in Chapter 7 cases, that includes an unexpired auto lease, has been whether the lessor's claim for excess mileage under the lease, or dents and scratches on the vehicle, constitutes a debt that was discharged in bankruptcy. According to the Bankruptcy Code, once a debtor receives a discharge for a Chapter 7 bankruptcy, per the requirements in § 727(a), the debtor is discharged "from all debts that arose before the date of the order for relief... and any liability on a claim that is determined under § 502 of this title as if such claim had arisen before the commencement of the case..." 11 U.S.C. § 727(b). The lessor of the vehicle would argue that claims for excess mileage, or dents and scratches, are post-petition claims, thus not subject to the discharge injunction in § 524(a).

The Bankruptcy Courts that have dealt with this issue have not agreed with the lessor's argument. The court in *In re Beck*, 272 B.R. 112 (Bankr. E.D. Penn. 2002), dealt with a debtor who filed for bankruptcy but retained the vehicle (without reaffirming), and continued to pay the vehicle lease payments until the end of the lease term (after they had received a discharge and the Chapter 7 bankruptcy case had been closed). The debtor failed to pay the lessor for the excess mileage the debtor had put on the vehicle, after the vehicle was turned in at the end of the lease term. The lessor then attempted to collect this amount, and the debtor filed suit alleging that the lessor violated both the discharge injunction of § 524(a) and reaffirmation requirements of § 524(c).

The court in *Beck* noted that there are two types of debts that are discharged under § 727(b), "(1) debt that arose prepetition and (2) claims determined under § 502." *Beck*, 272 B.R. at 117. In determining whether the claim arose pre- or post- petition, it is necessary to see whether it arose "as a result of the rejection of the [l]ease, thereby requiring it to be treated as a prepetition claim under § 502(g) and discharged under a separate provision of § 727(b)." *Beck*, 272 B.R. at 120. In sum, if the claim is determined to have arisen from the rejection of the lease by the trustee, then unless any of the exceptions to discharge in § 523 apply, the debt is deemed as discharged. *Beck*, 272 B.R. at 120.

Effect when trustee assumes or rejects the lease

Section 365(d)(1) of Bankruptcy Code

(d)(1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

Section 365(g)(1) of Bankruptcy Code

(g) Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition...

Rejection by trustee of lease

As mentioned above, when a Chapter 7 bankruptcy petition is filed, the trustee takes control of all the assets of the estate, including the debtor's rights under any unexpired lease. Per § 365(a), the trustee may either assume or reject the debtor's interest in an unexpired lease. If the trustee does not take any steps within 60 days after the order for relief, to either assume or reject the lease, then according to § 365(d)(1), the lease is deemed rejected. In addition, according to § 365(g)(1), the rejection of a lease constitutes a breach of the lease.

The court in *Beck* had concluded that if the claim for excess mileage was a result of the rejection by the trustee, then this claim would be deemed to be discharged. The court did determine that the claim for excess mileage are damages upon the rejection of the lease since the rejection "constituted a breach which generates a claim deemed to occur prepetition without regard to when the obligation otherwise

came due.” *Beck*, 272 B.R. at 124. In addition to concluding that the fact that the payment for excess mileage was not due until the end of the lease “provides no basis for excepting it from the debt to be discharged,” the court in *Beck* noted that simply because the debtor “made all previous payments provides no basis for excepting it from the debt to be discharged.” *Id.*

According to the court in *Beck*, rejection of a lease under § 365 does not mean that the lease is terminated. *Beck*, 272 B.R. at 121. It simply means that the estate had elected not to become obligated under this lease. *Id.* However, this means that “the parties are not foreclosed from performance post-bankruptcy and the extant contract will define the terms of the performance although clearly it will not obligate the debtor to perform absent reaffirmation.” *Id.*

Assumption by trustee of lease

Section 365(b)(1) of Bankruptcy Code

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

- (A) cures, or provides adequate assurance that trustee will promptly cure, such default;
- (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
- (C) provides adequate assurance of future performance under such contract or lease.

Section 365(f)(2) of Bankruptcy Code

(f)(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—

- (A) the trustee assumes such contract or lease in accordance with the provisions of this section; 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.

According to § 365, the trustee, not the debtor, has the power to assume a lease. The Bankruptcy Court in *Knight*, was urged by the lessor to compel the trustee to assume or reject the vehicle lease. The lessor essentially wants the trustee to file motions on all outstanding vehicle leases, because “where a leased vehicle has been surrendered post petition [the lessor] must wait for 60 days from the order of relief for the trustee to act under § 365 before taking any steps to process the vehicle.” *Knight*, 211 B.R. at 748.

The court in *Knight* held that the language of § 365(a) “clearly assigns the court the responsibility of reviewing, not dictating, a trustee’s decision to assume or reject.” *Id.*, at 749. The trustee, when determining whether to reject or assume the lease, must determine the best interest of the estate. *Id.* Therefore if the trustee determines it would not be in the best interest of the estate to assume the lease, no further steps are required since § 365(d)(1) states that after 60 days from the order of relief the lease is deemed rejected.

If the trustee does assume the lease, “absent a subsequent assignment he would be obligated, pursuant to 11 U.S.C. § 365(b)(1), to cure any defaults under its terms, including bringing any late payments current, to compensate for any actual pecuniary loss arising from any default, and to make all future payments.” *Knight*, 211 B.R. at 749. In addition, the trustee may assign the lease to the debtor if the requirements of § 365(f)(2) are met.

Remedy for debtor when a lessor violates the discharge injunction

It appears that the remedy for a lessor attempting to collect debts, resulting in a violation of the § 524 discharge injunction, is only contempt. Some courts, in addition to finding contempt, will award attorney’s fees against the party violating the discharge injunction. *Beck*, 272 B.R. at 126. The court in *Beck* held that although the excess mileage claims had been discharged, the debtor “may not bring a

private right of action based on § 524 for himself and on behalf of all others similarly situated seeking damages for [lessor's] post-discharge collection activities." *Beck*, 272 B.R. at 130.

Options for a lessor when lessee files Chapter 7 bankruptcy

Section 524(c) of Bankruptcy Code

(c) An agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under this title is enforceable only to any extent enforceable under applicable nonbankruptcy law, whether or not discharge of such debt is waived, only if—

- (1) such agreement was made before the granting of the discharge under §§ 727, 1141, 1228, or 1328 of this title;
- (2)(A) such agreement contains a clear and conspicuous statement which advises the debtor that the agreement may be rescinded at any time prior to discharge or within sixty days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of such claim; and
- (B) such agreement contains a clear and conspicuous statement which advises the debtor that such agreement is not required under this title, under nonbankruptcy law, or under any agreement not in accordance with the provisions of this subsection;
- (3) such agreement has been filed with the court and, if applicable, accompanied by a declaration or an affidavit of the attorney that represented the debtor during the course of negotiating an agreement under this subsection...
- (4) the debtor has not rescinded such agreement at any time prior to discharge or within sixty days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of such claim;
- (5) the provisions of subsection (d) of this section have been complied with; and
- (6)(A) in a case concerning an individual who was not represented by an attorney during the course of negotiating an agreement under this subsection, the court approves such agreement as—
 - (i) not imposing an undue hardship on the debtor or a dependent of the debtor; and
 - (ii) in the best interest of the debtor
- (B) Subparagraph (A) shall not apply to the extent that such debt is a consumer debt secured by real property.

From the discussion above, it appears that there is not much protection for the lessor when a lessee files for Chapter 7 bankruptcy and retains the vehicle without reaffirming. If this does happen, the lessor is prevented from collecting any monies owed by debtor after the discharge. This explains why the lessor in *Knight* attempted to get the court to compel the trustee to reject or assume the lease. It would have been in the lessor's best interest if the trustee had assumed the lease, thereafter assuming all obligations, or even if the trustee had assigned the lease to the debtor. The trustee does not have to do this if it would not be in the estate's best interest to assume the lease.

The most the lessor can hope is that the debtor does not wish to keep the vehicle, and on the statement of intention the debtor surrenders it to the lessor. At this point, if the debtor is not current on the lease payments, "the lessor may file a motion for relief from stay and probably will obtain relief to exercise its right under the contract to repossess the vehicle." *Knight* 211 B.R. at 749. Another option might be to have the debtor sign a reaffirmation agreement, however all the requirements of § 524(c) must be fulfilled to be considered valid.

If the debtor is current on the lease payments, and wants to continue to drive the vehicle, the lessor has fewer options. *Id.* If the debtor does follow this path, the lessor may not be able to get relief from the stay "for the purpose of taking possession of the vehicle because the debtor is not in default under the terms of the lease." *Id.* If in the future the debtor stops making lease payments, the lessor "would be prohibited from collecting the balance of the lease payments from the debtor. Meanwhile, the debtor has had the use of a depreciating vehicle." *Id.* After bankruptcy, if the debtor misses a payment and wants to cure the default and continue to make payments, "because of the discharge of her personal

liability for the payments, the lessor cannot tell the debtor that if she wants to cure the default and keep the vehicle she has an obligation to make timely future payments.” Id.

It appears that the lessor’s best option would be to have the trustee assume the vehicle lease, and assign it to a debtor “who was current on her lease payments and wished to keep the vehicle.” Id. This way the lessor is able to “enforce all its rights under the terms of the original lease, including its right to recover the balance of the lease payments from the debtor.” Id.