

When the Tenant Files Bankruptcy and the Effect of the Bankruptcy Reform Act on Landlords and Tenants

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A. Lease Assumption vs. Rejection

The provision in the bankruptcy code dealing with lease assumption and rejection, 11 U.S.C. § 365 is substantial. The basic concept is relatively simple. If a lease is assumed, the terms of the lease remain in full effect so that the parties' obligations are not modified. If a lease is rejected, the landlord may be able to recover something from the debtor, depending on the chapter of bankruptcy filed.

1. Chapter 7

The Chapter 7 Trustee has the sole power to assume or reject a lease, because it is part of the estate over which the Trustee takes control during the bankruptcy. A Chapter 7 Trustee is only going to assume a lease if it would result in some cash value to the estate which the Trustee is obliged to distribute to creditors. As you would imagine, residential leases usually don't have any cash value to the Chapter 7 Trustee.

A residential lease is automatically deemed rejected unless the Trustee assumes it within 60 days of the petition filing date. (11 U.S.C. §365(d)(1).) There is an argument to be made that a month-to-month lease need not even be listed by the debtor on Schedule G because of this 60 day time period. If the lease expires and renews every 30 days pursuant to the contract between the parties, there is nothing for the Trustee to assume or reject because the parties' lease is not part of the estate.

A cautious bankruptcy attorney lists every residential lease, with the understanding that there is little practical effect of whether the Chapter 7 Trustee assumes or rejects it anyway. Most landlords don't have any knowledge that the Bankruptcy Code

requires rejection or assumption of a lease. They are happily accepting timely rent from their tenant, because if there were any problems with delinquent rent, the debtor would be a former (not current) tenant.

Even if a landlord familiar with Bankruptcy law gets notice of a Chapter 7 filing, this landlord understands that the Trustee's failure to act in and of itself does not terminate the lease under Eighth Circuit law. Rather, this rejection removes the leasehold interest from the bankruptcy estate and returns it to the Debtor's hands. Technically, the bankruptcy estate has violated the lease, but it is not terminated between the landlord and tenant.

If you attempt to evict a tenant based on the Chapter 7 Trustee's failure to assume the lease, and the tenant still wishes to remain in business with you, the debtor's attorney is going to argue that you are violating the automatic stay (during the bankruptcy) or state law controlling termination of residential leases (after the bankruptcy.) Again, this is assuming that your tenant is in fact complying with the lease terms.

If your tenant has stopped paying rent after filing his or her bankruptcy, you can file a motion requesting relief from the automatic stay (or wait for the case to dismiss or discharge, and then immediately file.) The best course of action will be determined by the point in the bankruptcy at which your tenant stops paying rent or otherwise violates the lease.

As discussed below in Section B(1), a landlord who has already obtained an eviction judgment against a non-paying tenant who subsequently files bankruptcy has new protection under the reformed bankruptcy law.

2. Chapter 13

In a Chapter 13 case, the debtor has the power to assume or reject any unexpired lease. Should the debtor choose to assume a lease, the debtor is liable for the entire amount due on the lease, including repayment of any pre-petition delinquency. A Chapter 13 debtor will assume a lease if he or she wants to continue renting the property due to favorable lease terms, and may even have chosen a Chapter 13 over a 7 to stay in a lease despite delinquent rent.

The Chapter 13 Plan should provide for the assumption of the lease. (11 U.S.C. §1322(b)(7).) When the Bankruptcy Court confirms the Plan, the assumption of the lease is implicitly approved.¹

To assume a lease, the debtor must be able to cure any default promptly, unless the default (or associated penalty) is due to a non-monetary obligation under the lease. (11 U.S.C. § 365(b)(2).) Furthermore, the Chapter 13 debtor must provide “adequate assurance of future performance under such...lease.” (Id. at (b)(1)(C).)

You should object to a proposed Chapter 13 Plan if you do not feel that the monetary default is being cured in a reasonable amount of time by the debtor; for example, if the debtor proposes repaying you over a term of five years. You could also object to a lack of “adequate assurance” if the debtor’s bankruptcy filings leave room for doubt that the debtor can keep current on the ongoing rental obligation, as well as the monthly Chapter 13 Plan payments. You may wish to demand, for further assurance, that the lease be modified to add a co-signor, or a greater deposit.

A Chapter 13 debtor should reject a lease if he or she plans to move soon, or has

¹ While Rule 6006 of Bankruptcy Procedure requires a motion to assume, reject, or assign an unexpired lease, that is only required if this occurs outside of the Plan.

already vacated the premises and broken the lease. The unpaid rent from the period prior to the bankruptcy usually becomes a general unsecured claim, so payment on that will depend entirely on what unsecured, non-priority creditors are to receive under the Chapter 13 Plan. Damages which can be claimed by a landlord in a Chapter 13 case (or an asset Chapter 7 case) are discussed in greater detail in section below.

B. Limitation of the automatic stay for residential tenants in bankruptcy cases

The automatic stay starts on the day a bankruptcy petition is filed, except in certain circumstances. (11 U.S.C. §362) Generally, the automatic stay prohibits:

- “(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate;
- (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title; **[or]**
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title...”

However, there is no automatic stay as to:

“(3) under subsection (a) of this section, of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee’s rights and powers are subject to such perfection under section [546 \(b\)](#) of this title or to the extent that such act is accomplished within the period provided under section [547 \(e\)\(2\)\(A\)](#) of this title; **[or]**

(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...”

1. Current Tenants

Section 362(a)(3) was one of the provisions added in 2005 bankruptcy reform legislation. Eviction proceedings are not stayed if the landlord has obtained a judgment for possession prior to the filing of the bankruptcy petition unless the debtor takes certain actions, which the debtor is most likely unable to take.

More specifically, the debtor may receive an automatic stay lasting 30 days from the filing of the bankruptcy petition if the debtor certifies under penalty of perjury that there are circumstances under state law which would allow debtor to cure the entire monetary default which gave rise to the judgment returning possession to the landlord, even after this judgment was entered. (11 § 363(l.))

The debtor/ tenant must inform the Court of an eviction judgment on his or her current lease in the Petition. A copy of the Petition is attached as Appendix D. As you will see, a debtor/tenant must provide security to the Court in the amount of the rent owed in the next 30 days. This is an incredibly difficult standard to meet, and if a debtor makes this certification, you should request a hearing. The Bankruptcy Court will set a hearing within 10 days to determine if the debtor's assertion is correct, which requires an examination of Nebraska landlord tenant law. For the most part, your pre-petition restitution judgment means that there is no automatic stay preventing you from proceeding with eviction proceedings.

Furthermore, section 362(b)(23) provides an exception to the automatic stay if the landlord files a certification under penalty of perjury with the Court, and serves it on the debtor/tenant, stating that an eviction had been started or that the debtor has within 30 days before the certification either endangered the property or illegally used or allowed to

be used controlled substances at the property. Section 362(m)(1) provides that this stay exception applies 15 days after the lessor files and serves this certification. The debtor has right to object to this certification, and the Court will again hold a hearing within 10 days to determine if the certification is accurate, and whether the stay is in place.

Also note that there is no automatic stay as to commercial tenants who are outside of their lease term.

2. Former Tenants

As to a former tenant who has filed bankruptcy but no longer occupies the property, a landlord is stayed from acting on any debt arising from the tenancy, even if a judgment has already been obtained, and even if collection on that judgment has already begun. If you proceed with any collection actions at all, you should first receive an irate communication from the debtor's attorney demanding that you cease immediately. You face sanctions for violation of the automatic stay if you willfully proceed with collection activities despite actual notice of the bankruptcy filing.

The landlord will receive notice of the former tenant's bankruptcy because the debtor has listed this debt on Schedule F as an unsecured, non-priority claim. In a Chapter 7 case, the notice informs the landlord not to file a proof of claim. Heed this notice; you are wasting your time and effort (and possibly attorney's fees) by filing a proof of claim in a no asset Chapter 7 case. If the trustee determines that there are in fact assets to distribute, all creditors will receive another notice from the Court to this effect. It is then time to file your proof of claim.

In a Chapter 13, you will receive a notice of the debtor's bankruptcy filing and information from the Court as to the deadline to file your proof of claim. You may or

may not receive anything from the Chapter 13 debtor, it depends on whether the Plan includes any provision for the repayment of unsecured, non-priority creditors. The Chapter 13 Trustee should object to a Plan that does not provide for such payment, but should if the debtor were entering into the plan in good faith (meaning, the debtor has not funded the Plan with enough disposable income or provision for assets which would have been liquidated in a Chapter 7.) Many Chapter 13 debtors pay a percentage of their unsecured debt, and some pay all. See immediately below for more information on filing a proof of claim.

E. Tactics under the amended bankruptcy code

1. File Your Proof of Claim

You should file your proof of claim in an asset Chapter 7, or in a Chapter 13, before the deadline established by the Court. Late filing may result in a complete denial of your claim.

A proof of claim is filed by a landlord in a bankruptcy proceeding pursuant to 11 § 502(b)(6), and shall be allowed except:

“(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim **exceeds**—
(A) the rent reserved by such lease, **without acceleration**, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
(i) the date of the filing of the petition; and
(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
(B) any unpaid rent due under such lease, **without acceleration**, on the earlier of such dates...” (emphasis added.)

This limits your proof of claim primarily as to future lost rent; the lessor's potential claim for lost future rent is limited to one year's rent or 15% of the rent due over no more than the next three years of the lease, whichever is more. Any rent which was

delinquent at the time of filing is then added to the amount reached under subsection (A.)

This damages limit in subsection (b)(6)(a) is absolute, but note that this section addresses only damages actually resulting from the lease termination. Claims for damages arising under a lease for items such as physical damages to the premises, or for delinquent rent owed pre-petition, are not subject to these limitations. This legislation was intended to allow landlords some recovery of lost rent, but not to give them a huge advantage over other unsecured, non-priority creditors, as distributions to this class of creditors are frequently minimal.

Frequent issues involved in landlord proofs of claims are when and how the lease was terminated, and the degree of certainty to which the landlord can prove his or her damages. Sometimes it is obvious when the lease ended, as when written notice is given by one or the other party, and both parties acted in compliance with that date. As you probably know, however, landlords and tenants frequently disagree as to when a lease actually ended, and who caused the termination. Please note that you cannot deem a lease terminated by the mere filing of bankruptcy, however.

Remember, your proof of claim is based on actual damages. If you have already leased the property to another party at an amount equal to, or more likely in excess of, your damages claim, you are not in fact or law damaged by the termination of the lease and you will not be able to claim future lost rent. You have an obligation to mitigate your damages, which means you have to make reasonable efforts to get a new tenant on a lease and paying rent as soon as possible.

Ongoing occupancy of the property post-petition without paying rent or providing for assumption in the Plan leads to another type of claim, an administrative expense

entitled to priority payment. 503(b)(1)(A) The amount to which you are entitled is the reasonable rental value of the property, which is usually established by the terms of the violated lease but can be higher or lower with the proper evidentiary showing. A Chapter 13 debtor must pay priority claims in full within the life of the bankruptcy, unless it is dismissed, converted, or the debtor receives the rare hardship discharge. Again though, any

If the debtor or another party in interest (the trustee) objects to the amount of your proof of claim, you will have a hearing with the Bankruptcy Court at which it is your burden to prove your damages. If the objecting party can prove a contractual defense to future rent obligations (e.g. uninhabitable conditions), that defense does work against your future lost rent claim.

2. Dispute Discharge of Willful and Malicious Property Damage

As a landlord or landlord's attorney (or any other creditor who learns it will not be recovering a debt from a bankruptcy debtor), you will naturally feel something other than joy at the debtor's successful completion of all bankruptcy requirements and subsequent receipt of a bankruptcy discharge. You might even feel that the debtor should not be allowed to get rid of your debt so easily. You have already learned how delinquent rent and a claim for future lost rent will be treated in bankruptcy, but what about all the damage caused to your property before your tenant vacated it?

With the proper evidence and filing fee, you can file an Adversary Proceeding within the debtor's bankruptcy case asking the Bankruptcy Court to deny discharge as to a debt which arose from your former tenant's "willful and malicious" damage to your property. (11 U.S.C. §523(a)(6.) This should be done while the bankruptcy case is still

open; you can ask the Court for permission to reopen a closed bankruptcy to file an Adversary Proceeding, but you better have a compelling reason as to why you did not do so during the bankruptcy.

In a 2004 Nebraska Bankruptcy Court decision, BK Case No. BK03-42189 and Adversary Proceeding Case No. AP03-4059, Plaintiff landlord obtained a judgment against debtor after evicting her for non-payment of rent. The judgment included contractual damages of \$1,815 in delinquent rent and \$4,961.22 in damages to the property. After the former tenant filed bankruptcy, the Plaintiff filed an adversary proceeding requesting that the Court deny debtor a discharge as to the \$4,961.22 damages. Please note that Plaintiff did not contend that the contractual damages (the delinquent rent) should not discharge, which was wise because that debt did discharge along with debtor's other unsecured, non-priority debt.

However, Plaintiff provided evidence as to the condition of the property before and after debtor's tenancy, including photographs and testimony as to the degradation of the relationship between the parties which supported Plaintiff's contention that debtor/tenant had done some damage to the property on purpose. The Court made the factual findings that:

“[t]here was serious damage done to the house while the debtor was a tenant. Various fixtures were missing. Electrical wiring was damaged. Personal property, such as a couch, was ruined by the dog owned by the debtor. The debtor apparently permitted the dog to damage doors and walls in the facility. The basement was filled with trash, shelving was dismantled and other shelving was nailed into the walls. The refrigerator in the basement was spray-painted, paneling was painted, drywall was left with screws in the wall, and adhesive stickers were left on the walls, woodwork and floors. Light bulbs were removed, holes were pounded in the walls, an electrical plug was pulled from the wall. Wallpaper was torn off the wall, window latches were broken, a toilet flush handle was broken, and a rug around the toilet was urine soaked and mildewed. The

electric stove was pulled out from the wall and in an unworkable condition. Food was left in the refrigerator to rot. Cupboards were damaged. A built-in hutch had a corner chunk missing. The kitchen sink was damaged. Part of a countertop end was sawed off. Curtains were missing. There were numerous instances of damages caused to woodwork by weather stripping. A closet door was missing, and there was spray paint on the furnace.”

The Court noted that parties often dispute whether damage was from ordinary wear and tear, for which the tenant is not liable, or from intentional damage. To prevail in an adversary proceeding such as this, the plaintiff must prove debt incurred due to “willful and malicious” injury by preponderance of the evidence (more likely than not.) “Willful” is deliberate or intentional, and “malicious” is conduct which is certain or almost certain to cause financial harm.

Providing that damage was done deliberately is not as difficult as proving your tenant’s malice. Whether a debt will not discharge on these grounds is very much a factual question, and will require a case by case determination. I have given you this Bankruptcy Court decision because it includes a good discussion of cases in which discharge was denied on these grounds, and instances of damage caused by tenants which did not rise to level of willful and malicious.

3. Don’t Forget the Co-Signor!

If you have more than party liable to you for rent pursuant to the lease, you are not without recourse as to any contract or property damages to which you are entitled under state law, but which you are unable to collect from the debtor. Be careful, however, as the type of bankruptcy filed by your tenant controls your actions as to any co-debtor.

More specifically, a Chapter 7 bankruptcy filing does not impose an automatic stay as to a co-debtor. You may not practically want to proceed with an eviction action

against the tenant who's managed to stay out of bankruptcy (leaving you with the Chapter 7 debtor), but if the tenants/debtors are already out of the premises, the debtor's Chapter 7 does not stay you from proceeding with collection actions against a co-debtor. As you know, the co-debtor is liable in full for the damages you can prove in state court.

In a Chapter 13 bankruptcy, there is an automatic stay in place for a co-debtor as well so you should not pursue collection actions against either party after you receive notice of the debtor's bankruptcy filing. However, since the Chapter 13 Plan must signal the debtor's intent as to the lease (and provide payment to you for any arrearage), you will not have to wait long to determine whether the debtor is assuming or rejecting the lease, which will clarify your course of action.