

# ASSUME, ASSIGN, REJECT

## *What Happens to a Commercial Lease in Bankruptcy?*

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Commercial leases play a critical role in virtually every sector of the American economy. Leased real estate houses businesses of all shapes and sizes, and leased equipment runs small copy rooms, massive construction projects, and everything in between. Recognizing the importance of leases to business operations, the United States Bankruptcy Code includes a statutory scheme governing leases.<sup>1</sup> While involvement in a bankruptcy may seem a remote possibility for many attorneys, the widespread import of leases in the business community underscores the need for counsel to have a working familiarity with the Code's treatment of leases before a bankruptcy notice crosses their desks. Bankruptcy cases – especially business cases – often move quickly, and knowing the lay of the land at the outset can be invaluable to counsel and client. Through this article, counsel will gain an understanding of milestones that lessors of commercial real estate or equipment should consider when a lessee is a debtor in a chapter 7 or 11 business bankruptcy case.<sup>2</sup>

**DAY ONE: THE PETITION DATE AND THE AUTOMATIC STAY.** A voluntary bankruptcy case begins when a debtor files a petition for relief under the Bankruptcy Code. The date on which the petition is filed is aptly referred to as the “Petition Date,” and many future deadlines in the case are calculated based on the Petition Date or the “order for relief” date, which are the same date in voluntary cases.<sup>3</sup> Most business debtors are in a “chapter 7” or “chapter 11” case, named for the Code chapter that primarily governs the case. In a chapter 7 case, an appointed trustee winds down the debtor's

operations, liquidates its assets, and distributes proceeds to creditors in the order of priority set by the Code. In a chapter 11 case, the debtor becomes a “debtor in possession” (“DIP”) upon the filing of its petition and has nearly all of the rights, powers, and duties of a trustee, including the ability to control its operations and assets within the bounds of the Code.<sup>4</sup> The DIP can be replaced by an appointed trustee or examiner, but that seldom occurs.<sup>5</sup> While the typical goal of a chapter 11 case is for the debtor to obtain the court's “confirmation” or approval of a plan that reorganizes its assets and establishes a framework for paying its debts, some debtors opt to pursue asset liquidation and wind down their operations through a plan or a “363 sale” under § 363.<sup>6</sup>

The moment a debtor files its bankruptcy petition, the Code's “automatic stay” provision goes into effect and requires a non-debtor lessor to cease virtually all efforts to collect from its debtor lessee unless and until the lessor obtains a bankruptcy court order granting it “relief” from the automatic stay.<sup>7</sup> The automatic stay is one of the strongest protections the Code provides a debtor and, with limited exceptions,<sup>8</sup> prohibits all acts to collect prepetition debts, including terminating a commercial lease before its natural end and most acts to obtain possession of leased commercial property.<sup>9</sup> Penalties for violating the stay are steep: any individual injured by a “willful violation” of the stay “shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages,”<sup>10</sup> and corporate entities may request that the court hold a creditor violating the stay in contempt.<sup>11</sup> Notably, the

stay does not apply to a lessor's actions to obtain possession of its nonresidential real property under a lease that terminated by expiration before the Petition Date or terminates during the bankruptcy.<sup>12</sup>

**LEASE OPERATION DURING BANKRUPTCY.** A chapter 7 trustee or chapter 11 DIP/tenant must timely perform all obligations under unexpired nonresidential *real* property leases during bankruptcy.<sup>13</sup> The court may extend the debtor's time for performing any such obligation arising within 60 days after the bankruptcy filing, but not beyond those 60 days, in most cases.<sup>14</sup> The Consolidated Appropriations Act, 2021 ("CCA") temporarily amended the Code to permit courts to grant additional extensions to "subchapter V debtors," which are "small business debtors" eligible for bankruptcy under subchapter V of chapter 11.<sup>15</sup> Until that temporary amendment expires on December 27, 2022, the Code permits courts to extend a subchapter V debtor's time for performing obligations arising within 60 days of its bankruptcy filing to the earlier of 60 days after the order for relief date, plus an additional 60 days "if the court determines that the debtor is continuing to experience a material financial hardship due, directly or indirectly, to the coronavirus disease 2019 (COVID-19) pandemic," or the date upon which the debtor "assumes" or "rejects" the lease under the Code as discussed below.<sup>16</sup>

The Code imposes slightly different requirements on chapter 11 DIP/lessees of commercial *personal* property. The Code requires DIP/lessees of commercial personal property to timely perform all of their obligations under their unexpired leases "first arising from or after 60 days after the order for relief in a [chapter 11] case . . . until such lease is assumed or rejected . . ." <sup>17</sup> However, "based on the equities of the case," the court can "order[] otherwise with respect to the obligations or timely performance thereof."<sup>18</sup>

Although they are present in most commercial leases, the Code renders inoperable most *ipso facto* clauses terminating leases or restricting a debtor lessee's ability to assign its lease due to the lessee's financial condition or bankruptcy filing. Lease provisions permitting termination or modification of a lease or any right or obligation thereunder during a bankruptcy case generally are not effective if they are conditioned on the debtor's insolvency or financial condition, commencement of the bankruptcy, or appointment of or taking possession by a trustee.<sup>19</sup> That prohibition does not apply, however, if applicable law excuses a non-debtor party to the lease "from accepting performance from or rendering performance to the trustee or to an assignee of such . . . lease, whether or not such . . . lease prohibits or restricts assignment of rights or delegation of duties."<sup>20</sup>

**THE END GAME: ASSUME, ASSIGN, OR REJECT.** The Code grants chapter 7 trustees and chapter 11 DIP/lessees three options for addressing unexpired leases in bankruptcy: (1) assume the lease and proceed under its terms; (2) assume the lease and assign it to a third party; or (3) reject the lease and surrender the leased property to the lessor.<sup>21</sup> The time within which the trustee or DIP/lessee must make that decision differs depending upon the type of leased property (real or personal), type of bankruptcy case (chapter 7 or

11), and decisionmaker (chapter 7 trustee or chapter 11 debtor in possession).

Unless a chapter 7 trustee or chapter 11 DIP/tenant assumes a commercial, nonresidential *real* property lease by the earlier of 120 days (temporarily extended to 210 days) after the order for relief date or, in chapter 11, the date a plan confirmation order is entered, the lease is deemed rejected and the tenant must immediately surrender possession of the leased premises to the lessor.<sup>22</sup> The court may extend that 120-day (temporarily 210-day) period once for 90 days for cause, and any further extensions require the lessor's written consent.<sup>23</sup> The CCA's temporary extension of the Code's 120-day period to 210 days will sunset on December 27, 2022.<sup>24</sup>

That time period differs for *personal* property leases. In chapter 7 cases, if the trustee does not assume or reject an unexpired personal property lease within 60 days after the order for relief or within such additional time as the court orders for cause, the lease is deemed rejected.<sup>25</sup> In chapter 11 cases, the DIP/lessee may assume or reject an unexpired personal property lease at any time before confirmation of a chapter 11 plan.<sup>26</sup> Personal property lessors concerned about that potentially lengthy time period in chapter 11 may request that the court order a specific time period within which the DIP/lessee must assume or reject the lease.<sup>27</sup>

Only unexpired leases may be assumed.<sup>28</sup> Before an unexpired lease can be assumed, the Code requires the trustee or DIP/lessee to cure most defaults, compensate or provide adequate assurance that the trustee/DIP will promptly compensate a non-debtor party to the lease for any actual pecuniary loss resulting from those defaults, and provide adequate assurance of future performance under the lease.<sup>29</sup> Except in the case of nonresidential real property leases, defaults arising out of the tenant's failure to perform nonmonetary obligations are not required to be cured if it is impossible to cure the default by performing nonmonetary acts at and after the time of assumption.<sup>30</sup> However, if a nonmonetary default "arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated . . ."<sup>31</sup> Nevertheless, the Code does not require a trustee or DIP to cure defaults of lease provisions relating to the debtor's financial condition, commencement of a bankruptcy case, or appointment of or taking possession by a trustee, or to satisfy any penalty rate or provision relating to a default arising from the debtor's failure to perform nonmonetary obligations under the lease.<sup>32</sup>

The trustee or DIP/lessee may assign an unexpired lease to a third party if the trustee/DIP first assumes the lease under the foregoing requirements and provides the lessor adequate assurance of the assignee's future performance, whether or not there has been a default.<sup>33</sup> With two exceptions, lease provisions prohibiting, restricting, or conditioning assignment of a lease do not impact a trustee/DIP's authority to assign a lease.<sup>34</sup> Under those exceptions, the trustee/DIP may not assign an unexpired, nonresidential real property lease that terminated prior to the order for relief

or where applicable law excuses a non-debtor party to the lease from accepting performance from or rendering performance to an entity other than the DIP/lessee, whether or not the lease restricts assignment or delegation of duties.<sup>35</sup> Assignment of a lease relieves the trustee/DIP from any liability for a breach occurring after the assignment.<sup>36</sup> To protect the non-debtor lessor, the Code permits the lessor to “require a deposit or other security for the performance of the debtor’s obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant.”<sup>37</sup>

Special adequate assurance requirements apply if a trustee or DIP/tenant proposes to assume or assign a lease of real property in a shopping center. In that instance, the requisite adequate assurance of future performance under the lease includes assurance: (a) of the source of rent and other consideration due under the lease and, if assigned, that the financial condition and operating performance of the assignee and any guarantors is similar to that of the debtor and any guarantors at the time the debtor became the lessee; (b) that any percentage rent will not decline substantially; (c) that assumption or assignment is subject to all lease provisions, including, but not limited to, radius, location, use, or exclusivity provisions, and will not breach any such provision in any other lease, financing agreement, or master agreement relating to the shopping center; and (d) that assumption or assignment will not disrupt any tenant mix or balance in the shopping center.<sup>38</sup> The Code does not define “shopping center,” so courts have developed factors for evaluating whether a leased premises constitutes a shopping center.<sup>39</sup>

**OPTIONS FOR ADDRESSING LEASE REJECTION.** If a commercial *real* property lease is rejected, the trustee or DIP/lessee must immediately surrender the leased premises to the lessor.<sup>40</sup> If a *personal* property lease is rejected, then the leased property is no longer property of the bankruptcy “estate,” and the automatic stay terminates so that lessor may recover its property.<sup>41</sup> But what about the lessor’s damages arising out of the rejection?

The rejection of a lease constitutes a breach of the lease.<sup>42</sup> If the lease is rejected without first being assumed, then the breach is deemed effective immediately before the filing of the bankruptcy petition.<sup>43</sup> If the lease is assumed and then later rejected, however, then the breach is deemed to occur at the time of rejection if the case has not been converted to a case under another chapter.<sup>44</sup> If the case was converted before rejection, then the breach is effective immediately before the conversion if the lease was assumed before conversion or at the time of the rejection if the lease was assumed after conversion.<sup>45</sup>

Aside from recovering its leased property, the Code prohibits the lessor from pursuing traditional remedies to collect monetary damages arising out of the lessee’s lease rejection. The lessor’s recourse is generally limited to filing a proof of claim asserting its damages in the lessee’s bankruptcy case. Within limited exceptions, proofs of claim for prepetition claims in voluntary chapter 7 cases are due no later than 70 days after the order for relief for general creditors and 180 days after the order for relief for governmental units,<sup>46</sup> and

claims arising from the rejection of an unexpired lease “may be filed within such time as the court may direct.”<sup>47</sup> Although there is no statutory deadline for filing a proof of claim in a chapter 11 case, the bankruptcy court typically will enter an order setting a “bar date” by which proofs of claim must be filed or otherwise be barred or will enact a local rule establishing a standard bar date.<sup>48</sup> Proofs of claim are “written statement[s] setting forth a creditor’s claim” and must substantially conform to Official Form B410 unless the court orders otherwise.<sup>49</sup>

Official Form B410 requires the creditor to provide contact information, state the amount of and basis for its claim, and sign under penalty of perjury. A proof of claim based on a writing, such as a lease, must include a copy of the writing.<sup>50</sup> In many cases, it is advisable for the creditor to attach an accounting of its claim, especially if it includes multiple categories of damages, such as unpaid rent, property taxes, attorneys’ fees, collection costs, and/or liquidated damages. Proofs of claim become public records once filed, and claimants must redact personal numbers and other confidential information before filing.<sup>51</sup>

The Code establishes the “priority” of different types of claims, meaning the order in which they may be paid.<sup>52</sup> Most claims for damages arising out of rejection of a commercial lease are general unsecured claims that are paid if the debtor has funds remaining after first paying secured and “priority” claims. Rejection damage claims may qualify as “priority” claims if they are for “actual, necessary costs of preserving the [bankruptcy] estate,” which could include some unpaid rent obligations arising during the bankruptcy.<sup>53</sup> Obtaining that priority requires the creditor to file an application requesting the court’s allowance of the claim as an “administrative claim.”<sup>54</sup> Counsel should watch for entry of a “bar date order” or plan confirmation order setting a specific deadline by which administrative claim applications must be filed.

Lessors of personal property may also be entitled to priority payment of claims arising out of a trustee or DIP/lessee’s failure to timely perform obligations arising under the lease on or after the 60th day after the order for relief date. The Code requires those claims to be paid, regardless of administrative expense status.<sup>55</sup>

**THE MAIN POINT: PROACTIVE RATHER THAN REACTIVE REPRESENTATION.** Because bankruptcy cases often arise without warning and proceed at what some consider lightning speed, it is critical that attorneys understand the structure within which lessor clients and their unexpired commercial leases must operate while the debtor/lessee is in bankruptcy. Seemingly simple things like a phone call to a debtor/lessee to follow up on a missed rent payment could subject the client to substantial liability for an automatic stay violation, and missing a deadline to file a proof of claim or seek allowance of an administrative claim could render the client unable to recover damages. A familiarity with the Code’s statutory scheme allows practitioners to proactively, rather than reactively, counsel clients about pitfalls to avoid and develop strategies for protecting each client’s unique interests to the fullest extent that the Code allows. Closely reviewing this article is a good start. **BB**

## ABOUT THE AUTHOR

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is an attorney with Stoll Keenon Ogden PLLC, where she practices in the firm's Lexington office and focuses on bankruptcy and insolvency matters, business litigation, and business transactional services. As a commercial attorney with experience in a variety of industries, she advises businesses as they navigate financial and operational concerns. She works alongside clients to understand the intricacies of their day-to-day, ensure that they have the legal tools required to guide their organizations, and develop creative options for addressing obstacles.



She is a member of the Kentucky Bar Association Board of Governors, a Kentucky Bar Foundation Life Fellow, and a past president of the Fayette County Bar Association, Fayette County Women Lawyers' Association, and Junior League of Lexington. She serves on the FCBA Pro Bono Program Board of Directors, the Hearing & Speech Center Board of Directors, and the Shriners Children's Lexington Hospital Corporate Council.

A native of Richmond, Adams earned her B.A. in accounting, *cum laude*, from Transylvania University and her J.D. from the University of Kentucky J. David Rosenberg College of Law.

## ENDNOTES

- 1 All references to the "Bankruptcy Code" or "Code" herein are to the United States Bankruptcy Code, 11 U.S.C. §§ 101-1532.
- 2 This article does not discuss bankruptcy cases in which the debtor is an individual or bankruptcy cases under any Code chapter other than chapters 7 and 11.
- 3 "The commencement of a voluntary [bankruptcy] case . . . constitutes an order for relief," and "[a] voluntary case . . . is commenced by filing . . . a petition under [a] chapter [of the Code] by an entity that [is eligible to] be a debtor under such chapter." 11 U.S.C. § 301. Thus, "petition date" and "order for relief date" are often used interchangeably in voluntary bankruptcy cases.
- 4 11 U.S.C. § 1101(1) (defining "debtor in possession" as "debtor"); *id.* § 1107(a) (giving debtor in possession most rights, powers, and duties of a trustee).
- 5 11 U.S.C. § 1104 (establishing requirements for trustee or examiner appointment).
- 6 *Id.* § 363.
- 7 11 U.S.C. § 362(a) (imposing the stay); *id.* § 362(d) (governing requests for stay relief).
- 8 11 U.S.C. § 362(b) (setting forth exceptions to automatic stay).
- 9 *See, e.g., id.* § 362(a)(1), (2) (prohibiting "(1) the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy] case . . . or to recover a claim against the debtor that arose before the commencement of the [bankruptcy] case" and "(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the [bankruptcy] case").
- 10 *Id.* § 362(k)(1).
- 11 *See, e.g., Harker v. Eastport Holdings, LLC (In re GYPC, Inc.)*, 634 B.R. 983, 989 (Bankr. S.D. Ohio 2021) (finding that § 362(k) permits only individuals to obtain stay violation damages, and, "[b]ecause corporate entities . . . do not have the benefit of a statutory private right of action for a stay violation, they must proceed under a § 105 civil contempt theory") (citation omitted).
- 12 11 U.S.C. § 362(b)(10).
- 13 *Id.* § 365(d)(3)(A).
- 14 *Id.*
- 15 11 U.S.C. § 1182(1) (defining "debtor" under subchapter V as a "small business debtor"); *id.* § 101(51D) (defining "small business debtor").
- 16 11 U.S.C. § 365(d)(3)(B); *see also* P.L. 116-260, Div. FF, Title X, § 1001(f)(1)(A) (permitting temporary expanded extension to subchapter V debtors); P.L. 116-260, Div. FF, Title X, § 1001(f)(2)(A)(i) (providing for sunset of temporary expanded extension).
- 17 11 U.S.C. § 365(d)(5).
- 18 *Id.*
- 19 11 U.S.C. § 365(e)(1).
- 20 *Id.* § 365(e)(2).
- 21 11 U.S.C. § 365(a) (allowing assumption or rejection); *id.* § 365(f) (allowing assignment).
- 22 11 U.S.C. § 365(d)(4)(A).
- 23 *Id.* § 365(d)(4)(B).
- 24 P.L. 116-260, Div. FF, Title X, § 1001(f)(1)(B) (extending 120-day period to 210 days); *id.* § 1001(f)(2)(A)(ii) (providing for sunset of temporary 210-day period).
- 25 11 U.S.C. § 365(d)(1).
- 26 *Id.* § 365(d)(2).
- 27 *Id.*
- 28 11 U.S.C. § 365(c)(3) (prohibiting assumption or assignment of a lease "of nonresidential real property . . . [that] has been terminated under applicable nonbankruptcy law prior to the order for relief").
- 29 *Id.* § 365(b)(1).
- 30 *Id.* § 365(b)(1)(A).
- 31 *Id.*
- 32 11 U.S.C. § 365(b)(2).
- 33 *Id.* § 365(f)(2).
- 34 *Id.* § 365(f)(1).
- 35 *Id.* § 365(c)(1), (3).
- 36 *Id.* § 365(k).
- 37 *Id.* § 365(l).
- 38 *Id.* § 365(b)(3).
- 39 *See, e.g., In re Toys "R" Us Prop. Co. I, LLC*, 598 B.R. 233, 239-240 (Bankr. E.D. Va. 2019) (citing *In re Ames Dept Stores, Inc.*, 348 B.R. 91, 95 (Bankr. S.D.N.Y. 2006) (internal citation omitted) (describing multi-factor test).
- 40 11 U.S.C. § 365(d)(4)(A).
- 41 *Id.* § 365(p)(1).
- 42 *Id.* § 365(g).
- 43 *Id.* § 365(g)(1).
- 44 *Id.* § 365(g)(2)(A).
- 45 *Id.* § 365(g)(2)(B).
- 46 Fed. R. Bankr. P. 3002(c)(1).
- 47 *Id.* 3002(c)(4).
- 48 *See* Fed. R. Bankr. P. 3003(b)(1) (stating that, in a chapter 11 case, "[i]t shall not be necessary for a creditor . . . to file a proof of claim . . . except as provided in [Rule 3003(c)(2)]"; *id.* 3003(c)(2) (requiring "[a]ny creditor . . . whose claim . . . is not [listed on the debtor's schedule of liabilities] or [is] scheduled as disputed, contingent, or unliquidated [to] file a proof of claim . . . within the time prescribed by [Rule 3003(c)(3)]"; and *id.* 3003(c)(3) (requiring the court to "fix . . . the time within which proofs of claim . . . may be filed").
- 49 *Id.* 3001(a); Official Bankruptcy Forms are available at <https://www.uscourts.gov/forms/bankruptcy-forms> (last visited Apr. 11, 2022).
- 50 Fed. R. Bankr. P. 3001(c)(1).
- 51 *Id.* 9037.
- 52 11 U.S.C. § 507 (governing claim priority).
- 53 *Id.* § 503(b)(1)(A) (defining claims for "allowed administrative expenses"); *id.* § 507(a)(2) (giving second priority status to administrative expenses allowed under § 503(b)).
- 54 11 U.S.C. § 503(b) (requiring notice and a hearing before allowance of an administrative claim).
- 55 *Id.* § 365(d)(5).

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