

What Are A Tenant's Rights When A Landlord Files For Bankruptcy?

Michael J. Lichtenstein and Richard Goldberg***

The typical commercial scenario used to be that a tenant (retail or office) filed for bankruptcy and the landlord was confronted with an empty space or a tenant trying to assume and assign a below market lease. In recent years, there have been increasing landlord bankruptcies (General Growth is a good example) which have left tenants wondering what their rights are. This article discusses the protections afforded tenants under the Bankruptcy Code together with how different courts have treated a sale of real property in bankruptcy as it relates to leasehold interests.

The Bankruptcy Code provides specific remedies for a tenant whose lease is rejected when a landlord files for bankruptcy. However, there is a split in the courts as to whether a landlord debtor can sell its real property free and clear of interests, including the leasehold interest. Some courts have allowed a sale of the landlord's real property free of all claims and interest, including leasehold interests. Other courts have held that, in light of the specific protection afforded to tenants under the Bankruptcy Code, a landlord debtor's real property cannot be sold free and clear of a leasehold interest.

I. Executory Contracts And Unexpired Leases

11 U.S.C. § 365 governs the treatment of "executory contracts" and unexpired leases in bankruptcy. Generally speaking, Section 365(a) provides a trustee or Debtor in Possession with broad authority to assume or reject executory contracts and unexpired leases. This power is generally subject to court approval. The decision to assume or reject

*Michael J. Lichtenstein, Shulman, Rogers, Gandal, Porcy & Ecker, P.A.; mjl@shulmanrogers.com.

**Richard Goldberg, Shapiro Sher Guinot & Sandler; rmg@shapirosher.com.

an executory contract or unexpired lease is a matter within the “business judgment” of the debtor.¹

Under the business judgment test, a court should approve a debtor’s proposed rejection if such rejection will benefit the estate.² Moreover, a debtor’s decision to reject an executory contract or unexpired lease should be approved “except upon a finding of bad faith or gross abuse of the [debtor’s] business discretion.”³

In chapter 7 cases, a contract or lease is deemed rejected if it is not timely assumed. In cases under any chapter, a lease of nonresidential real property is deemed reject if it is not timely assumed. This power is specifically limited with respect to the rejection to leases of real property “so as to preclude eviction of the lessee.”⁴

II. Section 365(h) Protections For A Tenant

Under the Bankruptcy Code, if a landlord files for bankruptcy, the landlord cannot interfere with the tenant’s use, possession or quiet enjoyment of the property. While a landlord can reject a lease under Section 365 of the Bankruptcy Code, Section 365(h)(1)(A)(ii) provides:

If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—

(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease . . . 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 non-bankruptcy law.⁵

Section 365(h) establishes a framework for dealing with the bankruptcy of a lessor “to afford the debtor the benefit of rejecting an undesirable lease while at the same time

¹Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36, 39–40 (3d Cir. 1989). See also *In re Pesce Baking Co.*, 43 B.R. 949, 956 (Bankr. N.D. Ohio 1984).

²*In re Chi-Feng Huang*, 23 B.R. 798, 801 (Bankr. 9th Cir. 1982).

³*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985) cert. denied, 475 U.S. 1057 (1986).

⁴*Jetz Laundry Systems, Inc. v. Wingates, LLC*, 2005 WL 1388392 at *2 (S.D. Ohio 2005) (quoting *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 546 (7th Cir. 2003)).

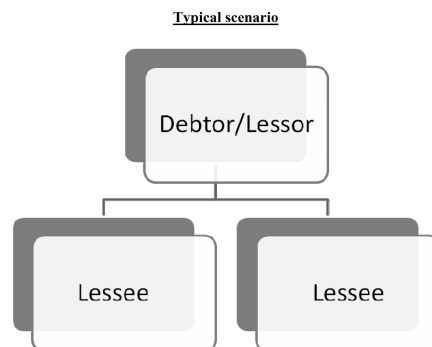
⁵11 U.S.C. § 365(b).

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protecting the property rights of the lessee.”⁶ Accordingly, even if the lease is rejected, a tenant can choose to retain possession for the balance of the term (including any extensions).⁷

Where a debtor/lessor rejects a lease the lessee has the option of treating the lease as terminated by the rejection (in the event that the rejection amounts to such a breach as would entitle the lessee to do so); or to retain its right in or appurtenant to the property for the term of the lease and any renewal or extension period. If the lessee retains possession, the rejection shall relieve the debtor/lessor of its other duties under the lease but the lessee is entitled to offset all damages arising from the rejection against future rent reserved under the lease (although the lessee may not seek damages based on the rejection as a claim against the estate and the damages that may be offset are limited to those caused by non-performance after date of rejection.) In essence, upon rejection, the lessee may choose to retain its right of possession, as well as other rights, including the amount and timing of the payment of rent.

Generally Section 365(h) has been held only to apply only to rent and possession; other obligations of the Debtor/Lessor under the lease may be freely rejected leaving the lessee with only the right to offset as a method of obtaining relief for the Debtor’s/lessor’s failure to perform.



⁶In re Silberkraus, 253 B.R. 890, 908 (Bankr. C.D.Cal 2000) (quoting In re LHD Realty Corp., 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982)).

⁷If the tenant chooses to, it can surrender the premises and file a claim for damages against the debtor’s estate. While a lessor’s claim for damages is limited to the greater of rent for one year or 15% of the remaining term of the lease, there is no such limitation for a tenant’s claim.

III. Cases

- Debtor/Lessor rejects leases with Lessees, Lessees are faced with choice of staying on or treating lease as terminated.
- If Lessee elects to stay, Lessee encounters significant practical issues on a going forward basis, e.g. Lessee will need to deal with maintenance issues, utility costs (if lease is not already triple net, it effectively becomes triple net) and other charges and obligations previously borne by Debtor/Lessor
- Unfulfilled continuing obligations are monetized and withheld from rent payments but could, in actuality, exceed amount of rent after set-off

In the Matter of Arden & Howe Associates, Ltd.,⁸ the Debtor owned a shopping center and entered into a pre-petition lease of space in the shopping center to Home Express Inc. The lease with Home Express had a restrictive covenant which prohibited certain types of business in other parts of the shopping center. The Debtor filed a bankruptcy petition and thereafter entered into a second lease to AKG for space to use as a comedy club; a trustee in bankruptcy was subsequently appointed who renegotiated the comedy club lease. Home Express learned of the lease and sued AKG and the Trustee asking the court to declare that AKG's planned comedy club would violate restrictions on other leases contained in Home Express' lease.

After Home Express commenced its bankruptcy case, the Trustee moved to reject Home Express' lease in order to rid the estate of the restrictive covenant and the rejection was approved. In ruling on Home Express' suit (the lease rejection was not at issue), the court held that 365(h) protects only possession, term and rent obligations and does not require that the Trustee/Lessor continue performing under the Lease and that Home Express' sole remedy is under 365(h)(2) i.e. setting off against future rent the damages incurred.

In *Acme Precision Building, Limited v. Dayton Forging & Heat Treating, Inc.*,⁹ an involuntary Chapter 11 petition was filed against the Debtor. Acme Dayton was a tenant of the Debtor and the physical condition of the premises were poor

⁸Matter of Arden & Howe Associates, Ltd., 1993 WL 129784 (E.D. Cal. 1993).

⁹Acme Precision Building, Limited v. Dayton Forging & Heat Treating, Inc., 23 B.R. 79 (Bankr. S.D. Ohio 1982).

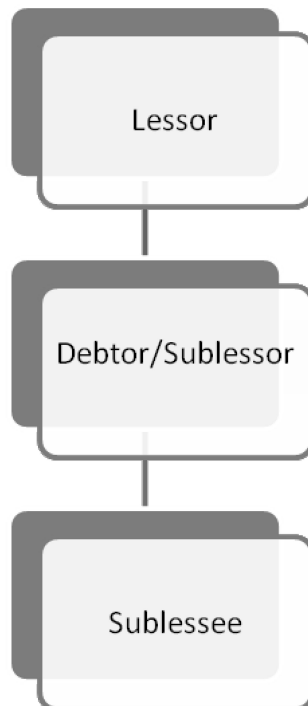
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due, in part, to the fact that the Debtor was in violation of its obligations under the lease to make repairs; the tenant was in violation of the lease for failing to pay utilities. The Debtor failed to assume or reject the lease under the applicable time period and thereafter filed a complaint against the lessee seeking forfeiture of the lease – the court interpreted these two occurrences as together constituting a rejection of the lease.

The court then concluded that this rejection terminated the Debtor's duty to perform under the lease other than to provide the premises to the lessee and that if the lessee elected to retain possession it had no recourse other than to offset from rentals damages caused by nonperformance of the lessor's obligations.

Often there are subleases that may be affected by a landlord's bankruptcy filing. These are referred to as "sandwich" leases.

"Sandwich" Leases



- Section 365(h) does not specifically cover situations where the debtor is a sub-lessor and seeks to reject a lease where it is both the prime tenant and sub-lessor.
- In such situations the sub-lessee likely does not have 365(h) election rights, and thus does not have a right to possession under the Bankruptcy Code
- This conclusion does not foreclose the sub-lessee from pursuing state law remedies against the prime lessor

In *Chatlos Systems, Inc. v. Kaplan*,¹⁰ the Debtor Chatlos Systems Inc. was a lessee under a lease with Kaplan. The Debtor subleased the space to TX technologies. The Debtor filed bankruptcy and informed the court that it did not intend to assume the lease (this is essentially known as a “rejection up and down”). The court entered an order that the lease shall be deemed rejected as of a specific date and ordering the Debtor to surrender the premises thereafter.

The time when the lease is deemed rejected came and passed, the Debtor did not surrender. Kaplan filed a motion requesting the court to order the Debtor to comply with the order and the Debtor argued that it was not in possession but TX is. The court found that when a lease is deemed rejected, any sub-leases under the primary lease must also be deemed rejected because the sub-lessee’s rights are wholly derivative of the prime lease and were extinguished with the debtor’s rejection of the prime lease. The court noted that Kaplan should have proceeded directly against TX but in state court.

In *In re Elephant Bar Restaurant, Inc.*,¹¹ the lessor of property to a Debtor/Lessee brought a motion requesting a declaration that an unexpired commercial lease was terminated due to the Chapter 7 Trustee’s failure to assume lease and surrender property. The court ruled that the lease was deemed rejected and thereafter legally terminated with respect to the debtor. The court further held that an unexpired sublease between debtor and third party was rejected based upon the deemed rejection of prime lease.

The court noted further that it was obliged to abstain from deciding issue of the non-debtor third party’s remaining possessory interest in property under state law after the deemed rejection of sublease. “With respect to a non-debtor third

¹⁰Chatlos Systems, Inc. v. Kaplan, 147 B.R. 96 (D. Del. 1992).

¹¹In re Elephant Bar Restaurant, Inc, 195 B.R. 353 (Bankr. W.D. Pa. 1996).

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party, the lease may still exist but third party rights therein survive only if mentioned explicitly therein and/or to the extent recognized under pertinent non-bankruptcy law.”

Also, in *In re Stalter & Company, Ltd.*,¹² the debtor was the lessee of certain property in New Orleans which it sublet to a third party. Thereafter, the Debtor filed a voluntary petition under Chapter 11 and moved to reject both the master lease and the sublease for the premises; the motion was granted. The sub-lessee tried to negotiate a new lease for the premises but could not, and moved to vacate the earlier order rejecting the master lease and sublease.

The bankruptcy court found that Section 365 gave the Debtor the power to reject and that the sub-lessee had no independent right to remain on premises under Code. The district court affirmed but in an odd fashion holding that while 365(h) does provide a sub lessee the right to maintain a possessory interest in a sub-leasehold, there is no real property to which the sub-leasehold attaches as soon as the primary lease is terminated. This opinion seems to rely on the interpretation that 365 provides specific rights where a debtor rejects an unexpired lease as lessor or sub-lessor.

IV. A Tenant’s Rights If A Landlord Debtor Seeks To Sell The Property Free And Clear Of All Liens And Encumbrances

Of potential concern to a tenant is a landlord that files for bankruptcy and then sells the property. Courts are split on how the tenant’s leasehold rights are treated in such a scenario. Whether a debtor can sell property free and clear of leasehold interests implicates sections 363(f)¹³ of the Bankruptcy Code which states that the property, under specified conditions, may be sold unencumbered of interests held by others:

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;

¹²In re Stalter & Company, Ltd., 99 B.R. 327 (E.D. La. 1989).

¹³There is nothing in Section 365(h) that prevents a landlord debtor from selling its property.

- 4) Such interest is a bona fide dispute; or
- 5) Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

There are two lines of cases interpreting this section. Some courts have held that the more specific provisions of Section 365(h) dictating how a lessee's rights are treated must be followed.

For example, in *In re Haskell, L.P.*,¹⁴ a debtor filed a motion to reject the lease, a motion to sell its real estate free and clear of all liens and interests (including the leasehold interest) and sought to compel the tenant to accept monetary satisfaction of its interest in the debtor's real property.¹⁵

The court declined to grant the relief sought and held that granting the motion would eviscerate the provisions of Section 365(h). There were two grounds for the court's conclusion. First, the court concluded that the tenant could not be compelled to accept money for its rejected lease under Section 363(f)(5) in light of the protections provided to a tenant under Section 365(h). Additionally, there was un rebutted evidence that the tenant's claim could not be quantified and therefore no monetary satisfaction could be achieved or compelled.

Similarly, in *In re Taylor*,¹⁶ the debtor sought to sell nursing home facilities free and clients of liens and interests, including leases. The court denied the motion, primarily because the court stated its belief that Congress intended Section 365(h) to control the rights of a landlord and tenant when a landlord files for bankruptcy. Further, that section reflects a careful balance between the needs of a bankrupt's estate and the rights of a tenant for which it bargained. Accordingly, the court concluded that, as the exclusive remedy for landlord/tenant issues, Section 365(h) overrides a landlord debtor's ability to sell property free and clear subject to the limitation set forth in Section 363(f).

In *In re Churchill Prop. III, L.P.*,¹⁷ the lessee objected to the rejection of its executory lease and, in the alternative, under Section 365(h), sought to retain possession in the

¹⁴In re Haskell, L.P., 321 B.R. 1 (Bankr. D. Mass. 2005).

¹⁵See also *In re Samaritan Alliance, LLC*, 2007 WL 4162918 *4 (Bankr. E.D. Ky. Nov. 21, 2007) (Section 365(b) is applicable in context of sale under Section 363(f)).

¹⁶In re Taylor, 198 B.R. 142 (Bankr. D. S.C. 1996).

¹⁷In re Churchill Prop. III, L.P., 197 B.R. 283 (Bankr. N.D. Ill. 1996).

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debtor's apartment complex that was sold. The bankruptcy judge held that the tenant could retain possession because it retained its rights under Section 365(h) notwithstanding a sale of the debtor's property. While believing that there is an inherent inconsistency between Section 363(f) and Section 365(h),¹⁸ the court concluded that the latter section "is more compelling and should rule the day." Ultimately, the court relied on the legislative history which the court believed reflected Congressional intent to balance landlords and tenants' rights while preserving a lessee's leasehold rights when a landlord files for bankruptcy.

Other courts have held that the two sections must be looked at in conjunction and that, notwithstanding Section 365(h), property may be sold free and clear of interests (including a leasehold interest) if one of the conditions of Section 363(f) can be satisfied.

In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*,¹⁹ the United States Court of Appeals for the Seventh Circuit was the first circuit court to address the interplay between Section 363(f) and 365(h). The bankruptcy court construed a sale order under Section 363(f) to extinguish a lessee's possessory rights. The district court disagreed but the Seventh Circuit reversed and approved the bankruptcy court's decision. "We reverse, concluding that under the plain terms of section 363(f), the sale order extinguished the lessee's possessing rights."

First, the Seventh Circuit concluded that the statute (Section 363(f) on its face permits a sale free and clear of liens and interests, including the lessee's possessory interest. Second, the Seventh Circuit noted that Section 365(h) is limited to circumstances in which a debtor rejects a lease. Here, the property was sold, the lease was not rejected (although the court acknowledged the same net effect on the lessee). The court also believed that Section 363(h) itself provides protection by conditioning a sale to a situation in which an interest (like a tenant's) is adequately protected. According to the Seventh Circuit, this may mean monetary compensation for the tenant rather than right to continued possession.

¹⁸The court also commented that an accepted principle of statutory construction is that the specific prevails over the general. Here, Section 365(h) is clear and specific in providing for certain rights to a lessee.

¹⁹*Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003).

In *In re Hill*,²⁰ the debtor operated a beer distributorship and asserted that he had entered into a lease with his father for certain premises. His father filed his own bankruptcy proceeding in which the property was sold free and clear of all liens, claims and encumbrances. First, the court found there was no real evidence that there was a lease. In any event, the court held that, to the extent the debtor had any possessory interest in the property, such leasehold interest had been extinguished when the property was sold under Section 363(f). The court was persuaded by the Seventh Circuit's decision in *Qualitech*.

An interesting interpretation was added in *In re Downtown Athletic Club of New York City, Inc.*,²¹ where the district court overruled the bankruptcy court which had held that a sale of the debtor's real property was not free and clear of alleged leasehold interests. The debtor sold its building which had both a hotel and athletic club and two residents who alleged they had unwritten leases objected. The district court concluded that the sale was free and clear of any interests under Section 363(f)(4) because there was a bona fide dispute as to the existence of the leasehold interests.

Additionally, the district court concluded that Section 365(h) only applies when a landlord debtor remains in possession of its property and rejects a lease and not when the property is sold.²² Accordingly, "when the debtor-lessor sells property subject to a lease free and clear of that lease pursuant to Section 363(f), the Court will not apply Section 365(h).

Recently, in *In re MMH Automotive Group, LLC*,²³ the Chapter 7 trustee sold the debtor's property free and clear of all liens and encumbrances. The owner of an unrecorded billboard lease argued that it should have received notice of the sale and that its interest was not eliminated as a result of the sale. The court concluded that the property could be sold free and clear of the lease under Section 363(f). However, because the lease contained a provision compelling the lessee to accept a monetary satisfaction, the lessee was entitled to be paid damages in accordance with the lease terms.

²⁰In re Hill, 307 B.R. 821 (Bankr. W.D. Pa. 2004).

²¹In re Downtown Athletic Club of New York City, Inc., 2000 WL 744126 (S.D.N.Y. June 9, 2000).

²²The Code itself makes no such distinction. See 11 U.S.C. § 365(h).

²³In re MMH Automotive Group, LLC, 385 B.R. 347 (Bankr. S.D. Fl. 2008).

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Conclusion

Once a landlord files for bankruptcy (under any chapter), the automatic stay prevents a tenant from simply exercising any self help remedies or from initiating any actions that would affect property of the estate. However, there are specific protections for tenants when lessors file for bankruptcy. Courts have generally held that to the extent a lease is terminated, a sublease is similarly terminated. Worse for sub-tenants, some courts have found they do not enjoy the same right to possession in the face of a lease rejection that the prime tenant has.

Clearly, tenants can choose to stay in the space even if a lease is rejected. However, there is a split in the courts as to whether a landlord debtor can sell its real property free and clear of interests, including the leasehold interest. Some courts have argued that the line of decisions that allow a landlord debtor to do so in return for monetary compensation (but not continued possession) essentially eviscerate the protections provided to a tenant whose lease has been rejected.