SOURCE:

http://www.law.cornell.edu/wex/Bankruptcy

Bankruptcy: an overview

Bankruptcy law provides for the development of a plan that allows a debtor, who is unable to pay his creditors, to resolve his debts through the division of his assets among his creditors. This supervised division also allows the interests of all creditors to be treated with some measure of equality. Certain bankruptcy proceedings allow a debtor to stay in business and use revenue generated to resolve his or her debts. An additional purpose of bankruptcy law is to allow certain debtors to free themselves (to be discharged) of the financial obligations they have accumulated, after their assets are distributed, even if their debts have not been paid in full.

William Bosco 2/18/12 1:11 AM

Comment: BUT lessors do not have the same standing in bankruptcy. They are not treated the same as a lender as they have no claim to the other assets of the lessee – they get their asset back if the ease is rejected in bankruptcy

Bankruptcy law is federal statutory law contained in Title 11 of the United States Code. Congress passed the Bankruptcy Code under its Constitutional grant of authority to "establish... uniform laws on the subject of Bankruptcy throughout the United States." *See* U.S. Constitution Article I, Section 8. States may not regulate bankruptcy though they may pass laws that govern other aspects of the debtor-creditor relationship. *See* Debtor-Creditor. A number of sections of Title 11 incorporate the debtor-creditor law of the individual states.

Bankruptcy proceedings are supervised by and litigated in the United States Bankruptcy Courts. These courts are a part of the District Courts of The United States. The United States Trustees were established by Congress to handle many of the supervisory and administrative duties of bankruptcy proceedings. Proceedings in bankruptcy courts are governed by the Bankruptcy Rules which were promulgated by the Supreme Court under the authority of Congress.

There are two basic types of Bankruptcy proceedings. A filing under Chapter 7 is called liquidation. It is the most common type of bankruptcy proceeding. Liquidation involves the appointment of a trustee who collects the non-exempt property of the debtor, sells it and distributes the proceeds to the creditors. Bankruptcy proceedings under Chapters 11, 12, and 13 involve the rehabilitation of the debtor to allow him or her to use future earnings to pay off creditors. Under Chapter 7, 12, 13, and some 11 proceedings, a trustee is appointed to supervise the assets of the debtor. A bankruptcy proceeding can either be entered into voluntarily by a debtor or initiated by creditors. After a bankruptcy proceeding is filed, creditors, for the most part, may not seek to collect their debts outside of the proceeding. The debtor is not allowed to transfer property that has been declared part of the estate subject to proceedings. Furthermore, certain pre-proceeding transfers of property, secured interests, and liens may be delayed or invalidated. Various provisions of the Bankruptcy Code also establish the priority of creditors' interests.

However, a recent decision by the Supreme Court has shifted this power towards the debtor. In Rousey v. Jacoway, (April 4th, 2005), the Court held that assets in Individual Retirement Accounts (IRA's) are protected under 11 U.S.C § 522(d) and thus exempt from withdrawal from the bankruptcy estate. This decision has broad implications for the baby-boomer generation, providing millions of Americans nearing retirement with increased protection of their earnings.

Recent passage of the Bankruptcy Prevention and Consumer Protection Act in April 2005 has also resulted in major reforms in bankrupcy law, outlining revised guidelines governing the dismissal or conversion of Chapter 7 liquidations to Chapter 11 or 13 proceedings. The law also expands the responsibilities of the United States Trustees Program to include supervision of random and targeted audits, certification of entities to provide credit counseling that individuals must receive before filing for bankruptcy, certification of entities that provide financial education to individuals before being discharged from debt, and greater oversight of small business Chapter 11 reorganization cases.

Definition from Nolo's Plain-English Law Dictionary

A federal legal process for debtors seeking to eliminate or repay their debts. There are two types of bankruptcies for consumers: Chapter 7, which allows debtors to wipe out many debts in exchange for giving up nonexempt property to be sold to repay creditors, and Chapter 13, which allows debtors to keep all of their property and repay all or a portion of their debts over three to five years. Businesses can file for Chapter 7 or Chapter 11 bankruptcy. Chapter 11 lets companies reorganize their debt load to stay in business.

Definition provided by Nolo's Plain-English Law Dictionary.

August 19, 2010, 5:11 pm

SOURCE:

http://delawarebankruptcy.foxrothschild.com/2008/10/articles/commercial-landlords/ten-things-every-commercial-landlord-should-know-about-a-tenant-in-bankruptcy/

About a Tenant in Bankruptcy (***THIS APPLIES TO REAL ESTATE LEASES - NOT EQUIPMENT LEASES)***

Posted on October 16, 2008 by Jason Cornell, Esq.

Ten Things Every Commercial Landlord Should Know About a Tenant in Bankruptcy

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As the economy fluctuates, tenant bankruptcies become a greater risk for commercial landlords. Yet some landlords are not familiar with the rights provided to them under the Bankruptcy Code, nor are they aware of the protections provided to a tenant in bankruptcy. For example, certain lease provisions are unenforceable once a tenant files for bankruptcy. Should a landlord attempt to exercise its rights under the lease without first seeking approval from the bankruptcy court, the landlord may be subject to strong sanctions. The purpose of this article is to provide landlords with the questions and answers they should consider when a commercial tenant files for bankruptcy.

1. What effect does a tenant's bankruptcy have on the lease?

Once a tenant files for bankruptcy, it has three options regarding the lease: it can assume the lease and continue performing all obligations, or assume and assign the lease to a third party, or reject the lease and surrender the premises and terminate performance. The Bankruptcy Code gives the debtor-tenant 120 days to decide whether to assume or reject the lease. During this period, the tenant can request one 90 day extension to decide what to do with the lease.

If the debtor-tenant fails to assume or reject the lease within the 120 day period, and no extension is granted, the lease is deemed rejected. This is a significant provision for landlords. To be proactive, landlords should review all pleadings filed in the tenant's bankruptcy proceeding to see if the debtor-tenant sought an extension of time to assume or reject. Additionally, landlords should review the tenant's motions to assume, motions to assume and assign, as well as motions to reject leases. The exhibits to these motions often contain schedules identifying the leases affected by the motion.

2. How does the "automatic stay" of the Bankruptcy Code apply to landlords?

The automatic stay is one of the most powerful protections provided to debtors in a bankruptcy proceeding. The stay acts as an injunction that prohibits creditors (including landlords) from commencing or continuing any proceeding against the debtor which could have been commenced prior to the bankruptcy. Before a landlord seeks to enforce its rights under the lease (such as through eviction, termination or foreclosure), the landlord should seek "relief" from the automatic stay by filing a motion with the bankruptcy court.

It is important for landlords to realize that the automatic stay becomes effective without notice or a hearing. Were a landlord to be found in violation of the automatic stay, the debtor-tenant may be able to recover actual damages from the landlord, including attorneys' fees. If the violation is found to be intentional, the debtor-tenant may recover punitive damages.

3. What is the status of the tenant's rental obligations while in bankruptcy?

While in bankruptcy, the Bankruptcy Code requires the debtor-tenant to satisfy all terms under the lease until the tenant either rejects the lease, or assumes and assigns it to a third-party. The landlord's claim for unpaid rent receives "administrative claim" status, which is a higher priority of claim than many of the other claims against the debtor. Creditors holding an administrative claim against the debtor will receive payment on their claims before "unsecured creditors," to the extent funds are available.

Should the debtor-tenant fail to pay the rent as provided under the lease, the landlord should file a motion for payment of administrative rent with the bankruptcy court. The rent motion in some instances can be heard within thirty to sixty days from the date in which it was filed. However, if an evidentiary hearing is needed to resolve the motion, several months could pass before the court issues a decision.

4. What are the landlord's "rejection damages"?

If the debtor-tenant seeks to terminate and surrender the lease, that is "reject it", the landlord may be entitled to a "rejection damage" claim. A landlord is not entitled to the full amount of unpaid rent due under the lease. Instead, the Bankruptcy Code limits the recovery a landlord may receive for rejection damages. The landlord's rejection damage claim is capped at the greater of one year's rent, or 15% of the rent due under the lease, not to exceed three years' rent.

To determine the amount of the rejection damage claim, the landlord should first determine the amount of damages it is entitled to under lease, regardless of the Bankruptcy Code's cap on rejection damages. If the total amount of the landlord's claim is less than the amount of the cap, the Code's limitation on damages does not apply.

5. What are the landlord's rights when the debtor-tenant decides to assume the lease?

Assumption of the lease is permissible even if the terms of the lease expressly prohibit assumption. Before a debtor-tenant can "assume" a lease, the tenant must cure all monetary and non-monetary defaults. Additionally, the debtor-tenant must provide the landlord with adequate assurance that the tenant will be able to perform under the lease going forward.

A debtor-tenant must serve the landlord with notice of its intention to assume the lease. The debtor may provide notice of its intent to assume in either a motion to assume, or a plan of reorganization. Regardless of the method, under either approach the landlord has only a limited amount of time to review and file an objection to the assumption of its lease and/or the proposed cure amount. If the landlord chooses to object to the assumption of its lease, it needs to file a written objection with the court.

6. What are the landlord's rights when the tenant assumes and assigns the lease to a third-party?

In conjunction with assuming the lease, the Bankruptcy Code allows the debtor- tenant to assign the lease to a third party. The party who is assigned the lease must provide the landlord with adequate assurance that it can meet the financial obligations of the lease. If the party who is assuming the lease cannot provide the landlord with adequate assurance, the landlord can object to the assignment.

Bankruptcy courts often apply the "business judgment" standard when considering whether to allow a tenant to assume and assign a lease. Under this standard, a debtor-tenant can assign a lease provided it can show the transfer of the lease is a reasonable business decision. Although courts provide debtor-tenants with broad discretion on the decision of whether to assume and assign a lease, the debtor-tenant must still demonstrate the assigned party's ability to cure defaults under the lease and make future payments.

7. How does a landlord recover its administrative rent claim?

The Bankruptcy Code requires the debtor-tenant to timely perform all obligations under the lease until such time that the tenant assumes or rejects the lease. If a tenant files for bankruptcy and maintains possession and use of the property, yet fails to pay rent, the landlord should consider filing a motion for an administrative claim.

Although the landlord is entitled to the fair market value for purposes of determining the amount of its claim, the rental amount provided in the lease is presumed to be the fair market value. If the tenant believes it is entitled to pay an amount less than the rate provided for in the lease, the tenant must show why the contract rate is not fair market value.

8. When can a landlord recover attorneys' fees from a tenant in bankruptcy?

Landlords may be able to recover attorneys' fees incurred when a debtor-tenant seeks to assume the lease, or assume and assign the lease to a third party. To recover attorneys fees, however, the landlord must meet several criteria. First, the lease must expressly state that the landlord is entitled to recover attorneys' fees as additional rent or in connection with the collection of rent. Next, the landlord must have prevailed in the proceedings in which it seeks to recover attorneys' fees. "Prevailing" in a bankruptcy proceeding may include filing an objection to a motion of the debtor-tenant and receiving a favorable decision (i.e., objecting to the cure amount proposed by the tenant).

The matter in which the landlord seeks attorneys' fees must be in pursuit or enforcement of the landlord's rights under the lease, not matters where the landlord challenges the debtor-tenant's rights under the Bankruptcy Code. Finally, the attorneys' fees must be reasonable. To determine whether fees are reasonable, courts will consider factors such as the amount in dispute relative to the fees requested, the debtor-tenant's good faith efforts to resolve the dispute and compliance with the Bankruptcy Code.

9. Can the landlord apply the tenant's security deposit to the landlord's claims?

Security deposits are considered property of the bankruptcy estate, and as such, are generally required to be returned to the debtor. Even so, landlords are permitted in some instances to setoff their claim against the security deposit. This benefits a landlord in two ways. First, instead of returning the deposit to the debtor-tenant, a landlord can setoff its claim against the deposit, and thus reduce the amount of the deposit that must be returned. Second, the landlord's rejection damage claim is a general unsecured claim, meaning it gets paid after all other types of claims under the Bankruptcy Code. However, by applying the security deposit, the landlord is more likely to receive payment ahead of other unsecured creditors.

Landlords should not setoff any claims they have against a debtor-tenant's deposit without first seeking permission from the bankruptcy court. If the parties reach an agreement as to the amount of the claim to be applied to the deposit, the debtor-tenant may consent to the landlord's use of the deposit.

10. How can a landlord protect itself prior to and during a bankruptcy?

Requiring a third-party guarantor is one way in which a landlord may obtain better creditor protection when entering into a lease. The Bankruptcy Code does not prevent a landlord from taking action against a guarantor to a corporate debtor-tenants' lease, provided the lease guarantor is not in bankruptcy.

Landlords can also seek protection through letters of credit. Using a properly drafted letter of credit allows a landlord to draw on the proceeds of the letter of credit should the tenant default under the lease. Letters of credit are generally not considered property of the tenant's bankruptcy estate.

Once a tenant files for bankruptcy, it is important that the landlord stay informed regarding the status of the proceedings. This is especially true regarding claims bar dates and objection deadlines. If a landlord misses the deadline in which to file a claim, it may be barred from recovering on its claim. Similarly, if the debtor files a motion to assume the lease and assign it to a third party, landlords have a very limited amount of time to file an objection to the assumption. This deadline is also significant as a landlord may dispute whether the party assigned to the lease is capable of complying with the terms of the lease.

Source: http://www.elfaonline.org/cvweb_elfa/Product_Downloads/EFeb07ll.pdf

THIS APPLIES TO EQUIPMENT LEASES

A Lessor's Walk Down the Bankruptcy Aisle

You have new rights in case of an unhappy break-up.

Leasing Law

Whether a lease of equipment is a "good" or a "service" has yet to be determined by the courts for purposes of 503(b)(9).

We know the old adage, something old, something new, something borrowed and something blue. An equipment lessor's rights in bankruptcy are now an amalgamation of this old adage. This article will provide an overview of the rights an equipment lessor may have if its lessee is involved in a bankruptcy proceeding.

Something Old

The rights of an equipment lessor were first set out in the 1978 version of the Bankruptcy Code (the "Old Code"). Much of what was set forth under the Old Code remains the law today. Thus, most know that a lessor's rights in bankruptcy are determined by a debtor lessee's decision to "assume" or "reject" the lease. If assumed, the lessee is required to cure the past due payment and other defaults and provide "adequate assurance" that future payment and performance is assured under the lease. Adequate assurance of future performance was and remains essentially a feasibility test—the likelihood that the debtor's lease obligations will be made in the ordinary course as they come due. This requires the lessor to drill down into the debtor's overall restructuring plan, to determine if what has been proposed makes economic sense. A debtor can also assume and assign a lease to a third party, thereby imposing a new

lessee on the lessor, if the lease can be otherwise assumed and if the new assignee provides adequate assurance of its ability to perform.

Pending assumption or rejection of the lease, the debtor remains obligated to commence making payments to the lessor 60 days after the date the bankruptcy was filed, unless the court shortens that period.

Case law has later allowed a debtor, whether an entity or an individual, who was either indifferent or sloppy to neither "assume" nor "reject" a lease under its plan of reorganization and instead elect to have the lease "ride through" the bankruptcy. If the lease rides through the bankruptcy, the lessor's rights are unaffected, although the lessor has the other protections provided in a bankruptcy case, and upon confirmation, the automatic stay will terminate and the lessor will be free to take whatever action it was otherwise authorized to take had the bankruptcy not been filed.

Something New

Under the amendments passed one year ago under what is known as the Bankruptcy Abuse Prevention and Consumer Protection Act (the "New Code"), Congress added a provision, the effect of which has not yet been litigated in the equipment leasing realm. Under New Code provision

503(b)(9), one who provides "goods" to a debtor in the ordinary course of business is entitled to have the "value" of the goods provided within 20 days of the filing of a bankruptcy petition treated not as an unsecured claim (usually paid pennies on the dollar), but as an administrative claim (as if it arose after the filing of the bankruptcy case and paid in one hundred cent dollars). To be entitled to the administrative claim, as of now, the claimant must file a motion with the court seeking allowance and payment of the 503(b)(9) claim. In the larger cases, some debtors facilitate the filing of the 503(b)(9) claim by allowing it to be added to the proof of claim filed, rather than enforced by a separate motion. For those lessors whose lease payment came due within 20 days of the filing date or can otherwise show that "goods having value" were given during the 20-day period, the provisions of 503(b)(9) could be quite helpful. The trick for equipment lessors is to determine what the term "goods having value" means. The term "services" is not used, only "goods." Whether a lease of equipment is a "good" or a "service" has yet to be determined by the courts

for purposes of 503(b)(9). Further, although a court may construe a traditional lease as a "service," a finance lease could be viewed differently. Likewise, when the lease is bundled with software or other items that may be deemed to be a purchased component, the argument becomes much stronger that an equipment lessor should be entitled to the equivalent of 20 days of lease payments as an administrative claim. As to "value," one would presume that the availability of the leased assets to the lessee during the 20-day period would constitute sufficient "value" having been given by the lessor. Over time, lessors likely will attempt to craft their leases in a way to potentially take advantage of this new bankruptcy benefit.

Something Borrowed

Under the New Code, Congress borrowed from the Chapter 13 structure and has now created an exception to the lease "ride through" provisions, if the lessee is an individual (doctor, lawyer, sole proprietor) who individually seeks Chapter 11 relief, rather than an entity (corporation, partnership, limited liability company, etc.). Under the New Code, an individual cannot allow his or her lease to "ride through" the bankruptcy. If the lease is not assumed in the confirmed plan, it is deemed rejected and the automatic stay terminates. That means the lessor in the individual Chapter 11 case will either receive all of its cure payments and adequate assurance of future performance, or the lease will be deemed rejected and terminated, and the equipment will be free to be seized if not returned voluntarily. Thus those lessors who lease to sole proprietors, doctors, lawyers and other professionals who do not utilize an entity structure should be mindful of this additional right and provision.

Something Blue

Assume for the moment that your equipment lease, in additional to requiring the lessee to make monthly pay-

Under the New Code, an individual

cannot allow his or her lease to "ride through" the bankruptcy.

ments, requires the lessee take other non-monetary action, for example, keeping the equipment marked with a blue tag at all times. Under the Old Code, there was a dispute whether a lessee in bankruptcy could assume the lease if the non-payment obligation of keeping the equipment marked with a blue tag had been previously violated.

The New Code now explicitly requires the lessee to not only cure any monetary defaults before the lease can be assumed, but also the non-monetary defaults, such as keeping the equipment tagged at all times with a blue tag. However, many times it is impossible to cure, after the fact, a status covenant, such as keeping an asset tagged with a blue tag. Therefore, if you as the lessor can prove that the blue tag was missing for a period of time, you can rightfully oppose the motion to assume on that ground alone, and presumably, you should prevail.

Blue tag covenants may not be the norm, but there are other status covenants, such as keeping the equipment insured at all times, that are routinely found in lease agreements. If insurance lapses, that could prevent a later assumption of the lease. Therefore, lessors should pay careful attention not only to the monetary provisions of their leases, but also the non-monetary covenants of their leases to provide ammunition if things go bad in the lease transaction and

divorce is imminent.

The New Code now explicitly requires the lessee to not only cure any monetary defaults before the lease can be assumed, but also the non-monetary defaults.

Divorce Tips

So, if you as a lessor find your lessee bride in bankruptcy, here are a few reminders based on the New Code that can assist you in the divorce:

1. If the lessee is an individual, your radar should go up and you should recognize the lease's ability to "ride through" the bankruptcy is no more. You can be pro-active to assure yourself that the bankruptcy plan does not permit a ride through of the lease, if that is consistent with your economic interests and goals.
2. As a lessor, you may have an administrative claim for the lease value provided during the 20 days prior to the bankruptcy filing. If you want to pursue this right in a specific case, don't sit on your rights. Seek them out. They will not be handed to you. You must ask for them to get them. Until the law is clarified, however, you are likely to have a battle over whether the 503(b)(9) benefit is available to a lease transaction.
3. If your lease contains non-monetary obligations, in addition to the payment obligations, your lessee must cure both before it can assume the lease. On your bankruptcy checklist should be a review of the non-monetary covenants, to determine if you can assert the past violation of

a non-monetary covenant in defense of a motion to assume (or assume and assign to a new bride) the lease.

If you are aware of these new rights, you may have the upper hand in the lease divorce proceedings.

ELT thanks Jay L. Welford of Jaffe Raitt Heuer & Weiss, P.C., Southfield, Michigan, for this month's column.