

**WHAT EVERY REAL ESTATE PRACTITIONER
NEEDS TO KNOW ABOUT BANKRUPTCY LAW**

by

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A. Overview of Chapters 7 and 11

Basic Bankruptcy Law; Types of Bankruptcies.

The four types of bankruptcies are as follows:

1. **Chapter 7 – Liquidation:** The non-individual debtor turns over all property to the Chapter 7 Trustee, and the individual debtor turns over all non-exempt property to the Chapter 7 Trustee. This Trustee sells or liquidates the property and distributes the proceeds to creditors pro rata, usually in a small one-time payment. The individual debtor will be released (*i.e.* discharged) from the unpaid portion of many types of debt unless a creditor's objection to the debtor's discharge is sustained, or unless a creditor obtains a judgment that its particular claim is nondischargeable, but corporate debtors in Chapter 7 do not receive a discharge. The Chapter 7 Trustee is always appointed by the United States Trustee and is usually a member of a panel of Trustees.
2. **Chapter 11 – Reorganization:** The purpose of this bankruptcy proceeding is to allow the debtor a breathing spell from creditors, thereby enabling the debtor to reorganize its financial affairs. This is the most expensive and complicated type of bankruptcy and can last for several years. If successful, a plan of reorganization would be proposed which is subject to the vote of creditors.
3. **Chapter 12 – Family Farmer Bankruptcy:** May only be filed by a family farmer with regular annual income. This proceeding is similar to a Chapter 13, described below.
4. **Chapter 13 – Adjustment of Debts:** Filed only by individuals with regular income (filing with or without a spouse) and with unsecured debts of less than \$307,675 and secured debts of less than \$922,975, 11 U.S.C. § 109(e).¹ The purpose of a Chapter 13 is for the debtor to pledge part of his or her income and/or other property to pay all or a portion of the debt. Once this portion of the debt is paid, the debtor is released (*i.e.* discharged) from the unpaid portion of the debts. Soon after the case is commenced, the debtor must propose a plan which fits within the strict requirements of the Bankruptcy Code. Pursuant to § 1322(b)(2) the Chapter 13 plan may modify the rights of secured and unsecured creditors, but the debtor's ability to modify a debt which is secured by a mortgage on the debtor's principal residence is limited (*see* § 1322(b)(5)).

There are two ways in which a bankruptcy may be commenced: **voluntarily** and **involuntarily** and both forms of commencement invoke the automatic stay. 11 U.S.C. § 362(a).

¹ Amounts correct as of April 1, 2004. As required under 11 U.S.C. § 104(b), the Chapter 13 dollar amounts are automatically adjusted at three-year intervals to reflect changes in the Consumer Price Index. As required under 11 U.S.C. § 104(b)(2), the next three-year automatic adjustments of the dollar amounts affecting the eligibility of a debtor to file Chapter 13 will occur on April 1, 2007.

In a voluntary bankruptcy, the debtor files the bankruptcy petition. In an involuntary bankruptcy, the statutory number of creditors file the bankruptcy against the debtor under 11 U.S.C. § 303. An involuntary case may only be commenced under Chapters 7 and 11 of the Bankruptcy Code.

B. The Automatic Stay

1. Section 362 – The Automatic Stay.

- (a) Section 362(a) of the Bankruptcy Code provides that the filing (whether voluntary or involuntary) of a bankruptcy petition operates (automatically) as a stay of:
- (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 the 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;
 - (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
 - (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
 - (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.
- (b) **EXAMPLES:** Common examples of matters falling within the above involving commercial real estate include (subparagraphs (1) – (8) below correspond to subparagraphs (1) – (8) above):
- (1) license revocation actions, actions seeking money judgments, injunctive actions, action against tenant for rent;

- (2) levy or execution, proceedings supplementary to judgment, garnishment actions;
- (3) acts to terminate executory contracts or leases;
- (4) lien perfection (except certain 10-day exceptions under § 362(b)(3)), foreclosure (except certain HUD mortgages under § 362(b)(8));
- (5) lien enforcement against property of the debtor that is not property of the estate (for example, property acquired postpetition);
- (6) cashing check postpetition, harassing telephone calls and letters (draw under letter of credit not stayed);
- (7) setoff (but not administrative freeze of debtor's bank account, *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995)).

2. Exception to the Automatic Stay.

- (a) Section 362(b) provides for exceptions to the automatic stay, including the following relating to commercial real estate:
 - § 362(b)(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 § 546(b) of this title or to the extent that such act is accomplished within the period provided under § 547(e)(2)(A) of this title;
 - § 362(b)(4) under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit or any organization exercising authority under the Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and Their Destruction, opened for signature on January 13, 1993, to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power;
 - § 362(b)(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;

§ 362(b)(18) under subsection (a) of the creation or perfection of a statutory lien for an *ad valorem* property tax imposed by the District of Columbia, or a political subdivision of a State, if such tax comes due after the filing of the petition.

(b) **EXAMPLES:** Common examples of the above exceptions involving commercial real estate include (subparagraphs below correspond to subparagraphs above):

§ 362(b)(3) postpetition recording of a purchase money mortgage or postpetition continuation of a financing statement which contains a security interest in fixtures, to the extent permitted under non-bankruptcy law, and to the extent that the trustee takes subject to said security interest. (§ 362(b)(3) does NOT authorize the creation of new rights or interests for the creditor, but merely permits perfection or continuation of perfection free from the automatic stay in circumstances where the creditor's actions would be effective against the trustee.).

§ 362(b)(4) enforcement of environmental protection laws (but a clean up order is a dischargeable claim enforcement of which is subject to the automatic stay under *Ohio v. Kovacs*, 469 U.S. 274 (1985));

§ 362(b)(10) if the debtor's interest as a lessee under a lease has terminated prepetition by the *expiration of the stated term of the lease*, then eviction action is not subject to the stay (see discussion in section 4(b) on page 5, below).

§ 362(b)(18) creation and perfection but not enforcement of liens for *ad valorem* taxes (this exception was added in 1994 to clarify the law as some courts had held property tax liens for postpetition taxes did not attach).

3. Injunctive Relief.

(a) **Against Guarantors or Key Personnel.** Actions to enforce rights against non-debtor guarantors or key personnel are not subject to the automatic stay. However, these parties may seek, and under appropriate circumstances obtain, injunctive relief under § 105(a).

(b) **Against General Partners.** A § 105(a) injunction may also be obtained for the benefit of a general partner of a partnership debtor (and presumably a member or manager of limited liability company) if the general partner's participation in

and/or funding of the reorganization effort is critical. *See In re: Old Orchard Inv. Co.*, 31 B.R. 599 (W.D. Mich 1983).

4. Property of the Estate – Commercial Real Estate Interests.

- (a) The principal sections of 362(a) and (b) relating to real estate require an understanding of the meaning of the term "property of the estate."
- (b) Section 541 defines property of the estate as follows:
 - (a) ...all the following property, wherever located and by whomever held:
 - (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.
 - (6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.
 - (b) Property of the estate does not include –
 - (2) any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case under this title, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case.
 - (c) Section 541 was drafted broadly to bring into the debtor's bankruptcy estate all property interests, no matter how limited. For example, redemption rights, leases, joint tenancy interests, and contract rights of a debtor are property of the debtor's bankruptcy estate. Property acquired by the estate after the filing of the bankruptcy petition is also "property of the estate" under § 541(a)(7).

5. Application of the Automatic Stay to Real Estate Interests.

(a) Foreclosure.

- (1) **In General.** The commencement or continuation of foreclosure proceedings, whether by judicial proceedings or by advertisement under power of sale, constitute acts to enforce a lien (*i.e.*, under or pursuant to a mortgage, deed of trust, deed to secure debt, judicial levy, judgment lien,

etc.) against property of the estate in violation of the automatic stay under § 362(a)(4).

(2) **Void v. voidable.** A foreclosure sale which occurs after the automatic stay takes effect is generally held to be void and of no force and effect. However, a good faith purchaser at a foreclosure sale is protected under § 549(c) if the real property is not located in the county where the bankruptcy case was commenced and a copy of the bankruptcy petition has not been recorded in the county where the real property is located. Warning: In *In re: Schwartz*, 954 F.2d 569 (9th Cir. 1992), a lender that closed a loan postpetition was not protected by § 549(c) and its mortgage was rendered void.

(b) **Lease Termination.** Once the debtor/tenant files bankruptcy, any commencement or continuation (other than the mere lapse of time) by a landlord of any act to terminate a lease interest of a tenant-debtor is a violation of the automatic stay as an act to obtain possession of property of the estate under § 362(c)(3).

(c) **Assignment of Rents.**

(1) **In General.** Rents derived from real estate that is property of the estate are also property of the estate. Postpetition acts by an assignee of the rents to enforce the assignment under MCL 554.231 *et seq.* violate the automatic stay under both §§ 3652(a)(3) and 362(a)(4).

(2) **Prepetition Exercise.** If the assignee has exercised an assignment of rents and is collecting rents prior to the filing of the bankruptcy petition, then the enforcement act has been completed prepetition and the continued collection of rents by the assignee postpetition is not an act to obtain possession of or enforce a lien against property of the estate. However, even if the assignee has not exercised the assignment of rents prepetition, the 1994 amendments to the Bankruptcy Code effectively make the assignee a secured creditor in the rents, which constitute cash collateral. *See* Section D.2 on page 19, below, regarding a landlord debtor's rights to use rents as cash collateral.

(d) **Actions in Bankruptcy Court.** Parties subject to the automatic stay may pursue actions in the bankruptcy court, for example, to determine whether or not the stay applies to them or an action they wish to pursue or for relief from the stay (*see* discussion in Section C. on page 8, below).

6. Stay Violations.

(a) **Void v. Voidable.** Generally acts in violation of the automatic stay are held to be void. However, some actions are found to be voidable, rather than void. Orders

of annulment or modification of the stay sometimes validate such actions but only in unusual circumstances.

- (b) **Knowledge.** Knowledge of the existence of the automatic stay is irrelevant as to whether the action taken constitutes a violation of the automatic stay, but lack of knowledge of the existence of the automatic stay might help protect the violator from punishment for stay violations especially if the debtor is an individual. (*See* 11 U.S.C. § 362(h)).
- (c) **Contempt.** A stay violation is punishable as a contempt of court. *Archer v. Macomb County Bank*, 853 F.2d 497 (6th Cir.1988). As a general rule, even if action taken with advice of counsel willful violations are punishable. *In re Markey*, 144 B.R. 738 (W.D. Mich. 1992), citing *In re Taylor*, 884 F.2d 478 (9th Cir.1989). Even if inadvertent, the violator must act to undo the violation and failure to do so may result in punishment as a willful action. *Matter of Toti*, 141 B.R. 126 (Bankr. E.D. Mich. 1992).
- (d) **Damages.** Under § 362(h) damages, including punitive damages, can be recovered by the individual debtor from the violator, *In re Sharon*, 234 B.R. 676, C.A. 6 B.A.P. (Ohio 1999); *In re Kortz*, 283 B.R. 706 (Bankr. N.D. Ohio 2002). Some courts have extended damage recoveries to corporate debtors; *In re Advanced Professional Home Care, Inc.*, 82 B.R. 837 (Bankr. E.D. Mich. 1988).

7. Termination of the Stay.

- (a) Section 362 (c) provides that unless earlier terminated pursuant to the request of a party in interest under §§ 362(d) – (f):
 - (1) **Property.** As to acts against property of the estate, the automatic stay continues until the property is no longer property of the estate; and
 - (2) **Other Acts.** As to any other act to which the automatic stay applies under § 362(a), the automatic stay continues until the earliest of:
 - (A) the time the case is closed;
 - (B) the time the case is dismissed; or
 - (C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, the time a discharge is granted or denied.
- (b) Property ceases to be property of the estate when it is abandoned or sold, or when the case is closed or dismissed, or when a discharge is granted or denied.

C. Relief from the Automatic Stay

1. **What is Relief from Stay?** Relief from stay refers generally to the various forms of relief that the Bankruptcy Court "shall" grant if grounds for such relief are established. These forms of relief include terminating, annulling, modifying or conditioning the stay. Relief from stay is sought by the real estate secured creditor in the single asset real estate case is as set forth in 2(e) on page 11, below. For an excellent discussion of relief from stay in a commercial real estate setting *see In re: Holly's, Inc.*, 140 B.R. 643 (Bankr. W.D. Mich. 1992).

The real estate secured creditor who seeks relief from stay usually obtains a termination of the stay (as to the real estate secured creditor only) permitting it to pursue remedies against the real property security under applicable non-bankruptcy law. This means usually that the real estate secured creditor may commence foreclosure of its mortgage, exercise its assignment of rents rights and pursue other remedies available under applicable non-bankruptcy law.

2. **Grounds for Relief from Stay.** Relief from stay is governed by § 362(d), which reads as follows:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay –

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

(A) the debtor does not have an equity in such property;
and

(B) such property is not necessary to an effective reorganization; or

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) –

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

- (a) **Cause.** Relief from stay for cause includes but is broader than lack of adequate protection. Examples of grounds constituting cause include: bad faith filing (*In re: Laguna Assoc. Ltd. Partnership*, 30 F. 3d 734 (6th Cir. 1994); *In re: Dixie Broadcasting, Inc.*, 871 F. 2d 1023 (11th Cir. 1989)); to allow multi-party litigation in a nonbankruptcy court to continue (*In re: Castlerock Properties*, 781 F. 2d 159 (9th Cir. 1986)); to allow actions with only a remote connection to the bankruptcy case involving third party rights to continue in a nonbankruptcy court (*Pursifull v. Eakin*, 814 F. 2d 1051 (10th Cir. 1987)); to obtain a judgment against the bankruptcy debtor to permit recovery against an insurer (*In re: Fernstrom Storage & Van Co.*, 938 F. 2d 731 (7th Cir. 1991); *A.H. Robins v. Piccinin*, 788 F. 2d 994 (4th Cir. 1986) *cert. den.*, 479 U.S. 876 (1986)).
- (b) **Lack of adequate protection.** Lack of adequate protection is by far the most common basis for seeking relief from stay under § 362(d)(1). Although "adequate protection" is not specifically defined in the Bankruptcy Code, § 361 provides non-mutually exclusive examples of what will or will not constitute adequate protection. Section 361 reads as follows:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by –

- (i) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
- (ii) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
- (iii) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

- (A) **Periodic payments.** Under § 361(1) the debtor can provide adequate protection by making a cash payment or periodic payments in the amount of the decrease in value of the secured creditor's interest in the property of the estate. The "decrease" is estimated by the Bankruptcy Judge based on evidence usually provided by experts.
- (B) **Lost opportunity cost.** The United States Supreme Court ruled in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988) that adequate protection does not include compensation to the secured creditor for the delay in the secured creditor's ability to reinvest foreclosure proceeds – what is referred to as the "lost opportunity cost." The Supreme Court also held the secured creditor, who was undersecured, was not entitled to interest on its claim as adequate protection. Recognizing that if the debtor could demonstrate the secured creditor's collateral was not likely to decrease in value (as is often the case with real estate collateral) which could result in considerable case delays (because the debtor could use the property without having to make any payments), the Supreme Court stated that this concern could be properly addressed under § 362(d)(2)(b). The Court noted that the words "necessary to an effective reorganization" mean there must also be "a reasonable possibility of a successful reorganization within a reasonable time."
- (C) **Application of payments.** Generally, adequate protection payments should be treated as payments on the secured claim. However, in real estate cases the assignment of rents complicates the issue. Since rents are part of the collateral and new rents are continuously generated, payments of adequate protection from rent receipts may be held to reduce the secured creditor's unsecured claim. If the secured creditor is oversecured, then the adequate protection payments should be credited to accruing post-petition interest.
- (D) **Additional or replacement liens.** Another form of adequate protection is the granting to the secured creditor of additional collateral or other replacement collateral. Valuation of the additional or replacement collateral is critical and can be problematic.
- (E) **Indubitable equivalence.** Indubitable equivalence is a "catch-all" concept which originated in the *In re: Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935) decision. Although rarely used, this

concept allows flexibility to the debtor in fashioning an offer of adequate protection.

- (F) **Equity cushion.** Another common form of adequate protection is the existence of an "equity cushion" – which exists when the value of the property exceeds the secured creditor's claim (including the claims of secured creditors senior to the secured creditor seeking relief from stay) by a margin sufficient to protect the secured creditor from value decreases during the case.
 - (G) **Junior liens.** Junior lienholders may suffer value decreases as a result of interest accruing on a senior lien under § 506(b).
- (c) **Lack of equity.** Alternatively, a secured creditor can seek relief from stay under § 362(d)(2) when the debtor lacks equity in the property and the property is not necessary to an effective reorganization. Lack of equity exists only when the aggregate amount of all debts secured by liens on the property (for example, unpaid property taxes, senior lien, junior liens, judgment liens, etc.) exceeds the value of the property.
- (d) **Not necessary to effective reorganization.** In most cases, the debtor's property is "necessary" to the ultimate reorganization. However, the "not necessary" requirement also requires a showing that the property is necessary for an "*effective* reorganization" meaning there must be a "reasonable possibility of a successful reorganization within a reasonable time." This means that the debtor must make a showing that a feasible Chapter 11 plan can be proposed.
- (e) **Single asset cases.**
- (i) A special rule applies to requests for relief from stay with respect to "single asset real estate." Single asset real estate is defined under § 101(51B) as "real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than \$4,000,000."
 - (ii) Section 362(d)(3) was added to the Bankruptcy Code in 1994. It requires in single asset real estate cases that relief from stay must be granted unless either (i) within ninety (90) days after the bankruptcy case is filed (or a later date if the bankruptcy court determines cause for an extension exists) the debtor has filed a plan of reorganization meeting the "effective reorganization" test or (ii) the debtor has commenced monthly payments

to all creditors whose claims are secured by the property (except judgment lienholders) in amounts equal to "interest at a current fair market rate."

(iii) Several cases have addressed the definitional issue in § 101(51B) as to when a debtor's business activity extends beyond the "operating the real property" by more than an insubstantial degree.

(f) **Valuation.** Valuation in bankruptcy cases for purposes of determining the extent of secured claims in property of the bankruptcy estate is addressed in § 506(a) which reads as follows:

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.*

Section 506(a) does not provide guidance as to how value is to be determined, but rather stresses the timing of the valuation. Section 506(a) leaves open the possibility that a secured creditor can prove up a lower valuation in relief from stay litigation and a higher value at a later plan confirmation.

(g) **Value minimization v. maximization.** Secured creditors have tended in early case valuations in relief from stay litigation to prove up lower "liquidation based" values – either to reduce or eliminate any equity cushion (and thus make it more likely the debtor will be required to make adequate protection payments) or to establish that the debtor has no equity in the property (one of two prongs the secured creditor must prove to obtain relief from stay under § 362(d)(2)). At plan confirmation, however, the debtor often is better served by a lower valuation which dictates the amount of the secured claim that must be repaid with interest leaving the undersecured balance to be paid as a general unsecured claim.

3. Procedural Framework.

(a) **362(e) and B.R. 4001.** Relief from stay litigation is designed to proceed on a "fast track." Section 362(e) provides that the stay terminates thirty (30) days after a request (by motion filing) for relief unless the Bankruptcy Court enters a preliminary hearing order continuing the stay pending a final hearing. The final hearing must be concluded within thirty (30) days of the conclusion of the preliminary hearing. Generally, all secured creditors with a security interest in the

collateral as well as the unsecured creditors committee must receive notice of the preliminary and final hearings. (If a creditors committee has not yet been appointed, then notice of the preliminary and final hearings must be served on the list of creditors filed pursuant to Bankruptcy Rule 1007 (commonly known as the twenty largest unsecured creditors)).

- (b) **Local Bankruptcy Rules.** Each bankruptcy court has local rules that provide more specific requirements and procedures for relief from stay motions. These local rules must be carefully followed by the secured creditor seeking relief to avoid further delay.
- (c) **Preliminary hearing.** If a preliminary hearing is held as contemplated by § 362(e), the debtor must appear, object to the stay relief, demonstrate there are material disputed issues of fact and that the debtor has a reasonable likelihood of prevailing at the final hearing. The preliminary hearing is generally not an evidentiary hearing with the court's decision based on arguments of counsel.
- (d) **Final hearing.** The final hearing will be an evidentiary hearing. The secured creditor bears the burden of proof on the debtor's equity (or lack of equity) in the property and the debtor has the burden of proof on all other issues (such as no diminution in value, whether the property is necessary for reorganization, whether there is a reasonable prospect for a reorganization within a reasonable period of time).

4. **Other Grounds for Relief from Stay.**

- (a) **Bad faith filing.** Relief from stay has also been granted based on a determination that the debtor's Chapter 11 case was filed in bad faith. *See* discussion in Section C.5., beginning on page 16, below.
- (b) **Prepetition waiver of automatic stay.**
 - (i) Prepetition waivers of the automatic stay are often included in forbearance agreements to negate the effects of subsequent bankruptcy filing. Although several sections in the Bankruptcy Code contain express provisions invalidating prepetition waivers, there is no such provision relating to the automatic stay.
 - (ii) Some bankruptcy courts will enforce a prepetition waiver of the automatic stay if certain conditions are found to exist. Other bankruptcy courts will not. Generally, enforcement has been limited to real estate cases.
 - (iii) A pre-bankruptcy waiver of the automatic stay was enforced in *In re: Shady Grove Tech Center Associates Limited Partnership*, 227 B.R. 422 (Bankr. D. Md. 1998) when the following conditions were satisfied: (1) the lender granted substantial concessions and incurred risks as part of

the workout agreement and in exchange for the waiver, (2) there was material, significant, substantial consideration given by the lender for the waiver provision, (3) the debtor and its counsel acknowledged that the waiver was voluntarily given after negotiations, (4) the rights of third parties were not materially affected by the waiver because there was no equity in the property, (5) there had been no substantial change in circumstances and the property was not and never would be necessary to any type of plan of reorganization, because there was no reasonable prospect of a successful reorganization within a reasonable time period, and (6) the waiver was negotiated between financially sophisticated parties and experienced counsel.

- (iv) Eastern District of Michigan Bankruptcy Judge Steven W. Rhodes has expressed the opinion that prepetition waivers of the automatic stay are unenforceable because (i) they are essentially an agreement not to file bankruptcy in single-asset real estate cases and thus void as against public policy and (ii) enforcement would have a negative effect on other creditors not parties to the agreement containing the prepetition waiver. *In re: 770 South Adams Ltd. Partnership*, Bench Op. No. 92-1222 (Bankr. E.D. Mich., Dec. 14, 1992).
- (v) Cases enforcing prepetition waivers of the automatic stay include *In re: Cheeks*, 167 B.R. 817 (D. S.C. 1994); *In re: Powers*, 170 B.R. 480 (D. Mass. 1994); *In re: Jenkins Court Associates Limited Partnership*, 181 B.R. 33 (E.D. Pa. 1995); *In re: University Commons, L.P.*, 204 B.R. 80 (M.D. Fla. 1996); *In re: Atrium High Point Limited Partnership*, 189 B.R. 599 (Bankr. M.D.N.C. 1995); *In re: Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991); *In re: Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988); *In re: McBride Estates, Ltd.*, 154 B.R. 339 (Bankr. N.D. Fla. 1993); *In re: Hudson Manor Partners*, No. 91-81065 (Bankr. N.D. Ga. Jan. 2, 1992) (unreported); *In re: Wheaton Oaks Office Partners*, 1993 W.L. 243414 (N.D. Ill. 1992) (unreported); *In re: Aurora Investments, Inc.*, 134 B.R. 982 (Bankr. M.D. Fla. 1991); *In re: Orange Park South Partnership*, 79 B.R. 79 (Bankr. M.D. Fla. 1987); *In re: Gulf Beach Dev. Corp.*, 48 B.R. 40 (Bankr. M.D. Fla. 1985); *In re: Snow*, 201 B.R. 968 (C.D. Cal. 1996); *In re: Wald*, 211 B.R. 359 (Bankr. D.N. Dakota 1997).
- (vi) Cases refusing to enforce prepetition waivers of the automatic stay include *Association of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446, 448 (3d Cir. 1982); *In re: Clark*, 69 B.R. 885, 889 (Bankr. E.D. Pa. 1987); *In re: Pease*, 195 B.R. 481 (Bankr. D. Neb. 1996); *Compass Bank for Savings v. Billingham (In re: Graves)*, 212 B.R. 692 (B.A.P. 1st Cir. 1997); *In re: South East Financial Associates, Inc.*, 212 B.R. 1003 (Bankr. M.D. Fla. 1997); *In re: Farm Credit of Central*

Florida, 160 B.R. 870 (Bankr. M.D. Fla. 1993); *In re: Best Finance Corp.*, 74 B.R. 243 (D.C. P.R.1987).

- (vii) The following commentaries have been written on the subject: Daniel B. Bogart, "Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout," 43 U.C.L.A. L. Rev. 1117 (1996); Michael St. Patrick Baxter, "Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide," 52 Bus. Law. 577 (1997); L. Louis Mrachek and C. Craig Eller, "Agreements for Relief from the Automatic Stay: Part 1," 69-Apr. Fla. B.J. 48 (1995); L. Louis Mrachek and C. Craig Eller, "Agreements for Relief of Automatic Stay: Part II," 69-May Fla. B.J. 44 (1995); William Bassin, "Why Courts Refuse to Enforce Pre-Petition Agreements That Waive Bankruptcy's Automatic Stay Provision," 28 Ind. L. Rev. 1 (1994); John P. McNicholas, "Prepetition Agreements and the Implied Good Faith Requirement," 1 ABI L.Rev. 197 (1993); Scott E. McFarland, "Waivers of Bankruptcy Rights in Workout Agreements," Probate & Property (American Bar Association, November/December 1994), p. 15; David S. Kupetz, "The Bankruptcy Code is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain," 54 Bus. Law. 55 (1998); Bruce H. White, "The Enforceability of Pre-Petition Waivers of the Automatic Stay," 15-Jan Am. Bankr. Inst. J. 26 (1996); Edward S. Adams and James L. Baillie, "A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay," 38 Ariz. L. Rev. 1 (1996); Mark F. Hebbeln, "Prepetition Waivers of the Automatic Stay in Bankruptcy: The Economic Case for Nonenforcement," 115 Banking L.J. 126 (1998); Ira J. Waldman and Adam B. Weissburg, "What's a Lender to Do: Revisiting Enforceability of Automatic Stay Waivers," 23 Cal. Bankr. J. 125 (1996); James T. Markus and John F. Young, "Enforcement of Pre-petition Waivers of the Automatic Stay," 26-Aug. Colo. Law. 47 (1997); Marshall E. Tracht, "Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law," 82 Cornell L. Rev. 301 (1997); Rafael Efrat, "The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay," 32 San Diego L. Rev. 1133 (1995); Irving D. Labovitz, "A Review of Current Cases and Developing Trends Considering the Efficacy of Section 362 Automatic Stay Waivers in Commercial Mortgages, . . . or 'What do You Have to Lose?'," 103 Com. L.J. 271, 283 (1998).

- (viii) Following is a sample waiver of automatic stay provision:

In the event of the filing of any voluntary or involuntary petition under the Bankruptcy Code (11 U.S.C. 101, *et seq.*) by or against [Borrower] (other than an involuntary petition filed by or joined in by [Lender]), [Borrower] shall not assert, or request any other party to assert, that the automatic stay under 11 U.S.C. § 362 shall operate or be interpreted to stay, interdict, condition, reduce, prohibit, inhibit, or interfere with the ability of [Lender] to enforce any rights it has by

virtue of this Agreement, or any other rights that [Lender] has, whether now or hereafter acquired, against any [Guarantor]. Further, [Borrower] shall not seek a supplemental stay or any other relief, whether injunctive or otherwise, pursuant to 11 U.S.C. § 105 or any other provision of the Bankruptcy Code to stay, interdict, condition, reduce, prohibit, inhibit, or interfere with the ability of [Lender] to enforce any rights it has by virtue of this Agreement against [Guarantor]. The waivers contained in this paragraph are a material inducement to [Lender's] willingness to enter into this Agreement and [Borrower] acknowledges and agrees that no ground exists for equitable relief which would bar, delay or impede the exercise by [Lender] of [Lender's] rights and remedies against [Borrower] or its [Guarantors].

In the event [Borrower's] property or any portion thereof or any interest therein becomes property of any bankruptcy estate or subject to any state or federal insolvency proceeding, then [Lender] shall immediately become entitled, in addition to all other relief to which [Lender] may be entitled under this Agreement, to obtain an order from the Bankruptcy Court or other court of competent jurisdiction granting immediate relief from the automatic stay pursuant to 11 U.S.C. § 362 so to permit [Lender] to pursue its rights and remedies against [Borrower] as provided under this Agreement and all other rights and remedies of [Lender] at law and in equity under applicable state law. In connection with such an order, [Borrower] shall not contend or allege in any pleading or petition filed in any court proceeding that [Lender] does not have sufficient grounds for relief from the automatic stay. Any bankruptcy petition or other action taken by the [Borrower] to stay, condition, or inhibit [Lender] from exercising its remedies are hereby admitted by [Borrower] to be in bad faith and [Borrower] further admits that [Lender] would have just cause for relief from the automatic stay in order to take such actions authorized under state law.

5. **Alternative Strategy to Relief from Stay – Dismissal for Bad Faith Filing.**

- (a) **Background.** As an alternative to seeking relief from stay, the real estate secured creditor may, if sufficient grounds exist, seek dismissal of the Chapter 11 real estate case under § 1112(b) as a "bad faith filing." This is alternatively known as the "good faith filing doctrine." This doctrine originated in the good faith filing requirement of the Bankruptcy Act of 1898, but was not specifically carried forward in the Bankruptcy Reform Act of 1978. Nevertheless, under the Bankruptcy Reform Act courts have adopted the doctrine in real estate cases.
- (b) **Victory Construction.** *In re: Victory Construction Co., Inc.*, 9 B.R. 549 (Bankr. C.D. Cal. 1981) involved the Chapter 11 case of previously dormant corporation that had recently purchased a former club property from another bankruptcy estate for the purpose of converting the property to a hotel. Negotiations for renovation financing broke down shortly after the acquisition and the secured lenders commenced foreclosure. The Victory Construction court dismissed the case as a "bad faith filing" based on three (3) grounds: perceived prefiling misconduct, the

filing was an unfair delay of a pending foreclosure and, of greatest significance, the start of a new business through reorganization was a misuse of Chapter 11 because jobs and going concern value preservation were absent.

- (c) **Victory Construction Progeny.** Victory Construction spawned a series of bad faith filing dismissal decisions which added factors to the list of indicia of bad faith filings. See *In re: Dutch Flat Investment Co.*, 6 B.R. 470 (Bankr. N.D. Cal. 1980) (no reasonable "probability" or "possibility" of plan confirmation); *In re: Winshall Settlor's Trust*, 758 F.2d 1136 (6th Cir. 1985) (§ 1112(b) contains implicit "on-going business" requirement); *In re: Little Creek Development Corp.*, 779 F.2d 1068 (5th Cir. 1986) (Chapter 11 petition filed after debtor was unable to post a bond as a condition to an injunction of a foreclosure pending litigation of a lender liability counterclaim was filed in bad faith; commenting that "[s]everal, but not all, of the following conditions usually exist," the court listed the following circumstances: (1) the debtor owns only one encumbered asset; (2) the debtor lacks employees other than its principals; (3) the debtor has "little or no cash flow and no available source of income to sustain a plan of reorganization"; (4) the debtor has few, if any, unsecured creditors; (5) a foreclosure is in process, which the debtor has unsuccessfully tried to prevent by defense on the merits or by posting a bond; and (5) there are "sometimes. . . allegations of wrongdoing by the debtor"); *In re: Phoenix Picadilly, Ltd.*, 849 F. 2d 1393 (11th Cir. 1988) (notwithstanding uncontroverted evidenced by the debtor of equity and reasonable prospects for a successful reorganization, case dismissed as bad faith filing due to presence of the following:
- (i) The debtor has only one asset, the property, in which it does not hold legal title [mortgagees held legal title];
 - (ii) The debtor has few unsecured creditors whose claims are small in relation to the claims of the secured creditors;
 - (iii) The debtor has few employees;
 - (iv) The property is the subject of a foreclosure action as a result of arrearage on debt;
 - (v) The debtor's financial problems involve essentially a dispute between the debtor and the secured creditors which can be resolved in the pending state court action; and
 - (vi) The timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to enforce their rights.)
- (d) **PRACTICE TIP:** An evidentiary hearing on a motion for dismissal will generally be heard prior to a final hearing on a motion for relief from stay. Accordingly, when the secured creditor has a compelling argument (and solid evidence in support) for a bad faith dismissal, the secured creditor should consider filing two (2) motions – one (1) for dismissal (which will most likely be heard first) and one (1) for relief from stay (which will be heard later if the case dismissal request is not granted).

6. Deed-in-Lieu of Foreclosure in Escrow.

- (a) Mortgage lenders often seek to obtain a deed-in-lieu of foreclosure in connection with loan workout negotiations under a forbearance agreement. Courts can characterize the deed-in-lieu in escrow as an equitable mortgage and/or an unenforceable "clogging" of the equity of redemption.
- (b) Courts have upheld the validity of deeds-in-lieu in escrow when certain circumstances exist. *See Ringling Brothers Joint Venture v. Huntington National Bank*, 595 So.2d 180 (Fla. Dist. Ct. App. 1992) (deed in escrow in connection with a mortgage loan workout given to avoid foreclosure; mortgagor received valuable new consideration to relinquish its right of redemption; mortgagee had not taken unfair advantage of the mortgagor; the following factors relevant: (i) the transaction involved commercial real estate rather than residential property; (ii) all parties were represented by counsel; (iii) separate and valuable consideration (in the form of new loan proceeds and revised loan documents covering the original loan plus the amount owing under two prior mortgages) was given to the mortgagor; (iv) the mortgagor acknowledged that it was not able to pay the mortgage indebtedness and had made no attempt to do so; (v) it appeared from the trial court record that there was no equity in the property (*i.e.*, the outstanding loan balance exceeded the fair market value of the property); (vi) the agreement between the parties was reached during a pending action by the first mortgage holder to foreclose its mortgage on the property); *Oakland Hills v. Lueders Drain District*, 212 Mich. App. 284, 537 N.W.2d 258 (1995) (held mortgagor's waiver of equitable redemption right as part of mortgage contract inception was invalid, however, commenting such an arrangement would be enforceable if entered into after default in good faith, for good consideration and under a contract separate and distinct from the mortgage); *Wright v. First National Bank of Monroe*, 297 Mich 315, 297 N.W.2d 505 (1941) (deed in escrow under mortgage loan workout enforceable because transaction was "voluntary settlement between the parties. . . a sale by the plaintiffs of their equity of redemption to the mortgagee, the consideration being the forbearance to foreclose and the acceptance of the property in full satisfaction of the mortgage debt."
- (c) The effects of a deed-in-lieu in escrow on junior lienholder should be considered. If and when the senior secured creditor takes title to the mortgaged property under a deed-in-lieu, its title will still be subject to junior liens; and, in the absence of agreements for releases, the junior liens must be foreclosed out by the senior secured creditor.
- (d) If the mortgagor who gives a deed-in-lieu in escrow becomes a bankruptcy debtor, the decisional law is not consistent as to whether the debtor in bankruptcy can void the escrow arrangement and the deed-in-lieu. *In re: Prairie Crossing, L.L.C.*, a prepetition deed-in-lieu of foreclosure agreement with a deed in escrow was upheld and the secured creditor was granted relief from stay to direct the

escrow agent to deliver the deed to it when the deadline for full payment of the secured debt passed postpetition. Thus arrangements may also be subject to avoidance as preferences or fraudulent conveyances.

- (e) A chapter 11 plan of reorganization can provide for a deed-in-lieu in escrow. Since these arrangements are specifically approved by virtue of the plan confirmation order, they will be enforced even in a subsequent (second) bankruptcy case.

D. Cash Collateral – Rents and Other Receipts and Assignment of Rents.

1. Right to Rents Before the Mortgagor Files Bankruptcy. Generally, a mortgagor is entitled to collect the rents from the mortgaged property until the expiration of the statutory redemption period following the mortgage foreclosure sale. However, there is an exception to this general rule if the mortgagor has given the mortgagee an assignment of rents. Michigan's Assignment of Rents Statute, MCLA 554.231, states that a mortgagee may, in conjunction with a mortgage on commercial or industrial property (other than an apartment building with less than six apartments or any family residence) obtain an assignment of rents from the mortgaged property as additional security. In order to be enforceable, the assignment must be recorded, MCLA 554.231.

- (a) The existence of an event of default under the terms of the mortgage or the assignment, and the mortgagee's compliance with any notice or other requirements in the mortgage or assignment of rents, are preconditions to the mortgagee's right to collect rents from the tenants of the property. The assignment becomes operative and binding upon the occupants of the mortgaged property from the date that the mortgagee files a notice of default with the register of deeds and serves the notice and a copy of the assignment upon the occupants of the property. MCLA 554.231(2).

- (1) Under Michigan law, the chronology of events that will lead to complete enforcement of assignment of rents is as follows: execution of assignment of rents; recording of assignment of rents; default under mortgage; recording of notice of default; and mortgagee's service upon tenants of recorded notice of default and the instrument creating the assignment of rents. *In re Mount Pleasant Ltd. Partnership*, 144 B.R. 727 (Bankr. W.D. Mich. 1992).

- (b) As soon as the mortgagee records the statutory notice of default, its rights under an assignment of rents takes priority over any judgment creditor's garnishment of the mortgagor's rents, even if the mortgagee hasn't yet served the notice on tenants of the mortgaged premises. *See Otis Elevator Co. v. Mid-America Realty Investors*, 206 Mich. App. 710, 522 N.W.2d 732 (1994).

2. The Right to Rents After the Mortgagor Files Bankruptcy. When a mortgagor files for bankruptcy, it needs to use the rents to pay professional fees, committee fees, and to

fund the plan of reorganization. Often, the mortgagee on commercial or industrial real estate, has already taken a security interest in, or an assignment of, the rents.

- (a) Under Bankruptcy Code § 363(a), the rents constitute "cash collateral". Section 363(a) defines "cash collateral" as follows:

"cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

- (b) If the mortgagee's security interest in the property is "adequately protected" as defined in 11 U.S.C. § 361, then perhaps a court will permit the debtor to use the rents as cash collateral, *i.e.* funds useable by the debtor in its reorganization.

- (i) A lender might be adequately protected if, for example, it is oversecured by the value of the property itself, so that the mortgagee can forego taking recourse as to the rents without danger to the lender's secured status. This application, however, gives rise to a number of sub-issues. For example, does the "cushion" of adequate protection (*i.e.* the amount by which the lender is oversecured) decrease as the interest on the secured loan aggregates? How much cushion is adequate to protect the lender? What measures should be taken when the value of the underlying property decreases and so decreases the secured lender's cushion or makes the fully secured lender an undersecured lender?

- (c) Even if the debtor is eligible to use cash collateral because it can adequately protect the lender, often the lender alleges that a default exists such that the assignment of rents has been triggered.

- (i) Generally, the lender will not succeed in arguing that the borrower's bankruptcy filing constitutes the triggering default, because Bankruptcy Code § 365(b)(2) (the so-called "*ipso facto*" provision) generally invalidates contractual clauses that deem the filing of bankruptcy a default.

- (d) The real question is: "who gets the money – the mortgagee, or the debtor/mortgagor?" This was a real conundrum under the pre-1994 Bankruptcy Code (11 U.S.C. § 552) which included "rents" among those post-petition proceeds to which a pre-petition security interest could extend, "to the extent provided by such security agreement and by applicable non-bankruptcy law."

Thus, under the pre-1994 Bankruptcy Code, the bankruptcy courts had to carefully analyze and apply the applicable state's law on assignment of rents.

- (e) In the 1994 amendments to the Bankruptcy Code, Congress added a new section to § 552(b) providing uniform federal treatment for rents and hotel revenues and dispensing with the "applicable state law" provision of the pre-1994 Bankruptcy Code. Currently, Bankruptcy Code § 552(b)(2) provides as follows:

... if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to the extent that the court, after notice and hearing and based on the equities of the case, orders otherwise. (Emphasis added)

- (f) As the comments to the 1994 amendments explain, "[u]nder this new provision, lenders may have valid security interests in post petition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable state law." Thus, even if the mortgagee has not yet recorded the notice of default or served it upon the tenants, the current version of Bankruptcy Code § 552 validates a valid assignment of rents.
- (g) Decisions of the federal courts in Michigan reflect the expected result: courts no longer address whether the secured interest was perfected under the state law and instead confine query to whether the underlying security agreement or assignment of rents provides for a valid assignment of rents at all. The 1998 unpublished opinion from the Sixth Circuit Court of Appeals in *In re Stearns Building* shows how the current version of Bankruptcy Code § 552 works.
 - (i) In *Stearns* the mortgagor owed the mortgagee approximately \$19 million. Just prior to filing bankruptcy, the mortgagor used \$46,200 of its collected rents to pay a retainer to bankruptcy counsel. At the time of that payment, the mortgagor was in default on the mortgage. The mortgagee filed a motion requiring the debtor to turn over the "net rents" and prohibiting the debtor from using property of the estate (*i.e.*, the rents) for payment of, *inter alia*, professional fees. After a hearing, the bankruptcy court ordered that:
 - (A) The debtor could not use any of the mortgagee's cash collateral to pay professional fees or any other expenses which are unrelated to maintenance of the complex.

- (B) Although debtor's counsel was awarded \$25,000 in interim fees, the fees could not be paid out of the pre-petition retainer (\$46,200) or out of any other cash collateral.
 - (C) Debtor's counsel had to immediately disgorge the \$46,200 retainer and the debtor had to surrender it to the mortgagee.
 - (D) Except for \$50,000 which the debtor was to use to maintain the building, the debtor was to surrender all rents to the mortgagee immediately. The debtor appealed to the district court and sought a stay of the bankruptcy court order. All stays were denied. The debtor then appealed to the Sixth Circuit Court, which affirmed both lower courts.
- (ii) *Stearns* illustrates that the changes in the law regarding Assignment of Rents are anti-debtor. Under the old version of the Bankruptcy Code § 552, debtors could take advantage of the apparent lack of clarity in Michigan's assignment of rents statute, and could raise all sorts of arguments to delay a turnover of rents to the mortgagee, or to try and create a sufficient risk that the debtor would get the mortgagee's consent to use of cash collateral so as to force a settlement on the issue. However, the current version of Bankruptcy Code § 552 no longer focuses on "applicable non-bankruptcy law" to determine the extent to which the mortgagee has an interest in the rents: the degree of "enforcement" actions by the mortgagee under the Michigan Assignment of Rents statute are unimportant under the current version of § 552 because the "extent" of the mortgagee's security interest in the rents is determined *solely* by the security agreement (*i.e.*, the assignment of rents document or the mortgage).
- (A) As long as the assignment of rents gives the mortgagee a pre-petition interest in rents, that security interest continues in rents which the debtor acquires post-petition.
- (iii) The practical effect is to move the "battlefield" from the bankruptcy court to the conference room, because the real fight under current § 552 should be *what* constitutes a default that triggers the assignment of rents. The "battle" might be meaningless by now, however, because these leader-oriented assignment of rent forms are probably ironclad by now.

E. The Impact of Bankruptcy on Redemption Rights (or "For Whom the Stay Tolls").

1. **Bankruptcy Code Sections 362 and 108 – Two Sections Read Together?** Bankruptcy Code § 362(a) contains the automatic stay, which is triggered as soon as a debtor files bankruptcy. *See* excerpt of § 362(a) at Section B.1 on page 2, above.

Bankruptcy Code § 108 (entitled "Extension of time") states, in pertinent part:

§ 108. Extension of time

(a) If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of—

(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(2) two years after the order for relief.

(b) Except as provided in subsection (a) of this section, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor or an individual protected under section 1201 or 1301 of this title may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act, and such period has not expired before the date of the filing of the petition, the trustee may only file, cure, or perform, as the case may be, before the later of—

(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(2) 60 days after the order for relief.

(a) Thus, pursuant to Bankruptcy Code § 108(b), the redemption or cure period of any commercial tenant, borrower, or land contract vendee who files bankruptcy is at least sixty (60) days. The debtor, however, will likely argue that the automatic stay in Bankruptcy Code § 362 should be applied instead, so as to extend the cure or redemption period indefinitely.

(b) When met with both arguments, some of the Bankruptcy Courts in Michigan (and throughout the country) have had trouble reconciling Bankruptcy Code §§ 362 and 108.

2. **Mortgage Foreclosures.** The Bankruptcy Courts in Michigan are most clear and unanimous in the mortgage foreclosure setting, and have held that Bankruptcy Code § 108(b) applies and that Bankruptcy Code § 362(a) does not toll, stay, or otherwise affect the running of the redemption period for mortgages in the Sixth Circuit. *In re Glenn*, 760 F.2d 1428 (6th Cir. 1985), *cert. den. sub. nom. Miller v. First Federal of Michigan*, 474 U.S. 849, 106 S. Ct. 144, 88 L. Ed. 2d 119 (1985). *See also, Rutterbush v. First Federal Savings and Loan*, 34 B.R. 101 (E.D. Mich. 1982), which held that rights of redemption are stayed only 60 days under Bankruptcy Code § 108. *See also, In re Marshall*, 54 B.R. 309 (Bankr. W.D. Mich. 1985).

- (a) *In re Glenn* involved three appeals to the Sixth Circuit Court of Appeals in which each of the debtors filed bankruptcy before the expiration of their respective rights to redeem the foreclosed property. Two of the debtors argued that the automatic stay tolled indefinitely the expiration of their time within which to redeem the property. The Sixth Circuit in *Glenn* noted that Bankruptcy Code § 362 fails to explicitly address the running of time periods, but Bankruptcy Code § 108 explicitly grants additional time in which to perform acts such as cure or redemption. Applying standard rules of construction, the Sixth Circuit ruled that because Bankruptcy Code § 108 explicitly governs the tolling issue, the court should not interpret Bankruptcy Code § 362 to cast it in conflict with § 108. *Glenn* thus concluded that "an interpretation of § 362(a) as an indefinite state of the statutory period of redemption would render § 108(b) superfluous."
- (b) The reasoning and outcome of *Glenn* is consistent with the majority of cases that have held that Bankruptcy Code § 108(b) governs the post-petition extension of mortgage redemption periods. For example, the Third, Seventh and Eighth Circuits have employed the same reasoning as *Glenn*. See, e.g., *In re Roach*, 824 F.2d 1370 (3d Cir. 1987); *Johnson v. First Nat'l Bank of Montevideo*, 719 F.2d 270 (8th Cir. 1983); *Goldberg v. Tynan*, 773 F.2d 177 (7th Cir. 1985). The following District Courts agree, see *In re Cucumber Creek Dev., Inc.*, 33 B.R. 820 (D. Co. 1983); *In re Martinson*, 26 B.R. 648 (D. N.D. 1983), *rev'd in part*, 731 F.2d 543 (8th Cir. 1984); *First Financial Sav. & Loan Assoc. v. Winkler*, 29 B.R. 771 (N.D. Ill. 1983); *Tabor Enterprises, Inc. v. Illinois*, 65 B.R. 42 (N.D. Ohio 1986); *In re Lally*, 51 B.R. 204 (N.D. Iowa 1985). Bankruptcy Courts in the following cases have also found that mortgage redemption rights are not tolled by Bankruptcy Code § 362: *In re Farmer*, 81 B.R. 857 (Bankr. E.D. Pa. 1987); *In re Flores*, 55 B.R. 210 (Bankr. D. N.J. 1985); *In re Coleman*, 82 B.R. 15 (Bankr. D. N.J. 1988); *In re Thomas*, 59 B.R. 758 (Bankr. N.D. Ohio 1986); *In re Markee*, 31 B.R. 429 (Bankr. D. Idaho 1983); *In re Smith*, 43 B.R. 313 (Bankr. N.D. 111. 1984); *In re Heiserman*, 78 B.R. 899 (Bankr. C. D. Ill. 1987); *In re Kjeldahl*, 52 B.R. 926 (Bankr. D. Minn. 1985); *In re Donaldson*, 43 B.R. 506 (Bankr. D. S.D. 1984); *In re Murphy*, 22 B.R. 663 (Bankr. D. Colo. 1982); *In re Sarasota Land Co.*, 36 B.R. 563 (Bankr. M.D. Fla. 1983); *In re Ruespin Corp.*, 85 B.R. 630 (Bankr. S.D. Fla. 1988); *In re Di Cello*, 80 B.R. 769 (Bankr. E.D. N.C. 1988).
- (i) Because of this majority position, if a mortgagor needs to file bankruptcy it should try to file *before* the redemption period even starts -- which means *before* entry of a judgment of foreclosure, or (at the latest) *before* the foreclosure sale is conducted -- in order to permit the automatic stay to have its maximum effect by tolling continuation of the foreclosure proceedings indefinitely, or at least until the automatic stay is lifted.
- (ii) Although a minority position, a few courts outside of Michigan have held that Bankruptcy Code § 362(a) actually tolls the redemption period. See, e.g., *In re Thomas J. Groso Invest., Inc.*, 457 F.2d 168 (9th Cir. 1972) (decided under the Bankruptcy Act, which is the predecessor to the Bankruptcy Code); *In re Shea Realty, Inc.*, 21 B.R. 790 (Bankr. D. Vt.

1982); *In re St. Amant*, 41 B.R. 156 (Bankr. D. Conn. 1984); *In re Sapphire Invest.*, 19 B.R. 492 (Bankr. D. Az. 1982); *In re McCallen*, 49 B.R. 948 (Bankr. D. Or. 1985).

- (c) In the consumer context, homeowners often consider filing bankruptcy in order to invoke the automatic stay and thereby avoid a mortgage foreclosure. However, the analysis of whether this strategy will work for the homeowner is intricate and complex, and requires consideration of numerous factors, for example:
- (i) Michigan is one of the states which enables debtors to select *either* the federal exemptions *or* the state exemptions when the debtor files bankruptcy. Although Michigan's homestead exemption is only \$3,500 (MCLA 600.6023(1)(h)), Michigan recognizes tenancy by the entireties, and applicable case law holds that entireties property cannot be used to satisfy the creditor claims of one spouse, *see, e.g., In re Groslight*, 757 F.2d 772 (6th Cir. 1985). (Entireties property can, however, be used to satisfy the claims of joint creditors of both the husband and wife. *See, e.g., Groslight*). If the home is owned by the entireties, the mortgage will be a joint obligation of the husband and wife, so the entireties exemption will exempt the residence if just one spouse files bankruptcy and the residence is held by the entireties. However, if both the husband and wife file bankruptcy, or if the residence is held other than by the entireties (*i.e.*, by a single person), then the entireties exemption won't protect the equity in the home and the debtor domiciled in Michigan will likely use the federal bankruptcy exemption embodied in 11 U.S.C. § 522(d)(1) which will exempt \$18,450 of the debtor's interest (*i.e.*, the debtor's equity) in the home.
 - (ii) If there is equity over and above the exempt amount, the house will likely be sold and the equity in excess of the exempt amount will be distributed to the creditors. The debtor might also consider reaffirmation of the mortgage, failing of which the mortgagee will move for relief of the automatic stay so that it can foreclose.
 - (iii) In a Chapter 13, the debtor may be able to use a Chapter 13 plan to "de-accelerate" the mortgage and extend the time and terms to cure any default under the mortgage. The debtor may propose to stay in possession of the home and pay the lender. However, the rights of a mortgagee with security in the debtor's principal residence are protected under § 1322(b)(2) of the Bankruptcy Code and generally cannot be modified beyond the permitted modifications specified in § 1322(b)(5). *See In re Boylan*, 255 B.R. 311 (Bankr. S.D. Ohio 2000).
- (d) **Prepetition Defaults and Chapter 13.** Consider a scenario where the homeowner debtor has defaulted under the terms of its mortgage prior to bankruptcy. The lender has sent the debtor a notice of the default and declared the full amount of the note due and payable. The debtor files for bankruptcy. Several questions

arise in the following instances: (i) where the debtor files a bankruptcy petition after the acceleration is declared but before the foreclosure proceedings; (ii) where the petition is filed after a foreclosure judgment has been entered but before the foreclosure sale; and (iii) where the petition follows the foreclosure sale. These situations force the questions of whether the debtor may propose a plan under Chapter 13 which reinstates the original timeframe of payment and whether the debtor will have the opportunity to cure the default.

- (i) The case of *Grubbs v. Houston First American Savings Assoc.*, 730 F.2d 236, 237 (5th Cir. 1984) (*en banc*) addresses the first question. There, the debtors had signed a three-year note with Houston First. Soon thereafter, the debtors defaulted on their note obligations. The lender accelerated the note and commenced foreclosure proceedings, which proceedings were stayed before judgment could be entered as a result of the debtor's chapter 13 filing. The debtor proposed a Chapter 13 plan including payoff of the note in 36 months. Emphasizing policy considerations to avoid races to the courthouse as lenders try to secure judgment before debtors' filing for bankruptcy, the court held that the debtor could cure the default, and such curing was not a prohibited modification of the loan. *Id.* The Second, Seventh and Sixth Circuits have held that a debtor may even stay a foreclosure judgment, undo the acceleration, cure the default and propose payments under the plan. See *In re Taddeo*, 685 F.2d 24, 26-27 (2d Cir. 1982); *In re Glenn*, 760 F.2d 1428, 1442 (6th Cir.), *cert. den.*, 474 U.S. 849, 106 S. Ct. 144, 88 L. Ed. 2d 119 (1985); and *In re Clark*, 738 F.2d 869 (7th Cir. 1984).
- (ii) *Clark* addresses the second question. The court justified its decision that the debtor could cure after the foreclosure judgment (but before the foreclosure sale) by noting that the lender's lien on the property remained intact. Inasmuch, the debtor had an interest in the property, which interest became property of the bankruptcy estate under § 541. Therefore, the automatic stay applied and the Chapter 13 plan could incorporate the debtor's property rights and possessory interest. See *In re Clark*, 738 F.2d 896. Because "cure", as referred to in § 1322 of the Bankruptcy Code, necessarily contemplates a return to the *status quo ante*, the court reasoned that the debtor must be able to de-accelerate.

In *Glenn*, the debtors filed Chapter 13 petitions on the same day the foreclosure judgment had been entered against them. In holding that the debtor could cure, the Sixth Circuit specified that if the right of redemption can be exercised within the terms of the applicable state statutes (plus the 60-day extension provided by § 108 of the Bankruptcy Code) then the exercise should be valid. See *In re Glenn*, 760 F.2d 1428, 1442.

- (iii) A debtor who is considering filing Chapter 13 **MUST** do so before the foreclosure sale. Where the petition follows a foreclosure sale, courts

generally will not allow debtors to cure. See *In re Hurt*, 158 B.R. 154, (9th Cir. BAP (Or.) 1993).

- (iv) **Postpetition Defaults.** Pursuant to § 365 of the Bankruptcy Code, the debtor must timely perform all obligations under nonresidential unexpired leases and executory contracts in order to continue to enjoy the benefits of those contracts, *i.e.*, the filing of a bankruptcy petition does not absolve the debtor of many of its post-petition obligations (except obligations related to insolvency or financial condition of the debtor or the filing of the case). To safely avoid termination of its leasehold interest or foreclosure on its homestead (both of which will require, if only as a precautionary measure, the non-debtor party to secure court approval) the debtor must meet most obligations which accrue post-filing/post-petition.
- (v) **Consider that Irrespective of the Bankruptcy Filing, the Mortgage Lenders Lien is not necessarily extinguished.** The mortgage lender's claim is treated as a secured claim in the bankruptcy. If a consumer is able to obtain a discharge in bankruptcy, the mortgage lien on the mortgaged property is not automatically extinguished. In a Chapter 7 case, provided that the lender's mortgage is valid under both state and bankruptcy law, a house will generally emerge from bankruptcy with the lien attached.
- (vi) **Because filing a Bankruptcy Petition may not Necessarily Forestall an Anxious Lender's Foreclosure Efforts for Long, a Troubled Consumer Should Consider other Options Prior to Filing for Bankruptcy.** Too often, consumers pursue bankruptcy rather than first trying to negotiate a non-judicial resolution with their respective lenders. The lender might be willing to consider a "work out" or even a forbearance agreement with a homeowner. Some lenders may even be willing to consider accepting interest-only payments over some short period of time.

3. **Land Contracts:** The Bankruptcy Courts in Michigan are split on whether Bankruptcy Code § 362(a) stays the redemption period for land contracts. In 1993, the Bankruptcy Court for the Western District of Michigan adopted the reasoning in *Glenn* in *In re Delex Management*, 155 B.R. 161, 166 (Bankr. W.D. Mich. 1993) (J. Gregg) (*citing In re Glenn*, 760 F.2d 1428, 1440 (6th Cir. 1985)) and held that "[t]he automatic stay does not operate to toll the running or expiration of a state law redemption period."

- (a) Some bankruptcy courts, however (especially courts in the Eastern District of Michigan), may still rely on a 1985 case, *In re Carr*, 52 B.R. 250 (Bankr. E.D. Mich. 1985). Although *In re Glenn* (decided in April, 1985) clarified that § 108 and not § 362(a) governs in mortgage redemption cases, just four months later the Bankruptcy Court for the Eastern District of Michigan (Judge Spector) decided *In re Carr* and ruled that the automatic stay of Bankruptcy Code § 362 governs in the land contract sale setting and operates to indefinitely toll the expiration of the cure period established by a pre-petition judgment of possession. To accomplish

this holding, the Court had to distinguish both the potentially controlling authority of the Sixth Circuit in *Glenn*, and also *In re Owens*, 27 B.R. 946 (Bankr. E.D. Mich. 1983).

- (i) In *Carr*, the land contract vendee was an individual who filed a chapter 13 bankruptcy petition on the ninetieth (90th) day after the vendors had obtained a judgment of forfeiture and possession. Under applicable state law, the debtor had until that ninetieth day, the petition date, to pay the judgment in full. The vendors filed a motion for relief from the automatic stay and argued that expiration of the redemption time cut off the vendee's right to cure the default. The bankruptcy court held that applicable state law and Bankruptcy Code §§ 362 and 1322 permitted the debtor the opportunity to cure defaults and reinstate the land contract.
- (ii) In *Carr*, the court distinguished the *Glenn* decision, reasoning that mortgage foreclosures are different from land contract forfeitures because in a land contract forfeiture no sale is ever conducted. In the situation before the court in *Carr*, the equivalent to a mortgage foreclosure sale (which had taken place in *Glenn*) was the end of the redemption period. Only at that time was there a fundamental change in the rights of the parties. Just as a filing of a bankruptcy petition before a foreclosure sale invokes the automatic stay, the court in *Carr* reasoned that the filing of the bankruptcy petition before the end of the redemption period should likewise invoke the automatic stay to ensure that the rehabilitative goals of the Bankruptcy Code were given full effect. Although the bankruptcy petition was filed on the last day of the applicable redemption period (*i.e.* the 90th day) the Court declined to enforce this 90 day redemption period. Because *Carr* arose in the context of a Chapter 13 individual bankruptcy case, it is uncertain whether it is equally applicable to the commercial situation. Indeed, part of Judge Spector's logic in *Carr* was that Bankruptcy Code § 1322(b) allowed a substantial cure right.
- (iii) The court in *Carr* also rejected *In re Owens*, 27 B.R. 946, 949 (Bankr. E.D. Mich. 1983) which held that the automatic stay should not apply because an indefinite redemption period would render § 108(b) superfluous. The *Owens* court ultimately held that "[s]ection 108(b) grants the Trustee a minimum of 60 days or the running of the statutory redemption period to redeem, whichever is longer." The *Owens* decision appears to be the better reasoned and more true to the Code. Nevertheless, the court in *Carr* rejected *Owens* on the basis of Bankruptcy Code § 1322(b)(5). *Carr* is perhaps best understood in the rehabilitative context of Chapter 13.
- (iv) The court's analysis in *Carr* might be undermined by current law in the Sixth Circuit Court, namely *In re Terrell*, 892 F.2d 469 (6th Cir. 1989) which treats land contracts as executory contracts rather than mortgages.

- (v) Because *Glenn* clearly held that time is not stayed by Bankruptcy Code § 362(a), and because *Glenn* is a Sixth Circuit decision and therefore might constitute controlling authority, in order to be safe a vendee who needs bankruptcy relief will likely file for protection under the Bankruptcy Code before the start of any cure or redemption period.
- (vi) *In re Horton*, 302 B.R. 198 (Bankr. E.D. Mich. 2003) is a land contract case which confirms that the filing of a bankruptcy petition does not reinstate a debtor's interest in property where the redemption period expired prepetition. In that case, the redemption period expired two days before the debtor's Chapter 13 filing. Because the redemption period expired prior to the petition date, neither the subject property nor the debtor's interest in such property constituted property of the estate. As such, the creditor need not have obtained relief from stay to exercise its available rights and remedies. In *Horton*, Judge McIvor found that "the reasoning set forth in *Glenn* and *Delex* applies to a land contract in a Chapter 13" and that there should be no distinction between Chapter 11 and a Chapter 13 for purposes of determining a land contract vendee's rights after the filing of the petition.

4. Leases. In order to get the benefits of bankruptcy, a tenant facing eviction (and who needs to file bankruptcy) will try to file bankruptcy before the judgment. If the tenant waits until after the judgment but within the ten days allowed to cure (before the writ of restitution issues), the bankruptcy filing may allow sixty days to cure non-payment under a lease under Bankruptcy Code § 108. There is little case law on the issue, however, because under the Bankruptcy Code § 365 a debtor only has sixty days to assume or reject a lease of non-residential real property.

- (a) Although courts both in and outside of Michigan continue to look to *Carr's* indefinite stay of time, the most logical result in the context of a lease is that a filing of a bankruptcy petition after judgment, but prior to issuance of a writ of restitution, will allow sixty days under Section 108(b) to cure defaults.

5. Conclusions and Recommendations.

- (a) The deadline for redemption of property in the mortgage foreclosure context is the later of the end of the redemption period or 60 days after the filing of the bankruptcy petition.
- (b) The redemption period for land contract should be the later of: (1) the applicable state law redemption period, or (2) 60 days after the filing of the bankruptcy petition. Debtors, however, may try to argue that *Carr* applies and the automatic stay in Bankruptcy Code § 362 tolls the redemption period indefinitely.
- (c) Similarly, the time to cure defaults on leases after entry of a judgment for possession but prior to the issuance of a writ of restitution is 60 days under Bankruptcy Code § 108.

- (d) While the automatic stay might apply, the majority of the decisions hold that the automatic stay enjoins *action* but does not toll time and, consequently, Bankruptcy Code § 108 will apply to toll the redemption or cure period for only 60 days. Neither § 362(a) nor any other Code provision will extend the cure period.
- (e) Thus, a bankruptcy petition filed by a mortgagor, land contract vendee or tenant after the judgment is entered only buys a sixty day breathing spell. Thereafter, the lessor, vendor, or lender will be able to seek modification of the stay to pursue its remaining remedies in state court, without the possibility of the debtor reviving its right to cure.
- (f) From the debtor's perspective, the only way to avoid the 60-day limit of Code § 108(b) and to take advantage of the maximum protection of the automatic stay embodied in Bankruptcy Code § 362(a) is to file the bankruptcy *before* entry of a state court judgment. The bankruptcy petition invokes the automatic stay: that stay would have to be lifted or modified *before* any action against the debtor may proceed.

F. Treatment of Commercial Real Estate Leases in Bankruptcy.

1. **Special Status of Leases for Nonresidential Real Property Under the Bankruptcy Code.** The Bankruptcy Code, especially after the amendments to it made in 1984, has a number of special provisions for leases of commercial or nonresidential real property. These provisions affect the timing within which certain procedures must occur, and the rights of the parties. *See generally* 11 U.S.C. § 365. Thus, it is important to distinguish residential real property from non-residential real property.

What is Non-Residential Real Property? A non-profit corporation operated 252-unit life care facility for the elderly. In dicta (having determined that the "lease" between the owner and the debtor was a mortgage) the court said that the property was residential in nature. The court believed that the important criterion is the character of the real property, not the relationship of the parties to the lease. "Nonresidential" modifies "real property" and describes the property, not the lease. *In re Independence Village, Inc.*, 52 Bankr. 715 (Bankr. E.D. Mich. 1985). *Accord: In re Care Givers, Inc.*, 113 Bankr. 263 (Bankr. N.D. Texas 1989) (nursing home leases). *Contra: Wilson v. Sonora Convalescent Hospital, Inc. (In re Sonora Convalescent Hospital, Inc.)*, 69 Bankr. 134 (Bankr. E.D. Cal. 1986) (commercial use is determinative).

2. **Leases and Executory Contracts in General.** The status of nonresidential leases of real property is part of the Bankruptcy Code's special treatment of executory contracts and leases, found in § 365. For example:
 - (a) A trustee or debtor-in-possession which is a party to an executory contract or lease may assume most leases, and even assign them to a third party, despite language in the lease or contract which would prohibit or restrict such assignment. 11 U.S.C. § 365(f), 365(e)(2).

- (b) The trustee or debtor-in-possession may ignore those provisions in a lease or executory contract which create a default by the mere filing of a bankruptcy or similar petition. 11 U.S.C. § 365(e).
- (c) Special rules governing administrative claims of lessors, limitations on claims for breach of a real estate lease, and the duties of the trustee or debtor-in-possession while under the protection of the bankruptcy court.

3. All These Special Provisions Lead to the Question "What is a Lease?"

- (a) A lease of real property for the purposes of the Bankruptcy Code is any rental agreement to use real property. 11 U.S.C. § 365(m).
- (b) A lease is distinguished from a financing agreement because a secured creditor has a different, although somewhat parallel, set of rights and burdens in a bankruptcy proceeding. In general, a court will look beyond the form of an agreement to determine whether it is a "true lease" or whether it is in reality a conditional sales contract or other financing tool. *In re Independence Village, Inc.*, 52 B.R. 715 (Bankr. E.D. MI 1985); *In re Mahoney*, 153 B.R. 174 (E.D. Mich. 1992). Section 365 does not apply to a security interest disguised as a lease; *Liona Corp. v. PCH Assoc. (In re PCH Associates)*, 804 F.2d 193 (2d Cir. 1986); *In re Opelika Corp.*, 67 BR 169 (Bankr. N.D. Ill. 1986); *In re Mahoney*, 153 B.R. at 176; *Matter of Lansing Clarion Ltd. Partnership*, 132 B.R. 845 (Bankr. W.D. Mich. 1991).
- (c) **Lease vs. Mere Occupancy Right – Lease Termination.** The existence of the lease, which may be assumed and assigned by a trustee or a debtor-in-possession, is different from a mere occupancy by a tenant where the lease has terminated.
 - (i) **Expiration of the Stated Term of the Lease.** The Bankruptcy Code provides that where a lease of nonresidential real property has terminated by the expiration of its stated term, any interest of the debtor as lessee under the lease is not included in property of the estate (11 U.S.C. § 541(b)(2)), and a landlord in such a situation is not barred by the automatic stay and may take any action to obtain possession of the property (11 U.S.C. § 362(b)(10)). This applies even if the expiration of the stated term occurs after the bankruptcy case has begun.
 - (ii) **Apparent Termination Prior to Filing Other than by Expiration of the Stated Term.** Of course, if a tenant has defaulted prior to filing bankruptcy, the landlord may have taken steps to attempt to terminate the lease prior to the filing of the bankruptcy petition. This can include a notice pursuant to the lease, or commencement of an unlawful detainer or other eviction proceeding. In determining whether a lease has been terminated, so as to cut off the right to assume or assign it, the bankruptcy courts generally look to state law. In Michigan, for example, where eviction is sought for non-payment of rent by use of summary

proceedings following a seven day notice to quit for nonpayment of rent, a right of redemption exists. The default can be cured at any time prior to the issuance of a writ of restitution permitting reentry by the landlord. MCLA 600.5744(8). However, if the landlord terminates the lease for non-payment, there is no right of the tenant to cure the default. In many states, a provision that automatically terminates the lease or executory contract on notice after certain kinds of default is enforceable. Where this has occurred, and the default is not solely because of the filing of a bankruptcy petition or other insolvent condition of the debtor, bankruptcy courts have treated the lease or contract as terminated. *See* for example *In re Benrus Watch Co.*, 13 B.R. 331 (Bankr. S.D. N.Y. 1981). In other words, section 365 does not create a right to cure.

4. **Paying the Current Post-Bankruptcy Filing Rent.** Whether or not the tenant has defaulted in the past, once a bankruptcy case is filed by or against a tenant, the landlord and the tenant want to know if the tenant must pay the rent and comply with the rest of the lease. Special provisions regarding the leases of nonresidential real property can be an advantage to the landlord in this area.
 - (a) **The Concept of an Administrative Expense.** In general, once a bankruptcy petition is filed the actual and necessary costs and expenses of preserving the estate after commencement of the case are entitled to treatment and allowance as an administrative expense. 11 U.S.C. § 503(b)(1)(A). Administrative expenses have first priority in any distribution to unsecured creditors in a bankruptcy case. *See* 11 U.S.C. § 507(a)(1).
 - (b) **Special Status of Nonresidential Real Estate Leases.** Many creditors or suppliers to a debtor must immediately confront the question of whether the rent they usually charge is allowable as the "actual, necessary costs and expenses of preserving the estate." But a special provision in the Bankruptcy Code requires the trustee or debtor-in-possession to comply with all the terms of any unexpired lease of nonresidential real property, at least until the lease is assumed or rejected. 11 U.S.C. § 365(d)(3). During the first 60 days of this period, the court can extend the time for the performance of any obligation that arises within that 60 day period, but not beyond the first 60 days. After that, the trustee or debtor-in-possession must timely perform all the substantive obligations of the debtor under the lease, until the lease is assumed or rejected.
 - (c) **"Fair Rental" Concept Abrogated for Nonresidential Real Estate Leases, if Pre-Assumption or Rejection.** Lessors are entitled to full rent called for in the lease during the post-bankruptcy pre-rejection period that the trustee occupies the premises, even in the case of a lease rejected automatically when trustee failed to assume within 60 days. *In re Wedemeier*, 237 F.3d 938, C.A. 8 (2001).

5. Assumption of the Lease.

- (a) **Time Frame for Assumption.** Within 60 days from the filing of a voluntary petition or the entry of an order for relief on an involuntary petition, the trustee or debtor-in- possession, subject to court approval, must either assume, reject, or get more time to decide whether to assume or reject a lease of nonresidential real property, failing of which the lease is deemed rejected, § 365(d)(4). This is true whether the case is proceeding under Chapter 7, 9, 11, 12 or 13. 11 U.S.C. § 365(d)(1), (2) and (4). If the lease is for residential real property, the trustee has 60 days to assume or reject only in a Chapter 7 (11 U.S.C. § 365(d)(1)) and in other cases, there is no stated time limitation but the election must be made prior to the confirmation, although any party may request an order requiring the trustee to determine within a specified period of time whether to assume or reject an executory contract or lease. 11 U.S.C. § 365(d)(2).
- (b) **The Drop Dead Clause - Automatic Rejection if no Action Taken in 60 Days.** Sections 365(d)(1) and (4) of the Bankruptcy Code provide that, if no affirmative court order has been made within the first 60 days to assume or reject the lease, or to extend the time to do either, the lease is automatically deemed rejected. This cuts off the right of the trustee or debtor-in-possession to assume or assign the lease by curing any defaults and finding a replacement tenant. The overwhelming majority of courts have held that the order allowing the assumption need not be entered in the 60 days, only that the debtor communicate to the court a definite intention to assume the lease. *Personnel Corp. of America v. Robert Fraser Holdings Ltd.*, 1993 WL 88264, *3 (S.D.N.Y. Mar 25, 1993); *In re Kros Bros. Development Co.*, 100 B.R. 480, 485 (W.D. Mo. 1989); *In re Burns Fabricating Co.*, 61 B.R. 955 (Bankr. S.D. MI 1986); *In re Aneiro*, 72 B.R. 424 (Bankr. S.D. Cal. 1987); *In re Delta Paper Co.*, 74 B.R. 58 (Bankr. Tenn. 1987); *In re By-Rite Distributing, Inc.*, 55 B.R. 740 (D. Utah 1985), reversing 47 B.R. 660 (Bankr. Utah 1985); *In re Musikhan Corp.*, 57 B.R. 938 (Bankr. E.D. N.Y. 1986); *In re Bon Ton Restaurant & Pastry Shop, Inc.*, 52 B.R. 850 (Bankr. N.D. Ill. 1985); *In re BDM Corp.*, 71 B.R. 142 (Bankr. N.D. Ill. 1987). Moreover, a number of courts require that the debtor's intent to assume be unconditional. *In re Atlantic Computer Systems, Inc.*, 173 B.R. 844 (S.D.N.Y. 1994).
- (c) **Manner of Assumption.** The vast majority of courts have held that the only method of declaring this definite, unconditional intent to assume is by timely filing a formal motion prior to the expiration of the 60 day period and that a lease cannot be assumed by conduct or implication alone. *See, In re Esmizadeh*, 272 B.R. 377, 385 (Bankr. E.D. N.Y. 2002) (Section 364(d)(4) was “clearly adopted to protect debtors from uncertainty regarding assumption and rejection of nonresidential leases,”); *In re Golden Triangle Film Labs, Inc.*, 176 B.R. 608, 609 (Bankr. M.D. Fla. 1994); *In re D'lites of America, Inc.*, 86 B.R. 299 (Bankr. N.D. Ga. 1988); *In re Lew Mark Cleaners Corp.*, 86 B.R. 331 (Bankr. E.D. N.Y. 1988); *In re Dublin Pub, Inc.*, 81 B.R. 735 (Bankr. N.D. Ga. 1988); *In re Treat Fitness Center, Inc.*, 60 B.R. 878 (Bankr. BAP. 9th Cir. 1986); *In re J. Woodson Hayes, Inc.*, 69 B.R. 303 (Bankr. N.D. Fla. 1987); *In re Swiss Hot Dog Co.*, 72 B.R. 569

(D. Colo. 1987). At a minimum, the motion must state how the debtor will satisfy the cure and adequate assurance requirements § 365(b). However, at least one court has ruled that a debtor can assume or reject a lease, without a formal motion, through conduct which communicates an unequivocal and unconditional intent to assume *In re 1 Potato 2, Inc.*, 58 B.R. 752 (Bankr. D. Minn. 1986); *In re Audra-John Corp.*, 140 B.R. 752, 755+ (Bankr. D. Minn. 1992) (adhering to *In re 1 Potato 2, Inc.*)

- (d) **Extending the 60 Day Drop Dead Period.** In complex cases, especially where the debtor or trustee is paying the rent and otherwise complying with the lease terms, extension of the 60 day period is often granted. To be safe, the extension should be requested in time for the court to enter an order granting it within the initial 60 days. In Michigan, the Eastern and Western District Bankruptcy Courts have ruled inconsistently on this issue. In *In re: Travel 2000, Inc.*, 264 B.R. 451 (Bankr. W.D. Mich. 2001), Judge Stevenson held that under Section 365(d)(4) the Court's decision on the Debtor's motion to assume or reject a lease need not be entered within the 60 day period, only that the motion be filed. On the other hand, in *In re: DCT, Inc.*, 238 B.R. 442 (Bankr. E.D. Mich. 2002), Judge Rhodes disagreed with the holdings of cases such as *Travel 2000*, and found that Bankruptcy Code § 365(d)(4) is clear and unambiguous and must be enforced according to its terms. Consequently, he held that the phrase "within 60 days after the date of the order for relief, *or within such additional time as the court, for cause, within said 60-day period, fixes*" means that it is not sufficient for the debtor to simply file the motion to extend the assumption/rejection deadline within the 60-day period. Instead, Judge Rhodes held that the order granting that extension must also be *entered* within the 60-day period.

Historically, courts had been divided as to whether 11 U.S.C. § 365(d)(4) requires entry of the order extending the deadline before the expiration thereof. Some courts have held that the statute is unambiguous and that the order must be entered before the expiration of deadline. *See, e.g., Debartolo Properties Mgmt., Inc. v. Devan*, 194 B.R. 46, 51 (D. Md. 1996); *In re Horowitz*, 167 B.R. 237, 242 (Bankr. W.D. Okla. 1994). Other courts have found the statute (Bankruptcy Code Section 365(d)(4)) to be ambiguous and, consequently, have held that, in order to comply with this 60-day deadline, it was sufficient for the debtor to *file* the motion to extend the assumption/rejection deadline within the 60-day period, even if the order granting the extension was entered *after* the expiration of the 60-day period. *See, e.g., In re Southwest Aircraft Services, Inc.*, 831, F.2d 848, 849, 853 (9th Cir. 1987), *cert. den.*, 487 U.S. 1206, 108 S. Ct. 2848, 101 L. Ed. 2d 885 (1988). In *Southwest*, the Ninth Circuit reasoned that it was unfair for a debtor to be punished (by having its nonresidential real estate leases deemed rejected) if the order extending the assumptions/rejections deadline was not entered within the 60-day period) based simply on the court's busy schedule. Several courts followed the reasoning of *Southwest*. *See, e.g., Southern Technical College, Inc.*, 148 B.R. 550 (Bankr. E.D. Ark. 1992); *In re Perfectlite Co.*, 116 B.R. 84 (Bankr. N.D. Ohio 1990); *In re Cork United, Inc.*, 83 B.R. 456 (Bankr. N.D. Ohio 1988); *In re Travel 2000, Inc.*, 264 B.R. 451 (Bankr. W.D. Mich. 2001). The common

theme among these cases was that 11 U.S.C. § 365(d)(4) was intended to give debtors a full 60 days in which to make the decision on assumption or rejection of a lease and, consequently, it was inappropriate for a bankruptcy court to require that the motion be filed *and* the order granting it be entered within said 60-day period. In *In re DCT, Inc.*, 238 B.R. 442 (Bankr. E.D. Mich. 2002), Judge Rhodes found 11 U.S.C. § 365(d)(4) to be unambiguous, and to require entry of the extension order with the 60-day period.

- (e) **Waivers Can Help Tenant!** Some courts have interpreted this 60 day automatic rejection rule as harsh, and have found ways to avoid its operation using the concept of waiver. For example, several courts have held that the acceptance of rental payments by the landlord after the 60 day period expired or the landlord's continued invitations to the debtor to assume the lease and provide adequate assurance of payment are acts which demonstrate the landlord's intent to waive the application of the 60 day rejection rule. *In re T.F.P. Resources, Inc.*, 13 C.B.C. 2d 1345 (Bankr. S.D. N.Y. 1985); *In re Lew Mark Cleaners Corp.*, 86 B.R. 331 (Bankr. E.D. N.Y. 1988). However, there is authority holding that the mere acceptance of rent after the 60 day period cannot stop the landlord from claiming that the lease has been rejected and terminated. *See, In re Las Margaritas, Inc.*, 54 B.R. 98 (Bankr. Nev. 1985); *In re BDM Corp.*, 71 B.R. 142 (Bankr. N.D. Ill 1987); *In re Soats Restaurant & Saloon*, 64 B.R. 442 (Bankr. Nev. 1986) and *In re Chandel Enterprises, Inc.*, 64 B.R. 607 (Bankr. C.D. Cal. 1986) (holding that allowing waiver and estoppel would defeat the legislative intent behind the automatic rejection extinguishing the debtor's interests in a leasehold). Unlike the acceptance of rent or some other action by the landlord after the 60 day period, courts are generally in accord that acceptance of rent during the 60 day period following the order for relief is not tantamount to a waiver by the landlord of the 60-day time period for assumption of an unexpired lease. *In re Ok Kwi Lynn Candles, Inc.*, 75 B.R. 99 (Bankr. N.D. Ohio 1987), *Chandel Enterprises, supra* and *Lew Mark Cleaners Corp., supra*.

6. What Happens When a Commercial Lease is Assumed?

- (a) **Court Approval for Assumption is Required, Even if There is no Default in the Lease.** The main test a court will use in deciding whether to approve assumption of a lease or executory contract (except in the case of a collective bargaining agreement which is governed by a special Code section) is the "business judgment" test. The same standard applies if the trustee or debtor-in-possession seeks to reject an unexpired lease or executory contract. Thus, if the trustee or debtor-in-possession shows that it properly exercised business judgment, assumption or rejection of the lease is in the best interests of the estate or will benefit the estate, courts generally grant the request and approve the assumption or rejection. *See In re Marina Enterprises, Inc.*, 14 B.R. 327 (Bankr. S.D. Fla. 1981).
- (b) **Ipso Facto Defaults.** Even though leases often contain provisions stating that bankruptcy, adverse financial condition, or appointment of a receiver or trustee is

a lease default, § 365(e)(1) nullifies this language in leases and in laws, and states that a lease cannot be terminated or modified on those grounds. Section 365(e)(1) often called the *Ipsa Facto* Default provision.

(c) **Assumption Where Substantive Default has Occurred.**

- (i) Additional burdens are placed on a trustee or debtor-in-possession where it seeks to assume a lease in which a substantive default has occurred. A substantive default is any default *other than* a breach of a provision relating to insolvency or the financial condition of the debtor, the commencement of a bankruptcy case, or appointment of some custodian before commencement of the case.
- (ii) If a substantive default has occurred, a trustee or debtor-in-possession may not assume an unexpired lease of nonresidential real property, unless, at the time of the assumption, it (1) cures or provides adequate assurance that it will promptly cure such default (2) compensates, or provides adequate assurance that it will promptly compensate the landlord for any actual pecuniary loss resulting from the default and (3) provides adequate assurance of future performance under the contract or lease. 11 U.S.C. § 365(b).
- (iii) A problem arises where the debtor's default is a nonmonetary default (*e.g.* failure to maintain the property as required). In such instances, debtors have argued that § 365 excludes nonmonetary defaults from the cure requirement. The cases are split at the circuit court level. In the case of *Worthington v. Claremont Acquisition Corp.*, 113 F.3d 1029 (9th Cir. 1997), the Ninth Circuit refused to allow a debtor that operated an auto dealership to assume its franchise agreement with the manufacturer. The franchise agreement contained a provision that the manufacturer had a right to terminate if the dealership was closed for more than seven consecutive days, and prior to filing the petition the debtor had interrupted operations for seven consecutive days. The court expressly rejected the debtor's argument that § 365 (b)(2)(D) excepted this nonmonetary default from the general cure requirement, and the court held that the lease requirement was not a penalty provision excepted from the cure requirement under § 365 (b)(2)(D). Because the debtor could not "cure" its default of interrupting dealership operations for seven consecutive days, the contract was not assumable. However, in *Eagle Insurance Co. v. Bankvest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004) (Cert. Denied. June 21, 2004), the First Circuit held that § 365 (b)(2)(D) exempts nonmonetary defaults from the cure requirements. Although the lease in *Eagle* was an equipment lease (and not a real property lease), *Eagle* represents a circuit court holding on the issue of whether non-monetary defaults must be cured in order for the lease to be assumed. On this basis, the court allowed a debtor to assume an equipment lease, even though the debtor was in default by not providing all equipment within the time period

specified by the contract. Nevertheless, the lessees of the equipment were entitled to submit separate claims for any losses or damages actually suffered.

(d) **Special Case for Shopping Centers.** For a shopping center lease, the Bankruptcy Code sets forth specific guidelines on what constitutes adequate assurance of future performance, namely (a) of the source of rent and other consideration due under the lease, (b) that any percentage rent due under the lease will not decline substantially, (c) that the assumption is subject to all provisions of the lease including, provisions such as radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating and, finally, (d) that the assumption or assignment of such lease will not disrupt any tenant mix or balance. 11 U.S.C. § 365(b)(3). All four criteria must be satisfied.

(i) **New Question: What is a Shopping Center?** These special provisions for shopping center leases have given rise to a question not answered in the Code which is: What is a shopping center? A trustee or debtor will ask this question to seek to avoid the specific and perhaps onerous burdens of assuming a shopping center lease. Similarly, a landlord may seek shopping center status so that the more stringent requirements will apply. *See In re Goldblatt Brothers, Inc.*, 766 F.2d 1136 (7th Cir. 1985), *In re Ames Department Stores*, 121 BR 160 (Bankr. S.D. N.Y. 1990) and *In re 905 International Stores, Inc.*, 57 B.R. 786, 788 (Bankr. E.D. Mo. 1985) for excellent discussions of what is a shopping center. *See also, In re Joshua Slocum Ltd.*, 922 F.2d 1081 (3d Cir. 1990) for a list of criteria.

7. **Assumption Creates a New Administrative Claim.** Once assumed, an executory contract or unexpired lease constitutes a new obligation of the estate. All obligations under the assumed lease become administrative expenses. Accordingly, if an assumed lease is breached or later rejected, the damages and other obligations arising out of the breach or rejection all have the status of an administrative claim. This means that the trustee or debtor-in- possession must be wary of whether to assume a lease. This is especially so if the assumption is in contemplation of assigning the lease to a third party, where the assumption and assignment are not simultaneous. *See, In re Multech Corp.*, 47 B.R. 747 (Bankr. N.D. Iowa 1985). That case involved a lease of industrial property. It was assumed by the debtor while it was trying to reorganize under Chapter 11. The proceedings were unsuccessful. The case was converted to a Chapter 7 liquidation and a trustee was appointed. The trustee rejected the lease. The court held that all damages arising from rejection of the lease were Chapter 11 administrative expenses, second only in priority to the administrative expenses of the converted Chapter 7 case. If there are not sufficient assets to pay all of the expenses of administration, the landlord may seek to charge the secured creditor with the unpaid rent under Section 506(c). In *In re Stauton Industries, Inc.*, 75 B.R. 699 (Bankr. E.D. MI 1987), Bankruptcy Judge Rhodes held for the secured creditor because use of the property did not allow the secured creditor to receive more than it would have otherwise received. Note, however, that a number of courts have denied the landlord standing to bring a Section 506(c) cause of action in the

first instance, reasoning that standing under Section 506(c) is restricted solely to trustees and debtors-in-possession. *Matter of Great Northern Forest Products, Inc.*, 135 B.R. 46, 63 (Bankr. W.D. Mich. 1991), citing *In re Interstate Motor Freight System*, 71 B.R. 741 (Bankr. W.D. Mich. 1987); *In re Dakota Lay'd Eggs*, 68 B.R. 975 (Bankr. D.N. D. 1987); *In re Wyckoff*, 52 B.R. 164 (Bankr. W.D. Mich. 1985).

8. Rejection of Leases. There are two ways in which a lease of nonresidential real property may be deemed rejected.

- (a) **Passage of Time.** As previously noted, if a lease of nonresidential real property is not assumed or rejected within 60 days from an order for relief, or within some extended period of time, the lease is deemed rejected. If a debtor's communication of an intent to assume is not sufficiently definite or unconditional, it is as if the debtor never assumed the lease. *See In re Nutrax*, Judge Graves (E.D. Mich. December 11, 1987). Once the lease is deemed rejected, the trustee or debtor-in-possession "shall immediately surrender such nonresidential real property to the lessor." 11 U.S.C. § 365(d)(4).
- (b) **By Court Order.** If the lease is not a lease of nonresidential real property, or if rejection is sought before expiration of the time period, rejection may be accomplished by an order of the court. As with assumption, the business judgment test is used. In contrast to a rejection by passage of time, the trustee or debtor-in-possession is not automatically obligated to return the leased property to the lessor. This obligation may be imposed in an order allowing rejection, but circumstances may also exist where the debtor would be permitted, even without the consent of the landlord, to remain in possession after rejecting the lease. Under these circumstances, it would be liable to the landlord to pay a reasonable rental and other charges as an administrative expense, although the written lease would not necessarily govern the amounts due.

Section 365(a) allows the trustee or debtor-in-possession "subject to the court's approval" to assume or reject any executory contract or unexpired lease. Many courts have interpreted this as meaning that no rejection or assumption is made until a court order is entered approving the rejection or assumption. *In re National Steel Corp.*, 316 B.R. 287, 303+ (Bankr. N.D. Ill. 2004); *In the Matter of Whitcomb & Keller Mortgage Co., Inc.*, 715 F.2d 375, 380 (7th Cir. 1983); *In re Walat Farms, Inc.*, 69 B.R. 529 (Bankr. E.D. MI 1987). However, a Minnesota Bankruptcy Court has held that the effective date of a rejection can be the time at which the debtor gave unequivocal notice to the landlord of its intention to reject, even if the actual court approval came much later. *In re 1 Potato 2, Inc.*, 58 B.R. 752 (Bankr. D. Minn. 1986). In that case, shortly after it filed the petition, the debtor wrote a clear letter to the landlord stating its intention to reject. The court held that under the circumstances, no immediate court approval was necessary and the rejection of the lease was effective upon lessor's receipt of the rejection letter. The court held that assumption or rejection can be accomplished by "a clear and unequivocal communication of intent" separate from entry of an actual court order. *See also, Matter of William J. Brittingham, Inc.*, 39 B.R. 575, 577 (Bankr. D. Del. 1984). However, a letter from a debtor to landlord "rejecting" the lease was held insufficient as a rejection in *In re National Oil*,

80 B.R. 525 (Bankr. D. Colo. 1987); *see also*, *Paul Harris Stores, Inc. v. Mabel L. Slater Realty Trust*, 148 B.R. 307, 310 (S.D. Ind. 1992).

9. Rejection Constitutes a Breach of the Lease. 11 U.S.C. § 365(g).

- (a) If the rejection is made in a situation where the debtor-in-possession or trustee never assumed the lease, the rejection gives rise to a general unsecured claim against the debtor for unpaid future rent called for in the lease. A cap is imposed on future rent claims by 11 U.S.C. § 502(b)(6). A claim for future rent:
 - (i) runs from the earlier of the date of the filing of the petition and the date on which the lessor repossessed or the lessee surrendered the leased property.
 - (ii) is the maximum of the rent reserved under the lease, without acceleration, for the greater of one year, or 15% not to exceed three years, of the remaining term of the lease.
 - (iii) to this may be added any claim for unpaid prepetition rent.

This creates a maximum general unsecured claim, and is subject to ultimate determination in accordance with damage principles of the applicable state law. *Samore v. Multech Corp.*, 47 B.R. 747 (Bankr. N.D. Iowa, 1985). The landlord has the burden to show damages resulting from the termination of the lease.

- (b)
 - (i) If the lease or contract assumed and *then* rejected or breached, the default occurs at that time, and the other party has an administrative claim. *Memphis-Shelby County Airport Authority v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 783 F.2d 1981 (5th Cir. 1986). If a contract is entered into during chapter 11 and then rejected in a superseding chapter 7, the other party has administrative claim. *Samora v. Boswell (In re Multech Corp.)*, 47 BR 747 (Bankr. N.S. Iowa 1985).
 - (ii) For purposes of determining when the obligation to pay administrative rent ceases, *In re Revco D.S., Inc.*, 109 Bankr. 264 (Bankr. N.D. Ohio 1989), held that a lease is rejected when a court order to that effect is entered, not when a letter "rejecting" the lease is sent to the landlord.
- (c) **Treatment of Security Deposits.** If the landlord holds a security deposit, the landlord can seek relief from the automatic stay in order to set off the security deposit against rent and other charges due under the lease and which were to be covered by the security deposit. *In re William J. Brittingham, Inc.*, 39 B.R. 575 (Bankr. D. Del. 1984). This case also holds that under the Bankruptcy Code, a security deposit taken prepetition may not be set off against post-petition rents which become administrative claims upon rejection of the lease. *Id.* at 578.

10. Assignment of Lease by Trustee or Debtor-In-Possession. With the exception of contracts to lend money or make other financial accommodation, or contracts such as personal service contracts, a trustee or debtor may assign an unexpired lease or executory

contract to a third party. This power to assign exists regardless of language in the agreement which would purport to prohibit or restrict it. Section 365(e)(2). As with assumption of the lease, however, the Code imposes certain standards and protections on assignment.

(a) **Requirements Preceding Assignment.**

- (i) First, the trustee or debtor-in-possession must assume the contract and meet all those requirements of the Bankruptcy Code. See Part III F & G above.
- (ii) The assignee or proposed assignee must provide adequate assurance of future performance of the lease, whether or not the lease is in default. 11 U.S.C. § 365(f)(2). Whether adequate assurance has been given is a question of fact, the chief determinant being whether rent will be paid. *In re Sanshoe Worldwide Corp.*, 139 B.R. 585 (S.D.N.Y. 1992).

(b) **Special Provisions for Shopping Centers.** As with assumption of the lease, assignment must meet all the special requirements of a shopping center lease. In addition, the landlord may require that the proposed assignee and its guarantors, if any, be similar in financial condition and operating performance to the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease. Thus, one can compare the tenant's original status when the lease was entered into with that of any proposed assignee. This puts the burden of proof on a trustee who wants to assume and assign a lease, by first requiring the trustee to find debtor's historical financial data (sometimes from 20 or 30 years ago), then requiring the trustee to find an assignee (or guarantor) who can meet the often substantial financial condition that the debtor had when it entered into the lease.

(c) **Shopping Center Lease Provisions Regarding Assignment.** Standard lease provisions receive the following treatment by bankruptcy courts:

- (i) **Ipsa Facto Clauses.** So called "*ipso facto*" provisions in shopping center leases are not enforceable in bankruptcy, to the extent that they "prohibit, restrict or condition the assignment of such contract or lease," and the trustee may assign such contract or lease despite *ipso facto* provisions contained therein. Section 365(e)(2).
- (ii) **Restrictive use provisions.** Restrictive use provisions in shopping center leases have yielded differing results.

Courts have held that a trustee can assume and assign a lease even when the lease contains a restrictive use provision which the assignee will not follow when the lessor has not shown actual or substantial detriment resulting from the assignee's noncompliance with the provision. *See In re U.L. Radio Corp.*, 19 B.R. 537 (Bankr. S.D. N.Y. 1982) (Lease provided that leased premises could be used only as a television store; interpreting § 365(f)(3), court held trustee can assign and assume lease which provided

that leased premises can only be used as a TV store even though assignee would use premises as a bistro. The lessor had not shown actual or substantial detriment.)

Recently, shopping center landlords got a real boost on this issue with the Fourth Circuit's opinion in *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004). In this case, Trak Auto Corporation, the debtor/tenant, sought permission from the bankruptcy court to assume and assign its lease in a shopping center (located in Chicago, Illinois) to a clothing store. The shopping center lease contained a restrictive use clause which limited use of the leased premises to retail sales of automobile parts and accessories and such other items as the debtor/tenant sold at its other stores. Consequently, the issue was whether the proposed assignment of the shopping center lease at a clothing store was permissible even though the assignee fell outside the use restriction clause contained in the shopping center lease.

In deciding the issue, the bankruptcy court concluded the use restriction contained in the shopping center lease violated Bankruptcy Code § 365(f)(1) which is the section of the Bankruptcy Code that invalidates clauses in leases (or executory contracts) that restrict or prohibit assignment.² The bankruptcy court also concluded that there was insufficient evidence to support a finding that the assignment of the Trak Auto lease to a clothing store would disrupt the tenant mix at the shopping center. The lessor appealed to the United States District Court, which affirmed the bankruptcy court ruling.

When the lessor appealed to the Fourth Circuit Court of Appeals, the Circuit Court reversed. Basically, the Circuit Court framed the issue as the conflict between Bankruptcy Code § 365(b)(3)(C) (which states that a debtor/tenant's assignment of a shopping center is *subject to* any use restriction)³ and Bankruptcy Code § 365(f)(1) (which generally allows a

² Bankruptcy Code § 365(f)(1) states:

(f)(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (3) of this subsection; except that the trustee may not assign an unexpired lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event.

³ Bankruptcy Code § 365(b) states:

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

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

debtor to assign its lease notwithstanding a provision restricting assignment). After reviewing the legislative history (including the amendments to Bankruptcy Code § 365(b)(3)(C), which appeared to be designed to require that the assumption or assignment of the lease is subject to *all* of the provisions of the lease, including radius provisions, location, use, exclusivity, etc.) the Fourth Circuit reasoned when a shopping center lease is assigned in bankruptcy, Congress' purpose is evident and Bankruptcy Code § 356(b)(3)(C) is designed to preserve the landlord's bargained-for protection with respect to the premises' use and other matters that are spelled out in the lease with the debtor/tenant.

The Fourth Circuit Court of Appeals in *Trak Auto* also held that Bankruptcy Code § 365(b)(3) governs because "a specific [provision] closely applicable to the substance of the controversy at hand controls over a more generalized provision." Consequently, the court enforced the language of Bankruptcy Code § 365(b)(3)(C), rather than the more general language of Bankruptcy Code Section 365(f)(1), and reversed the orders of the lower courts which permitted the assignment of an automobile retail lease to a clothing store.

(C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to-

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

(3) For the purposes of paragraph (1) of this subsection and paragraph (2)(B) of subsection (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance-

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

(4) Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, other than a default of a kind specified in paragraph (2) of this subsection, the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease.

- (iii) **Provisions entitling a landlord to profits or an increase in rent on assignment.** A provision in a lease entitling the landlord to profits on assignment held to apply only to voluntary assignments, not to bankruptcy assignments. *In re National Sugar Refining Co.*, 21 B.R. 196 (Bankr. S.D. N.Y. 1982).

Section 365(f)(3) prevents enforcement of a provision in a lease which calls for an increase in rent to a market rate upon assignment, when the debtor assumes and assigns the lease in a Chapter 11 case. *In re David Orgell, Inc.*, 117 BR 574 (Bankr. C.D. Cal. 1990).

- (iv) **Rights of first refusal.** At least one court has held that rights of first refusal are unenforceable in bankruptcy. The court in *In re Mister Grocer, Inc.*, 77 B.R. 349 (Bankr. D.N.H. 1987), considered the assignment of a lease which contained a right of first refusal in favor of the landlord. The provision stated that, if the debtor or any trustee of the debtor wished to assign the lease, the landlord had the right to match the offer. The debtor in possession had entered into a contract to sell certain assets along with the leasehold estate, and the sale was dependent upon whether or not the landlord had the right under the lease to match the offer for the sale of the leasehold estate. Holding the §365(f)(1) invalidated any provision which restricts or conditions the assignment of the lease, the court held the right of first refusal unenforceable.

- (d) **Obtaining Security Deposit from Assignee.** Whether or not the property is a shopping center, the lessor may require a security deposit or other security for the performance of the tenant's obligations substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant. 11 U.S.C. § 365(1). This "other security" can even include the grant of a security interest in other assets of the assignee or perhaps even the debtor, to secure performance under the assigned lease.

- (e) **Debtor (or Trustee) is Released from Further Liability Once an Assignment is Made.** Any assignment to any entity of an executory contract or unexpired lease after it has been assumed under § 365 of the Bankruptcy Code relieves the trustee, the debtor-in-possession, and the estate from any liability for any breach of the lease which occurs after the assignment. 11 U.S.C. § 365(k). This is in conflict with the usual non-bankruptcy rule that an assignment, without some express release of the original tenant, does not relieve the original tenant of liability for breaches by the assignee. This often overlooked provision is another reason for a landlord's diligence in assuring that any proposed assignee from a debtor-in-possession or bankruptcy trustee be well-qualified to undertake the lease obligations.

- (f) **Problems with the Assumption and Assignment Provision.** Section 365 requires that the trustee or debtor-in-possession assume a lease or executory contract before it is assigned. Assumption expressly requires court approval but

§ 365 contains no similar requirement for assignment of the lease. A trustee or debtor would be well advised to obtain court approval, however, and condition his, her or its assumption of the lease upon accomplishing an assignment. Otherwise, the trustee or debtor can be in the position of having assumed a lease, and thereby creating an administrative expense for the entire balance of the lease term. Then, if the expected assignment, for some reason, does not take place, the result could be a large, unanticipated burden on the estate. Query: Does this render the assumption conditional?

11. Can the Landlord Get the Space Back?

- (a) Unless a lease of nonresidential real property has terminated by the expiration of its stated term, the automatic stay protects the debtor-in-possession or trustee from any action to obtain possession of the premises. 11 U.S.C. § 362(a) and (b)(10).
- (b) If the automatic stay is in effect, whether or not the tenant is in default, the landlord must first seek lifting of the automatic stay to obtain repossession of the space.
- (c) In requesting relief from the automatic stay, the requesting party must show one of two grounds, (a) that there is cause, including lack of adequate protection of an interest in property of the party making the request, or (b) that the debtor does not have an equity in the property which the landlord is seeking to recover, and the property is not necessary to an effective reorganization. 11 U.S.C. § 362(d).
- (d) If there is no default in post-petition rent payments, given the usual necessity of a debtor-in-possession or trustee for a place from which to have a base of operations, the "cause" element can be burdensome for a landlord to establish at the outset of a bankruptcy case.
- (e) Once a motion to modify or lift the stay is made, it must be heard and decided within certain time limits. 11 U.S.C. § 362(e), or else the automatic stay is terminated with respect to the moving party. A safe practice when defending any Motion for Relief from the Automatic Stay is to move the court to continue the automatic stay until the conclusion of the hearing on the Motion for Relief from the Automatic Stay.
- (f) **Landlord's Alternative.** Instead of lifting the automatic stay, the landlord has other alternatives. One is to move to enforce the landlord's rights under § 365. These include the right to have the tenant comply with all the lease terms while it is deciding whether to accept or reject the lease (11 U.S.C. § 365(d)(3)) and the right to put pressure on the tenant to make the decision as to whether to assume or reject the lease. 11 U.S.C. § 365(d)(4). Finally, if the lease is deemed rejected because the 60 day time period for deciding whether to assume or reject has passed without proper action by the tenant, the tenant is under a duty to surrender immediately the nonresidential real property to the lessor, without the necessity of proceeding in state court. However, if the tenant fails to do so, an action to lift the

stay or other enforcement of this provision must be brought in the bankruptcy court.

G. The Landlord as Debtor

At times, it is the landlord, and not the tenant, which files for bankruptcy protection usually under either Chapter 11, a reorganization, or Chapter 7, a liquidation.

1. **Many of the Same Rules Apply.** The power of a debtor to assume or reject an unexpired lease exists whether or not the debtor is the lessor or the lessee. In addition, for leases of nonresidential real property, the debtor, whether lessor or lessee, must timely perform all the obligations of the lease until the lease is assumed or rejected. This would be especially important where the property is an office building or shopping center and the landlord furnishes heat, common area maintenance and security. The requirements for assumption and assignment of a contract are the same including the requirement to cure all past defaults.
2. **Some of the Rules are Different.**
 - (a) There is no express time limit within which the debtor as lessor must assume or reject a lease, even one of nonresidential real property. The 60 day drop dead clause applies only when the debtor is the lessee.
 - (b) If the lease is rejected by the landlord, the tenant does not necessarily have to move out. If rejection is otherwise a breach of the lease, the lessee can remain in possession for the term of the lease and for any renewal or extension of the term enforceable under non-bankruptcy law.
 - (c) The claim of a lessee against a lessor when the lessor rejects the lease is wiped out, except the lessee may set off rent falling due against any damages which occur by reason of the debtor's nonperformance of the lease.
 - (d) Where the debtor is the lessor, the lessee may not require any security deposit if the lease is to be assigned.

H. Sale of the Debtor's Owned Real Estate

Bankruptcy Code § 363 governs the sale of real estate which the debtor owns. Generally, the debtor's sale of its real estate is not a sale in the ordinary course of its business and, consequently, Bankruptcy Rule 6004 will apply and it requires the debtor to file a motion for court authority to sell the property. Sale of property outside the ordinary course of the debtor's business may be by private sale or by public auction; often the debtor prefers an auction sale because they believe that it will generate the highest and best offers.

1. **Sale Free and Clear of Liens, Claims and Encumbrances.** *In Re Qualitech Steel Corporation, et al.*, 327 F.3d 537 (7th Cir. 2003) demonstrates that a sale "free and clear" of liens, claims and encumbrances can wipe out other interests in the property, such as lessee's interests. *Qualitech* is a case of first impression at the circuit court level and it

attempts to reconcile Bankruptcy Code § 363(f), which authorizes the sale of a debtor's property free and clear of any "interest" other than the interest of the bankruptcy estate, and § 365(h), which protects the rights of the lessee when the debtor/lessor rejects a real estate lease. The debtor in *Qualitech* owned a steel mill on a 138-acre tract of land in Indiana. Before filing bankruptcy, Qualitech had entered into two related agreements with Precision Industries, Inc. and a related company named Circo Leasing Co., LLC (collectively, "Precision"). One of those agreements required Precision to build a supply warehouse at Qualitech's facility and operate it for ten years so as to provide on-site integrated supply services for Qualitech. A second agreement was a land lease pursuant to which Qualitech would lease to Precision the property beneath the warehouse for a period of 10 years. The lease (which was not recorded) gave Precision exclusive possession of this warehouse in exchange for nominal rent (\$1 per year).

Qualitech filed a Chapter 11 bankruptcy in 1999 and very shortly thereafter all of its assets were sold at auction for a credit bid of \$180 million: the purchaser was a group of senior pre-petition lenders that held the senior mortgage on the 138-acre tract of land in Indiana. Precision (like all of the other creditors and parties in interest in the Qualitech bankruptcy case) received notice of the sale and of the hearing on the sale, but *did not object to the Sale Order*, even though the Sale Order directed that Qualitech was to convey its assets to the pre-petition lenders "free and clear of all liens, claims, encumbrances and *interests*" (except for some specifically enumerated liens). The Sale Order was entered pursuant to Bankruptcy Code § 363(f). Somehow, at the appellate level Precision *acknowledged* that one of the conditions in Section 363(f) had been satisfied, so as to permit the sale to proceed free and clear of Precision's interest.

Although there were negotiations between Precision and the purchaser of the property regarding the purchaser's possible assumption of the supply agreement and/or lease with Precision, those negotiations were unsuccessful and Precision's lease and supply agreement were *de facto* rejected. Precision vacated the premises in late 1999, and the purchaser (without Precision's knowledge or consent) changed the locks on the building. Precision sued the purchaser and the case was referred to the bankruptcy court. In its argument, Precision relied on Bankruptcy Code § 365(h), which provides that if a landlord rejects an unexpired lease of real property, the tenant has the option to either treat the lease as terminated, or to retain its rights under the lease (including rights relating to the amount and timing of rent payments, quiet enjoyment, subletting, assignment, etc.) for the balance of the lease term and for any renewal or extension of those rights to the extent that they are enforceable under applicable non-bankruptcy law.

Despite Precision's argument, the Bankruptcy Court held that the purchaser obtained title to Qualitech's property free and clear of *any* possessory rights that Precision otherwise might have enjoyed under its lease. In so holding, the Bankruptcy Court ruled that Precision's possessory interest was among the type of interest which was extinguished by the Sale Order and its language that the purchaser acquired Qualitech's property "free and clear of all liens, claims, encumbrances and *interest*." The Bankruptcy Court emphasized that the Sale Order was unequivocal and not open to interpretation. Implicit in the Bankruptcy Court's ruling was its rejection of the notion that Bankruptcy Code § 365(h) operated to preserve Precision's possessory rights as a lessee in the face of the Sale Order.

Precision appealed to the U.S. District Court, and the District Court reversed. The District Court held that Bankruptcy Code §§ 363(f) and 365(h) appear to be in conflict with one another because § 365(h) appears to grant the tenant the right to retain the benefits of a lease,⁴ while § 363(f) appears to permit the debtor to divest the tenant of its leasehold. The District Court also found the Sale Order to be ambiguous because the sale of Qualitech's assets was made pursuant to Bankruptcy Code §§ 365 *and* 363, yet the Sale Order did not plainly or explicitly state that it extinguished Precision's possessory interest. Indeed, the District Court found that because the Sale Order preserved for the purchaser whatever right the debtor had to assume or reject executory contracts and unexpired leases, the Sale Order suggested that Precision's rights under the lease were *not* extinguished by the sale.

Qualitech appealed the District Court's ruling to the Seventh Circuit Court of Appeals, which reversed. The Seventh Circuit explained the issue as follows: whether a sale order issued under Bankruptcy Code § 363(f), which purports to authorize the transfer of a debtor's property "free and clear of all liens, claims, encumbrances, and interests," extinguishes the lessee's possessory interests in the property or, alternatively, whether Bankruptcy Code § 365(h) operates to preserve the lessee's possessory interests in the property even in the face of a "free and clear" Sale Order. In reversing the district court, the Seventh Circuit emphasized the following:

- (i) Precision never objected to the proposed sale, or to entry of the Sale Order. After the bankruptcy court entered the Sale Order, Precision did not appeal it. *If*

⁴ Bankruptcy Code § 365(h) states:

(h)(1)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and-

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or

(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) 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 nonbankruptcy law.

(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance.

(D) In this paragraph, "lessee" includes any successor, assign, or mortgagee permitted under the terms of such lease.

Precision had filed a timely objection to the sale, then Bankruptcy Code § 363(e)⁵ would have *required* the bankruptcy court to prohibit or condition the sale so as to provide adequate protection of Precision's interest.

- (ii) Clearly, Precision's right to possess the property as a lessee qualified as an "interest" for purposes of Bankruptcy Code § 363(f).
- (iii) Although Bankruptcy Code § 365(h) allows a lessee to remain in possession of estate property after the debtor/lessor has rejected the lease, Bankruptcy Code § 363(f) is not subject to 365(h). Although both Section 363 and 365 of the Bankruptcy Code contain cross-references to other provisions, 363(f) and 365(h) do not contain cross-references to one another. Consequently, the Seventh Circuit found that it was improper for it to construe 365(h) as superceding 363(f), or *vice versa*.

Bankruptcy Code § 363(f), which permits a debtor to sell property free and clear of any lien, claim, encumbrance or any other interest that another person or entity might have in that property, but only if:

- (A) applicable non-bankruptcy law permits sale of such property free and clear of such interest;
- (B) such entity consents;
- (C) 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;
- (D) such interest is in bona fide dispute; or
- (E) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Bankruptcy Code § 365(f) requires the debtor to show only *one* of these five preconditions for a sale "free and clear" of other interests. Bankruptcy Code § 363(e) provides protection to any party in interest (*i.e.*, lienholder, tenant, etc.) from the debtor's attempt to sell free and clear of any interest because it states that, upon the request of any entity that has an interest in the property which is to be used, sold or licensed by the debtor, the court (with or without a hearing) *shall*

⁵ Bankruptcy Code § 363(e) states:

- (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

prohibit or condition such use, sale or lease as necessary to adequately protect such interest.