

SECTION 365 IN THE CONSUMER CONTEXT: SOMETHING OLD, SOMETHING NEW, SOMETHING BORROWED, SOMETHING BLUE

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I. INTRODUCTION

In 1991, Michael Andrew cheerfully observed that executory contract law had become "a hopelessly convoluted and contradictory jurisprudence."¹ He was referring to the case law confusion regarding the consequences of rejection of an executory contract. Does rejection mean contract annihilation (evaporation, defenestration, rescission) or simply breach? Today, thanks to Andrew, most courts agree that rejection means breach.² The debate has moved to the next frontier, namely, what does "breach" mean? Does it signify *termination* of the contract or simply the nondebtor party's right to damages.³ In the consumer context, the distinction has allowed courts to conclude that a debtor can assume a residential lease that has terminated prepetition so long as it has not expired.

In short, the situation in 2000 differs little from that in 1991. Section 365 continues to generate more than its fair share of confusion and contradictory case law. The following materials discuss several pockets of litigation in the consumer context. Some issues are *sui generis*

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1. Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 1 (1991).

2. *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

3. *Eastover Bank v. Sowahee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), cert. denied, 513 U.S. 874 (1994).

to consumers, and therefore "new" to the § 365 landscape, e.g., assumption of a terminated residential lease and characterization of rent-to-own contracts. Some are old, e.g., the chronic "is-this-a-true-lease-or-one-for-security" bugaboo? Some are "borrowed"—the issues of prompt cure and the nondebtor's rights in the event of postassumption breach.

Where does "blue" fit in here? There are several possibilities. It could refer to us as we struggled with the § 365 case law. It could describe the section itself because Congress just can't seem to get it right (probably because it is impossible to codify rules to deal with ALL executory contracts and unexpired leases). It also seems to capture the mood of bankruptcy attorneys when they get a § 365 issue because they know the case law is "hopelessly convoluted and contradictory" and the likely outcome will be result-driven.

The § 365 consumer debtor case law has a further complication. Much of it arises in the context of the last great bankruptcy frontier, Chapter 13. Until recently, Chapter 11 has occupied the minds and hearts of courts and attorneys. Not any more. And, as attorneys and courts take a closer, harder look at Chapter 13, it is no longer possible to describe it as a "streamlined creditors-can't-vote Chapter 11." Chapter 13 is unique, presenting its very own quandaries, not the least of which is how its provisions and § 365 interact. We live in interesting times.

II. WHO CAN ASSUME OR REJECT AN EXECUTORY CONTRACT OR UNEXPIRED LEASE?

A. INTRODUCTION

According to § 365(a), "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."⁴ This means the Chapter 7 trustee has the power to assume or reject in Chapter 7 proceedings. It suggests the Chapter 13 trustee has that power in Chapter 13 cases.

In Chapter 7, the "who" question has a crystal clear answer. The trustee and only the trustee has the power.⁵ Ironically, this crystal clear answer creates problems when the Chapter 7 debtor wants to retain the

4. 11 U.S.C. § 365(a) (1998) (emphasis added).

5. See, e.g., Carrico v. Tompkins (*In re Tompkins*), 95 B.R. 722, 724 (9th Cir. B.A.P. 1989) (decision to assume or reject a lease in a Chapter 7 setting is solely the trustee's for a 60-day period only).

benefits and rights of a rejected lease or contract. In Chapter 13, courts have had to struggle to reach the common sense conclusion that the *debtor*, not the trustee, has the power to assume or reject under § 365.

B. THE POSTREJECTION PROBLEM IN CHAPTER 7: *IN RE KNIGHT*

As noted, the Chapter 7 trustee alone enjoys the power to assume or reject executory contracts and unexpired leases in Chapter 7 cases.⁶ What if the trustee rejects the unexpired lease or executory contract because it has no value to the estate, but the debtor wants to retain its benefits and rights? *In re Knight*⁷ describes the dilemma posed to the trustee, the debtor and the nondebtor.

Knight involved the lease of a 1996 Oldsmobile. When the debtor filed bankruptcy, she had possession of the car, was current on her lease payments and wanted to retain it. GMAC filed a motion to compel the trustee to assume or reject the lease. The trustee filed an objection, which the United States trustee "seconded."

The court began by noting that a Chapter 7 debtor "has no authority to exercise the option of assuming or rejecting leases."⁸ GMAC argued that the trustee's failure to assume the lease would result in its "deemed rejection" pursuant to § 365(d)(1). That would constitute a breach of the lease according to § 365(g). That breach, in turn, might result in termination of the lease by operation of law. For sure, the "deemed-rejection-a.k.a.-breach" would give GMAC the right to terminate the lease because the lease agreement defined "default" to include "any other act that is a default under a Lease contract under applicable law."⁹ Thus, even if the debtor-lessee wanted to keep the car, GMAC could obtain relief from the stay, declare the lease terminated and recover the car. But, argued GMAC, if the trustee assumed the lease, the trustee could assign his interest to the debtor under § 365(f)(2). If the trustee were willing to do that, GMAC would agree not to raise any issues of adequate assurance of future performance, under either § 365(b)(1)(C) as to the trustee or

6. *Affordable Efficiencies, Inc. v. Bane (In re Bane)*, 228 B.R. 835, 841 (Bankr. W.D. Pa. 1998) (section 365(d)(4) provides right to trustee and no other party to assume or reject; therefore, lessor's actions cannot waive trustee's right, lease is deemed rejected because trustee did not act within 60 days after the filing and debtor does not have right to assume it following conversion to Chapter 13), *aff'd mem.*, 182 F.3d 906 (4th Cir. 1999) (table).

7. 211 B.R. 747 (Bankr. D. Or. 1997).

8. *Id.* at 748.

9. *Id.*

under § 365(f)(2)(B) against the debtor/assignee. Then both the debtor and GMAC would have the right to enforce the lease pursuant to its original terms.¹⁰

GMAC informed the court that it was filing motions to compel the trustee to assume or reject in *all* Chapter 7 cases in Oregon. It eschewed trustee abandonment because abandonment would not result in assumption and only assumption would give GMAC all its pre-bankruptcy rights.

The trustee objected to GMAC's motion, arguing that the power to assume is discretionary and should not be exercised unless the decision would benefit the estate. He maintained that

it is unfair to the debtors for him to make a decision to either assume or reject a lease which will directly impact only the debtor. If the trustee were to reject the lease, GMAC would have the option as to whether it wanted to do business with the debtor. The debtor would have no option. Further, the trustee will often not know that there is an outstanding lease until the § 341 hearing . . . [and] may not have time . . . to file a motion to assume or reject. Additionally, if the court were to require the trustee to file motions under § 365 on all outstanding vehicle leases, it could be setting a precedent which would obligate the trustee to thoroughly review all the debtor's ongoing contract payments and file § 365 motions to assume or reject on every one, including, but not limited to, utility services, furniture and appliance leases and medical equipment leases. GMAC's proposed process would place a significant burden on the trustee and on the court. In asset cases, the cost of filing such pleadings may be at the expense of the estate's creditors.¹¹

According to the court, GMAC was really asking the court to order the trustee to *assume* the lease. A motion to compel was not necessary to effect a rejection because it would occur with the simple passage of time. The court understood GMAC's predicament if the trustee did not assume. If the debtor were current on her lease payments at the commencement of the case, GMAC could not obtain relief from the stay to obtain possession of the vehicle because the debtor would not be in default. If, at any later time, the debtor stopped making payments, the discharge would preclude

10. *Id.*

11. *Id.*

GMAC from collecting the balance owed. GMAC would only be entitled to repossess the depreciated vehicle. In addition, "[if], postbankruptcy, the debtor missed a lease payment but wished to cure the default and continue the lease payments, because of the discharge of her personal liability for the payments, the lessor cannot tell the debtor that if she wants to cure the default and keep the vehicle, she has an obligation to make timely future payments."¹² Assumption would solve GMAC's dilemma because it would permit postbankruptcy enforcement of the lease according to its terms.

The court refused to order the trustee to assume the lease for several reasons. First, the court's role is to review, not dictate, a trustee's decisions under § 365. Second, assumption is only warranted if it is in the estate's best interest, and GMAC had failed to show how assumption would benefit the estate at all. In fact, the court believed that assumption would harm the estate if the trustee assumed, but did not assign the lease. In that event, the trustee would have to cure defaults, compensate the lessor for actual losses and make all future payments. The absence of default in this case did not mean its absence in others, given GMAC's decision to file these motions in all Chapter 7 cases in Oregon.

The court went on to make two significant observations. First, GMAC had never answered the court's question as to how it had handled such situations before it began making these motions. Second, it had "coincidentally" initiated its practice of filing these motions "immediately after Sears was severely sanctioned nationwide . . . for systematically obtaining reaffirmation agreements with debtors which were never filed with or approved by the bankruptcy court."¹³

The last portion of the opinion was cautionary. Essentially, the court said the following. Even though rejection constitutes a breach, courts disagree on whether breach effects a termination. If rejection does *not* terminate the lease, and postrejection, the lessor and debtor-lessee "re-negotiate" an agreement that looks like their prepetition lease, that will presumptively represent a reaffirmation of the parties' prepetition lease. And if so, the lessor needs to follow the rules regarding reaffirmations unless it wants to find itself in violation of § 524(a)'s permanent injunction. In any such litigation, the court warned, "the creditor will

12. *Id.* at 749.

13. *Id.* at 750

have the burden of proving that the agreement represents a new, postpetition obligation."¹⁴

Knight makes several important points:

1) Only the trustee has the power to assume in a Chapter 7 case and a court will only approve the decision to assume if it will benefit the estate.

2) A Chapter 7 debtor's interest in retaining leased property or contract rights will rarely benefit the estate.

3) In most cases when the debtor wants to retain the benefits of an executory contract or unexpired lease, the contract will be deemed rejected 60 days after the petition date because the trustee will not bother to act¹⁵

4) Rejection represents breach, but breach does not necessarily mean the contract is terminated. If it still breathes, its negotiated continuation constitutes a reaffirmation agreement and the nondebtor party had better comply with § 524(c).¹⁶

Although not mentioned in *Knight*, one assumes that attempts to change the contract terms to make the renegotiated lease or contract look like a "new, postpetition" agreement are fraught with peril. Courts were not born yesterday. Moreover, the Sears debacle has made them ever more aware and vigilant.¹⁷

14. *Id.*

15. See 11 U.S.C. § 365(d)(1) (1998).

16. *But see In re Petersen*, 110 B.R. 946, 950 (Bankr. D. Colo. 1990) (where informed Chapter 7 debtor-lessee elects, postpetition, to adopt and continue prepetition commercial lease agreement rejected by the trustee, and legally sufficient postpetition consideration exists between the parties, the lease will be deemed binding, enforceable postpetition obligation of the debtor rather than invalid reaffirmation agreement).

17. Thomas J. Yerbich, Esq., notes the courts' ad hoc approach to the postrejection situation and Congress' attempt to correct the problem. *Consumer Leases - A Proposed Alternative*, CRACKING THE CODE: A NEWSLETTER OF INSOLVENCY PROFESSIONALS, 30 Mar. 1999. [<http://www.abiworld.org/abidata/online/newslet/99maryerbich.html>]. He argues the proposed legislation is inadequate. Among other things, it should: expressly establish that the § 524(c) reaffirmation and § 365(b) cure requirements apply to rejected leases; spell out the consequences of the debtor's failure to "assume," e.g., the lease is deemed terminated and the debtor must immediately surrender the property; establish a deadline for "assumption;" require the debtor to give early notification of his/her intentions; prohibit a debtor's continued use without compensating the lessor; and preclude the lessor from extracting additional concessions or terms that improve upon its prepetition "bargain." Mr. Yerbich's recommendations blur the assumption process with that of reaffirmation.

(continued...)

The postrejection problem exists with residential leases as well. As one court noted, "it would be an aberrant circumstance where a Chapter 7 trustee would assume (with the concomitant requirement of cure) a residential apartment lease"¹⁸ Residential real estate lessors need to be on guard lest they, too, run afoul of the Code's reaffirmation provisions.¹⁹

The authors recently heard that a Massachusetts Chapter 7 debtor filed a motion to assume a car lease. Although finding the motion odd, the judge ultimately granted it because no one objected. The story underscores why the rules governing reaffirmation, not assumption, should control such situations. A motion to assume requires notice to the nondebtor party and such other parties in interest as the court may direct.²⁰ It is a contested matter²¹ and as such, no response is required.²² The party against whom relief is sought—the nondebtor party, in our situation, the lessor—is hardly going to go into court and hop up and down to protest the Chapter 7 debtor's request to assume the lease. It will please the nondebtor lessor no end to receive notice of the debtor's motion. What about other creditors of the debtor? Will they object? One assumes they will be supremely indifferent. Why should they care what the debtor does with his or her postpetition income? They have no stake or interest in the decision. A Chapter 7 debtor's motion to assume subjects the proposed action to the "scrutiny" of one party who is ecstatic over the news and others—the general creditor body—who couldn't care less. In a word, no one is going to object. A motion to assume channels evaluation of the motion to a listless audience focused solely on its own problems and sorrows.

The process governing reaffirmation subjects the debtor's decision to two potential levels of "review," both of which are designed to scrutinize the wisdom of the decision in terms of its effects on the debtor and the debtor's dependents. Section 524(c) states the rules regarding

17. (...continued)

They are different substantively as well as procedurally.

18. *In re Sheard*, 1999 WL 454260 *2, n.5 (Bankr. E.D. Pa. June 24, 1999) (No. 98-19627DWS).

19. 11 U.S.C. § 524(c)(6)(B) (1998) presently exempts consumer debts secured by real property from its requirements. One wonders if the exemption should extend to residential real property leases as well?

20. FED. R. BANKR. P. 6006(c).

21. FED. R. BANKR. P. 6006(a).

22. FED. R. BANKR. P. 9014.

reaffirmation. The proposed agreement must be submitted to the court.²³ If the debtor is not represented by an attorney, the court must approve the agreement as in the debtor's best interest and not imposing an undue hardship on the debtor or the debtor's dependents.²⁴ If the debtor was represented by an attorney during the course of negotiating the agreement, the attorney is supposed to serve a similar oversight function.²⁵ If the attorney believes the agreement will impose an undue hardship, he or she should not sign the required affidavit. The court must then approve (or disapprove) the agreement pursuant to § 524(c)(6)(A).

The same terms and the same postpetition obligations may result, whether the Chapter 7 debtor assumes or reaffirms. The difference lies in the degree of scrutiny involved, the nature of the scrutiny and who will do the scrutinizing. A Chapter 7 debtor's decision to retain the benefits of a prepetition contract or lease affects the debtor and the debtor's dependents, not the debtor's creditors. The debtor's attorney and the court are the parties properly, legitimately and genuinely concerned with the debtor's decision. The rules regarding reaffirmation address the real issues. Reaffirmation pursuant to § 524(c), not assumption under § 365, is the appropriate process to evaluate a Chapter 7 debtor's decision to retain the benefits of a prepetition contract.

The Chapter 7 debtor who wishes to retain possession of a car subject to a security interest has an additional option. The debtor can redeem it for the amount of the allowed secured claim.²⁶ In some jurisdictions, the debtor may choose a "fourth option": to retain the car so long as she continues to make payments under the original agreement.²⁷ For a debtor wishing to retain a *leased* car, assumption of the lease is not an available remedy because the debtor does not have the power to assume in a Chapter 7. Moreover, a Chapter 7 lessee cannot redeem leased goods. Therefore, the lessee in Chapter can only retain leased goods through the reaffirmation process.

23. 11 U.S.C. § 524(c)(3) (1998).

24. *Id.* § 524(c)(6)(A).

25. For instance, the attorney is required to submit an affidavit or declaration stating that the debtor's decision to reaffirm was voluntary and a product of informed consent, *id.* § 524(c)(3)(A), and does not impose an undue hardship on the debtor or a dependent. *Id.* § 524(c)(3)(B).

26. 11 U.S.C. § 521 (1998).

27. See *Capital Communications Fed. Cred. Union v. Boodrow (In re Boodrow)*, 126 F.3d 43 (2d Cir. 1997); *contra Bank of Boston v. Burr (In re Burr)*, 160 F.3d 843 (1st Cir. 1998) (rejecting fourth option).

C. CHAPTER 13

In Chapter 13, unlike Chapter 11, the Chapter 13 trustee and the debtor are always two different persons. Section 1302 details the trustee's duties. Section 1303 describes the debtor's rights and powers. Chapter 13 is limited to individual debtors.²⁸ The debtor, not the Chapter 13 trustee, proposes the plan. A Chapter 13 plan can assume or reject contracts and leases not previously rejected.²⁹ If only the debtor can propose a Chapter 13 plan, and the plan can assume or reject contracts not previously rejected, one would think the debtor would have the right to assume and reject under § 365, but § 365 says nothing about Chapter 13 debtors.

Section 365's failure to mention the Chapter 13 debtor is anomalous.³⁰ Section 365(a) authorizes the *trustee* to assume or reject. In addition, § 365(d)(2) does not identify the Chapter 13 debtor as an appropriate object of a motion to compel.³¹ Indeed, it implies otherwise because it provides that "the court, on request of any party to such contract or lease, may order the *trustee* to determine within a specified period of time whether to assume or reject such contract or lease."³² One court surmised that this probably represented a drafting oversight because "[i]n practice, it makes little sense to compel the Chapter 13 trustee, rather than the debtor, to assume or reject an unexpired lease or executory contract particularly where the debtor—and not the Chapter 13 trustee—exercises the option in connection with the plan."³³

The courts have taken different paths to reach the "common sense" result. Many courts assume, without analysis, that the Chapter 13 debtor has the power to assume or reject executory contracts and unexpired leases.³⁴ Others seem to find the authority from § 1322(b)(7) which permits a Chapter 13 plan to "provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not

28. 11 U.S.C. § 109(e) (1998).

29. *Id.* § 1322(b)(7).

30. *In re Yasin*, 179 B.R. 43, 47 (Bankr. S.D.N.Y. 1995).

31. *Id.*

32. *Id.* (emphasis added).

33. *Id.* at 48.

34. See, e.g., *In re DiCamillo*, 206 B.R. 64, 66 (Bankr. D.N.J. 1997) ("a Chapter 13 debtor may assume or reject an 'unexpired lease of the debtor'").

previously rejected under such section"³⁵ Yet others seem to equate the Chapter 13 debtor with the Chapter 11 debtor in possession.³⁶ One court cryptically relied on the limited role of the trustee in Chapter 13 cases and § 103(a) "which states that all provisions found in Chapters 1, 3, and 5 are applicable to cases filed under Chapter 7, 9, 11, 12, or 13."³⁷

The Code's apparent distinction between a trustee and a Chapter 13 debtor led to an interesting result in *In re Dodd*.³⁸ The Chapter 13 debtors in *Dodd* operated a franchise restaurant. They filed on December 2, 1986. More than 60 days later, on February 10, 1987, the landlord filed a motion to compel them to surrender the nonresidential premises. The debtors countered with a request to extend the time to assume or reject their lease. The issue was whether § 365(d)(4) applied in a Chapter 13 case. If it did not, the debtors were not bound by its restrictive deadlines and presumably could wait until confirmation to decide.³⁹

Needless to say, the nondebtor lessor maintained that § 365(d)(4) did apply in Chapter 13 cases. The debtors and Chapter 13 trustee argued it did not "because a Chapter 13 trustee is not empowered to operate a debtor's business and, therefore, cannot make a decision regarding assumption or rejection of a lease."⁴⁰ The court agreed with the debtor and trustee. Section 1302 does not authorize the Chapter 13 trustee to operate the business. Rather, § 1304(b) authorizes the Chapter 13 debtor to do so.

35. See, e.g., *In re Sheard*, 1999 WL 454260 *1, n.3 (Bankr. E.D. Pa. June 24, 1999) (No. 98-19627DWS) ("Section 1322(b)(7) gives the debtor who is the one to propose the Chapter 13 plan the ability to assume or reject notwithstanding the language of § 365 which speaks of assumption and rejection by the trustee. Thus while the Code would appear to also give the Chapter 13 trustee the right to assume or reject, this matter is commonly left to the debtor who has the interest and information to make such decision." (quoting 5 NORTON BANKRUPTCY LAW & PRACTICE 2D § 121:10 at 121-107)); *Riddle v. Aneiro* (*In re Aneiro*), 72 B.R. 424, 427 (Bankr. S.D. Cal. 1987).

36. See, e.g., *In re Scott*, 209 B.R. 777, 781 n.5 (Bankr. S.D. Ga. 1997) (noting, in a Chapter 13 case, that "although [§ 365] uses the word 'trustee,' the right to assume or reject . . . can also be exercised by a debtor-in-possession in a reorganization case."); *In re Brewer*, 233 B.R. 825, 828 (Bankr. E.D. Ark. 1999) (citing *Scott*).

37. *In re Hall*, 202 B.R. 929, 932 n.2 (Bankr. W.D. Tenn. 1996).

38. 73 B.R. 67 (Bankr. E.D. Cal. 1987).

39. If § 365(d)(4) does not apply in Chapter 13 cases, that means no time limits of any kind exist on the decision to assume or reject nonresidential real property leases in Chapter 13 cases. Section 365(d)(1) is limited to Chapter 7 cases. Section 365(d)(2) covers cases under Chapters 9, 11, 12 and 13, but is limited to unexpired leases of residential real property. The court never discussed the broader implications of its holding.

40. *Dodd*, 73 B.R. at 68.

11 U.S.C. § 365(d)(4) is inconsistent with § 1304. If it is the debtor who is to operate the business, how can the trustee make a decision on whether a lease of nonresidential real property should be assumed or rejected? It would not be practical to burden a trustee with having to make this decision when the trustee will never operate a business.⁴¹

Moreover, specific provisions in the operating chapters govern over general provisions in the service chapters. Because the Chapter 13 debtor is the person who operates the business, it is the Chapter 13 debtor who should decide, "by way of confirmed plan,"⁴² whether to assume or reject. Therefore, according to the court, § 365(d)(4) did *not* apply in Chapter 13 cases. The court believed that the relative speed of Chapter 13 proceedings protected nondebtor lessors from long periods of uncertainty and therefore satisfied the policy predicate underlying § 365(d)(4)'s enactment.

The court never discussed whether "trustee" in § 365(a) means the same thing as "trustee" in § 365(d)(4). *Dewsnup*⁴³ notwithstanding, a term used in one subsection usually has the same meaning when it is used in another subsection of the same provision. If so, the court was effectively holding that a Chapter 13 debtor *cannot* assume or reject under § 365(a) even though he or she could exercise that same power via a plan. Presumably other courts would be disinclined to extend *Dodd's* holding to § 365(a). That would simultaneously preclude the Chapter 13 debtor from rejecting under § 365(a) and potentially subject the estate (and debtor) to greater administrative expenses.

Bankruptcy Rule 6006 inferentially supports the argument that "debtor" in § 365 includes Chapter 13 debtors. It provides:

A proceeding by a party to an executory contract or unexpired lease in a [C]hapter 9 municipality case, [C]hapter 11 reorganization case, [C]hapter 12 family farmer's debt adjustment case, or [C]hapter 13 individual's debt adjustment case, to require the

41. *Id.* at 68-9.

42. *Id.* at 69

43. *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) ("allowed secured claim" in § 506(d) has different meaning from same term in § 506(a) because Court was not convinced Congress intended to depart from pre-Code rule that liens pass through bankruptcy unaffected).

trustee, debtor-in-possession, or *debtor* to determine whether to assume or reject the contract or lease is governed by Rule 9014.⁴⁴

As one court noted, "debtor" is superfluous in a Chapter 9 case because "trustee" means "debtor."⁴⁵ Moreover, "debtor" in Bankruptcy Rule 6006 does not refer to the Chapter 11 debtor in or out of possession. "The only . . . situations in which the reference to 'debtor' would not include the 'trustee' are Chapter 12 and Chapter 13 cases. Of course, the rules do not supplant the statute in the event of conflict, but presumably the rule and § 1322(b)(7) and common sense are enough to overcome § 365's 'plain meaning.'"

Although courts have adopted different ways of getting there, most have reached the same conclusion. The Chapter 13 debtor is the party entitled to assume or reject, be it by separate motion under § 365, or in the plan. The Honorable Keith Lundin concurs:

It makes little sense for anyone other than the debtor to move for assumption or rejection It makes even less sense to interpret the Code to preclude a [C]hapter 13 debtor from assuming, assigning, or rejecting an unexpired lease or executory contract before confirmation of a plan. The Code could be interpreted to allow the [C]hapter 13 trustee to manage executory contracts and unexpired leases before confirmation to the exclusion of the debtor and then permit the debtor to use § 365 only as part of a plan; however, there is no obvious logic to this division of responsibility. The [C]hapter 13 trustee has no statutory responsibility to police the management of unexpired leases and executory contracts in advance of confirmation. The [C]hapter 13 debtor on the other hand may have great incentives to get out of unfavorable leases or executory contracts or to assume favorable ones. It makes little sense to require the debtor to convince the [C]hapter 13 trustee to invoke § 365 on the debtor's behalf when the debtor is the party best situated to commence and prosecute such actions. Chapter 13 debtors should be allowed to get out of an apartment lease, reject a car lease, cancel a contract for the lease of furniture or home appliances, or assume such contracts by filing a motion for assumption or rejection at any time after the petition. Congress could have made this power more clearly available to [C]hapter 13

44. FED. R. BANKR. P. 6006.

45. *In re Yasin*, 179 B.R. 43, 48-49 (Bankr. S.D.N.Y. 1995).

debtors; § 1322(b)(7) should be interpreted to permit [C]hapter 13 debtors § 365 relief in advance of confirmation of a plan.⁴⁶

III. HOW TO ASSUME IN CHAPTER 13

Bankruptcy Rule 6006(a) states: "A proceeding to assume, reject, or assign an executory contract or unexpired lease, *other than as part of a plan*, is governed by Rule 9014."⁴⁷ Because Rule 9014 requires a motion, reasonable notice and the opportunity for a hearing, Rule 6006(a) clearly establishes the ground rules for assumption or rejection *outside* of a plan. It leaves something to be desired in terms of what is required when assumption or rejection is proposed as part of the plan. Does it require notice and an opportunity for a hearing and if so, what will suffice?

Several courts have discussed the issue.⁴⁸ They have *not* reached the same conclusions. Prudence dictates giving the nondebtor party specific notice of the intent to assume when the debtor proposes to assume the contract or lease in the plan.

Although one case, *In re Flugel*,⁴⁹ involved an unexpired lease of nonresidential real estate, and hence triggered § 365(d)(4)'s "deemed-rejected-if-not-assumed-within-60-days-of-the-filing" mandate, the court's reasoning may extend beyond the business context to consumer debtors seeking to assume residential leases and leases of consumer goods. Certainly, it won't hurt consumer debtors to comply with its teachings.

The debtors in *Flugel*, doing business as Spicy Fish Tales, filed a plan along with their Chapter 13 petition on November 29, 1995. They attached an additional page entitled "17. Special Provision. Real Estate Lease Assumption."⁵⁰ This page described their proposed treatment of two leases during the pendency period and beyond, including payment of arrearages. On December 1, 1995, the complaining lessor, DWA, received a notice of the stay and the first page of the petition. On December 8, it received notice of the § 341 meeting. That notice

46. KEITH M. LUNDIN, CHAPTER 13 § 3.47 at 3-24 (2d ed. 1994).

47. FED. R. BANKR. P. 6006 (emphasis added).

48. See, e.g., *In re REPH Acquisition Co.*, 134 B.R. 194 (N.D. Tex. 1991); *In re Hall*, 202 B.R. 929 (Bankr. W.D. Tenn. 1996); *In re Flugel*, 197 B.R. 92 (Bankr. S.D. Cal. 1996); *Riddle v. Aneiro* (*In re Aneiro*), 72 B.R. 424 (Bankr. S.D. Cal. 1987).

49. 197 B.R. 92 (Bankr. S.D. Cal. 1996).

50. *Id.* at 94.

summarized the plan generally and stated that the plan itself was on file with the bankruptcy court. It also provided:

"Special Notice to DWA SMITH CO" regarding "BACK RENT/LEASE" as follows: Creditors named above who have allowed claims for real estate or mobile home arrears shall be paid 100% in non-cumulative installments as indicated. Monthly payments shall be in advance of other creditors . . . Post-petition regular monthly payments shall be paid to lienholders by the debtor directly.⁵¹

Along with other objections to confirmation, DWA argued that the debtors could not assume the lease because they had never filed a motion to assume, more than 60 days had passed since the filing of their petition, and therefore, the lease was deemed rejected pursuant to § 365. The court framed the issue as whether "a motion to assume [is] necessary when assumption is proposed in a plan."⁵²

The court concluded that a formal motion under Bankruptcy Rule 9014 was not necessary, but a debtor must give notice to the nondebtor party to satisfy the policy objective underlying § 365(d)(4) "to prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-à-vis the estate."⁵³ The court adopted the holding of *REPH Acquisition*⁵⁴ that even if Bankruptcy Rule 6006 excuses a motion, assumption pursuant to a plan requires notice and an opportunity for a hearing.⁵⁵ The court was satisfied that DWA had received sufficient notice. The debtors had expressed their intention to assume in their plan. They had filed the plan with their petition. Shortly thereafter, DWA received notice of the § 341 meeting with specific notice of the debtors' intention to assume DWA's lease.

DWA had an opportunity to object, which it did on January 11, and March 8, 1996, and an opportunity to be heard. DWA was afforded the safeguards which would have been afforded under [Bankruptcy] Rules 6006(a) and 9014. This Court holds that the

51. *Id.*

52. *Id.*

53. *Id.* at 95.

54. *In re REPH Acquisition Co.*, 134 B.R. 194 (N.D. Tex. 1991).

55. *Id.*

assumption provision in the plan, together with the § 341 Notice, satisfied the requirements of § 365(d)(4).⁵⁶

The court added a cautionary note, warning debtors not to rely solely on the § 341 notice which is prepared and sent by the Chapter 13 trustee.

In this case the 341 Notice made specific mention of the Debtor's intent to assume the particular lease with DWA. The result may not have been the same had the 341 notice failed to mention DWA specifically. A debtor may wish to send specific notice to landlords. Similarly the result may not have been the same had the plan simply carried a blanket boilerplate assumption provision as in *REPH*.⁵⁷

Another opinion, also involving a nonresidential real estate lease, took a different tack. In *Riddle v. Aneiro (In re Aneiro)*,⁵⁸ the court began by noting that § 365(a) requires court approval for assumption or rejection. Bankruptcy Rules 9013 and 9014 require requests for court orders to be made by motion. "A motion is 'made' when served on the opposing party."⁵⁹ The court clerk served a § 341 notice on all creditors. Under "Summary of Proposed Plan," the notice stated:

Debtor's Chapter 13 proposed plan for treatment of debts is on file at court and is a public record. Creditors must refer to the plan for precise details [U]nable to adequately summarize debtor's proposed plan. Each creditor is advised to contact the attorney for debtor and request a true copy of debtor's proposed plan to determine how the plan might affect each creditor.⁶⁰

According to the court, the debtor made a motion to assume when the clerk sent the § 341 notice and notice of the plan. "The liberal policies underlying Chapter 13 relief do not require a separate, formal motion to assume a lease when the debtor communicates an intent to assume

56. *Id.* at 95-6.

57. *Id.* at 96 n.6; see also *In re Hall*, 202 B.R. 929, 933 (Bankr. W.D. Tenn. 1996) (Chapter 13 debtor satisfied requirements when she provided for assumption of lease in her plan, sent notice of assumption to lessor by attaching copy of plan to § 341 notice, no one objected to confirmation, and court confirmed her plan).

58. 72 B.R. 424 (Bankr. S.D. Cal. 1987).

59. *Id.* at 427.

60. *Id.*

pursuant to § 1322(b)(7) under the terms of a plan filed within the § 365(d)(4) time period.⁶¹

Notwithstanding *Aneiro*, it is better to be safe than sorry. Debtors should send the nondebtor party a personalized notice of their intent to assume under the plan and describe the terms of the proposed assumption.

IV. EFFECT OF FAILURE TO ASSUME OR REJECT

A. IN CHAPTER 7

Section 365 attempts to provide closure in Chapter 7 for *all* executory contracts and *all* unexpired leases, whether they involve residential or nonresidential real estate, commercial or consumer personal property leases. Section 365(d)(1) provides that an executory contract or unexpired lease of residential real property or personal property "is deemed rejected in a [C]hapter 7 case if the trustee fails to assume or reject it within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes"⁶² Section 365(d)(4) states a similar rule for nonresidential real property leases in which the debtor is the lessee, but its message applies to all the relief chapters and it adds "and the trustee shall immediately surrender such nonresidential real property to the lessor."⁶³

The rules are clear, both in terms of their governing time limits and who must act.⁶⁴ They are also conclusive. Chapter 7 trustees are not

61. *Id.*

62. 11 U.S.C. § 365(d)(1) (1998) (emphasis added).

63. The one missing piece is nonresidential real property leases in which the lessor is the debtor.

64. The consequences of § 365(d)(4) are *not* so clear. In fact, § 365(4) inspired the judge-made distinction between "breach" and "termination." See, e.g., *Eastover Bank v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874 (1994). The rejection-as-breach "doctrine" arose in response to holdings that § 365(d)(4) *terminates* a debtor-commercial lessee's lease agreement, its leasehold interest *and any and all third party rights and interests associated with them*. See, e.g., *In re Gillis*, 92 B.R. 461, 465-66 (Bankr. D. Haw. 1988) (effect of rejection is to terminate lease absolutely and state law cannot affect or impair it: so, too, bank's security interest in debtor-lessee's leasehold estate is completely extinguished because no leasehold interest remains to which security interest could attach).

Although never articulated, the rejection-as-breach courts seem concerned with protecting the rights of third parties with an interest in the debtor's leasehold interest, e.g., financiers and sublessees. Terminating the debtor's leasehold interest has harsh consequences to them. It also benefits the lessor. For instance, assume Bank has a valid interest in Debtor-Lessee's leasehold interest (a common phenomenon in ground leases). In terminator territory (jurisdictions that hold § 365(d)(4) *terminates* the lease), Lessee's lease agreement and leasehold interest would terminate by operation of law at the

(continued...)

excused from acting within the requisite time even when they do not know about a lease or contract.⁶⁵

B. IN CHAPTER 13

The situation in Chapter 13 is less clear. First, with the exception of § 365(d)(4)⁶⁶ neither § 365 nor any Chapter 13 provision deems

64. (...continued)

end of the 60 day period and Bank's contract rights under the lease would as well. As a result, Bank's collateral—Lessee's leasehold estate—would evaporate. Bank's secured claim would become an unsecured claim. That result obtains in terminator territory even though Lessee's ground lease grants Bank a variety of protections and rights vis-à-vis Lessor in the event of Lessee default.

Viewed cosmically, a lessor stands to benefit (significantly) from the happenstance of a commercial lessee's bankruptcy and failure to assume within the requisite period of time described by § 365(d)(4). Lessee's financier stands to suffer a significant loss. What may have been a fully secured claim becomes "fully" unsecured. Assuming Lessee's estate has no assets, Bank would lose its entire claim. If Lessee's estate had assets, Bank would lose less, but suffer a loss nevertheless. Moreover, other creditors of the estate would receive less in distribution given the addition of Bank's unsecured claim. For sure, the estate would suffer a loss in the amount by which the value of the leasehold estate exceeded the indebtedness owed to Bank.

Although non-terminator courts ascribe different effects to § 365(d)(4)'s passive rejection, they uniformly agree it does not *terminate* the lease or the lessee's leasehold interest. Consequently, a leasehold mortgagee's collateral would not evaporate. Therefore, after relief from the stay, Bank could foreclose against the leasehold interest at state law and recover its claim or portion thereof. If the debtor had subleased the property, Bank's foreclosure would not cause any disruption to Lessor in payment or otherwise, nor would it create a vacancy in the premises. Bank would simply sell the leasehold interest and the right to receive the sublease rentals to a third party. Lessor would be no worse for the wear. It would receive exactly what it bargained to receive at state law. In addition, creditors of Lessee's estate would not have to divide their small pie into still smaller pieces to take into account a new unsecured claim. With luck, the pie might expand if Bank could sell its interest for more than the indebtedness owed.

As noted, limiting the consequences of § 365(d)(4) automatic rejection to breach protects the rights of third parties with interests in the leasehold. As presently constructed, § 365 does not protect such third parties. Some courts have taken the situation into their own hands. The leading rejection-is-breach opinion is *Eastover Bank v. Sowahee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874 (1994).

The rejection-as-breach doctrine has had a life of its own. Courts in the consumer context have used it to breathe life into what would otherwise appear to be moribund leases. See Part IX of these materials *infra*.

65. *Carrico v. Tompkins (In re Tompkins)*, 95 B.R. 722, 724 (9th Cir. B.A.P. 1989) (trustee has affirmative duty to investigate for unscheduled executory contracts and statutory presumption of rejection of such contracts not assumed within 60 days is conclusive); *Hoffman v. Vecchitto (In re Vecchitto)*, 235 B.R. 231, 236 (Bankr. D. Conn. 1999) (same); *Affordable Efficiencies, Inc. v. Bane (In re Bane)*, 228 B.R. 835, 840 (Bankr. W.D. Va. 1998) (same), *aff'd mem.*, 182 F.3d 906 (4th Cir. 1999) (table).

66. At least one court has said § 365(d)(4) does not apply in a Chapter 13 case because (d)(4) speaks about the trustee and in Chapter 13 cases, it is the debtor who assumes and rejects because only the debtor can propose a Chapter 13 plan. See *In re Flugel*, 197 B.R. 92 (Bankr. S.D. Cal. 1996) and

(continued...)

executory contracts and unexpired leases rejected if action is not taken by a certain time. Moreover, assumption requires an affirmative act, either the debtor's separate motion to assume in advance of a plan or a plan provision proposing assumption, followed by court approval. In terms of time, § 365(d)(2) authorizes the "trustee" to

assume or reject an executory contract or unexpired lease of residential real property or of personal property . . . at any time before confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.⁶⁷

Thus, with the exception of nonresidential real estate leases in which the debtor is the lessee, the Chapter 13 debtor has until plan confirmation to decide whether to assume or reject unless the court, in response to a nondebtor party's request, fixes an earlier moment in time. Absent any action by anyone, it would appear that the contract or lease is neither assumed nor rejected in a confirmed Chapter 13 case. Presumably, as in Chapter 11 cases, such contracts and leases "ride through" bankruptcy unaffected.⁶⁸ The nondebtor party does not have a claim for bankruptcy purposes, and therefore does not participate in any way, e.g., receive a distribution. In addition, the contract is binding on the debtor despite the bankruptcy discharge.

We could not find any Chapter 13 case on point. (Maybe that is because most Chapter 13 plans address the issue and expressly provide for rejection of all executory contracts and leases not assumed?) The situation is only rarely addressed in the Chapter 11 case law. We discuss

66. (...continued)
discussion in Part III *supra*.

67. 11 U.S.C. § 365(d)(2) (1998).

68. See, e.g., *Phoenix Mutual Life Insur. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1281 (5th Cir.) ("A debtor in Chapter 11 must either assume or reject its leases with third parties If it does neither, the leases continue in effect and the lessees have no provable claim against the bankruptcy estate), *cert. denied*, 506 U.S. 821 (1992); *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996) (unexpired lease or executory contract may be treated in four ways: it may (1) be rejected, (2) be assumed and retained, (3) be assumed and assigned, or (4) "ride through" the bankruptcy process); cf. *National Labor Relations Bd. v. Bildisco & Bildisco*, 465 U.S. 513, 546 n.12 (1984) ("in the unlikely event that the contract is neither assumed nor rejected, it will 'ride through' the bankruptcy proceeding and be binding on the debtor even after a discharge is granted. The non-debtor party's claim will therefore survive the bankruptcy proceeding.") (Brennan, J., concurring & dissenting).

an opinion involving an individual Chapter 11 case on the assumption that its reasoning would apply if a comparable fact pattern were to arise in a Chapter 13 context. The lesson to be learned is more for the nondebtor party than the debtor.

In *In re Col*,⁶⁹ the debtors, husband and wife, began their bankruptcy journey in Chapter 11. Before filing, they had entered into agreements to lease four vehicles including two BMWs. The debtors did not seek to assume or reject their lease agreements during administration of the Chapter 11 case nor did the leasing company move to compel their assumption or rejection. The debtors obtained confirmation of their plan, but the case converted to a Chapter 7 when they failed to consummate it. The lessor sought an administrative claim of \$17,140 on the two BMWs, representing accumulated unpaid monthly lease payments.

The court noted that the lessor's claim was only entitled to administrative expense status if the leases had been assumed or the estate had benefitted from the use of the vehicles.⁷⁰ The court explained that even though § 1123(b)(2)⁷¹ permits a Chapter 11 plan to propose assumption of an unexpired lease, that right is subject to § 365.

[T]he trustee's power under section 365(a) . . . is not absolute but rather is "subject to court approval." Thus, what the plan proposes with respect to assumption, assignment or rejection of executory contracts is not necessarily what the court will determine to be permissible. Section 1123(b)(2) is permissive. The plan may provide for the assumption or assignment of an executory contract. On the other hand, the contract may "ride through" the plan as unaffected.⁷²

The court concluded the leases were never assumed because she never "had the opportunity to pass on the issue of whether assumption would benefit the estate,⁷³ and never authorized assumption." Because the lessor did not even allege, let alone prove, that the BMW leases had benefitted the estate, the court denied its request for an administrative claim.⁷⁴

69. 189 B.R. 40 (Bankr. S.D.N.Y. 1995).

70. *Id.* at 46.

71. 11 U.S.C. § 1322(b)(7) is the Chapter 13 analogue.

72. *Cole*, 189 B.R. at 46.

73. *Id.*

74. *See id.* But see *In re Frady*, 141 B.R. 600, 603 (Bankr. W.D.N.C. 1991) (debtor must assume or reject rent-to-own contract and creditor entitled to administrative expense claim for unpaid

(continued...)

Presumably, the Chapter 13 nondebtor party to an unassumed, unrejected executory contract or unexpired lease would suffer a similar fate, but that result is not inevitable. At the very least, nondebtor parties should read the debtor's plan and object to its confirmation if it does not provide for their contract or lease. The nondebtor party can also move the court to compel the debtor to decide in advance of confirmation. Both the debtor and the nondebtor party have the power to effect closure here.

Even in a Chapter 7 case, the nondebtor party can find itself out of luck. In *Maupin v. Franklin Equity Leasing Co. (In re Maupin)*,⁷⁵ the Chapter 7 trustee abandoned the debtor's car lease. The debtor, apparently without objection from the lessor, continued to use the car from the petition date, February 19th, until he surrendered it to the lessor on August 20th. The debtor received his discharge on June 23. The lessor sued the debtor in state court to recover for the debtor's postpetition use of the vehicle. The debtor brought an adversary proceeding in bankruptcy court alleging a violation of the discharge order.

The court concluded the lessor had violated the discharge order by seeking to enforce a discharged debt. It reasoned as follows. Because the trustee abandoned the vehicle as an asset of the estate, the lease was deemed rejected pursuant to § 365(d)(1). Rejection constitutes a breach of the lease, giving rise to a prepetition claim for damages. That claim includes the loss of rent for the remainder of the lease term. As a prepetition claim, § 727(b) discharged it. Consequently, the lessor's attempt to collect for the debtor's postpetition use of the vehicle violated § 524(a)(2)'s permanent injunction. *Maupin* has a clear moral for nondebtor lessors: Do not allow a Chapter 7 debtor to retain possession and use of your property absent a valid reaffirmation agreement.

Another analysis is possible and we think preferable, namely, a debtor's postpetition, postrejection use gives rise to a postpetition claim in favor of the lessor against the debtor, not the estate. As such, the lessor's claim is not affected by the debtor's bankruptcy discharge.

One thing is clear. The position and rights of lessor and debtor post-rejection/abandonment in a Chapter 7 are nebulous at best.

74. (...continued)
postpetition rental payments).

75. 165 B.R. 864 (Bankr. M.D. Tenn. 1994).

V. EFFECT OF CONVERSION ON RIGHT TO ASSUME & TIME PERIODS

Section 348 defines the effects of conversion. According to its general rule, even though conversion constitutes an order for relief under the chapter to which the case is converted, that does not alter the date the petition was filed, the date the case was commenced or the date of the (original) order for relief.⁷⁶ Section 348(c) states an exception to that rule. For purposes of § 365(d), the conversion order constitutes the order for relief, i.e., the date of the conversion order is the date of the order for relief for purposes of the § 365(d) deadlines. The legislative history tells us that "the time the trustee (or debtor in possession) has for assuming or rejecting executory contracts recommences, thus giving an opportunity for a newly appointed trustee to familiarize himself with the case."⁷⁷

Does this mean the § 365(d) clock starts ticking all over again if the case converts from one chapter to another? Not exactly or rather, not always.

A. FROM CHAPTER 7 TO CHAPTER 13

A Chapter 13 plan may, "subject to section 365 of this title, provide for assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor *not previously rejected under such section*."⁷⁸ This means a debtor *cannot* assume a contract or lease in her converted Chapter 13 if the lease or contract was rejected under § 365 in the Chapter 7 proceeding. For example, in *Affordable Efficiencies, Inc. v. Bane (In re Bane)*,⁷⁹ the Chapter 7 trustee did not, within 60 days after the order for relief, move either to assume the nonresidential lease or to extend the time to decide. When the debtor later converted to Chapter 13, the lessor sought relief from the stay. The debtor-lessee opposed, arguing that upon conversion, a new 60-day period began to run.

The court disagreed. Section 365(d)(4) gives the trustee 60 days to assume or reject or to extend the time to decide. If the trustee fails to act during that time, whatever the reason, the lease is deemed rejected.

76. 11 U.S.C. § 348(a) (1998).

77. Notes of Committee on the Judiciary, SEN. REP. No. 95-989.

78. 11 U.S.C. § 1322(b)(7) (1998).

79. 228 B.R. 835, 840 (Bankr. W.D. Va. 1998), *aff'd mem.*, 182 F.3d 906 (4th Cir. 1999) (table).

Given the plain language of the statute, and absent a motion for extension prior to expiration of the 60-day period, this Court does not have the authority to extend the rejection period once the period has run. In the case at bar, the 60-day period ran before the conversion to [C]hapter 13. Therefore, the lease was deemed rejected and conversion to [C]hapter 13 did not give either the Debtor or the [C]hapter 13 trustee a new 60-day period to assume or reject.⁸⁰

As several courts have noted, "in virtually every Chapter 7 no-asset case the trustee realizes no benefit from assuming the debtor's residential lease, and thus in virtually every Chapter 7 no-asset case, the residential lease is deemed rejected after the requisite 60-day period."⁸¹

Assume the debtor petitions for Chapter 7 relief. Sixty days comes and goes with no action at all regarding any unexpired lease or executory contract. At that point, the debtor informs you about her residential lease and her desire to keep it. Is all lost? Maybe not.

In *Westgate Village Apts. v. Sims (In re Sims)*,⁸² the debtor had filed a Chapter 7 petition in 1996 in response to her landlord's action to repossess the premises. Prior to and after her Chapter 7 petition, the debtor "failed to make her rent payments of \$2.00 a month."⁸³ The order granting the lessor relief from the stay provided that the lease "was

80. *Id.* at 841; see also *In re Sheard*, 1999 WL 454260 at *4 (Bankr. E.D. Pa. June 24, 1999) ("[T]he debtor controls the chapter under which she files. Thus, if it is the debtor's intention to retain the property, she will file under Chapter 13 (or convert to Chapter 13 prior to the sixty day deadline) which gives her the ability to assume her executory contract or lease."); *U.S.A. for Veterans Admin. v. Benson (In re Benson)*, 76 B.R. 381 (Bankr. D. Del. 1987) (trustee's failure to act in Chapter 7 resulted in deemed rejection of residential lease and once rejected, debtor could not assume it in her subsequent Chapter 13 plan); 2 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 8.27, at 8-51 (1993) ("conversion does not resurrect the rights that the debtor lost during the Chapter 7 case. For example, if the debtor's right to assume an executory contract expired during the Chapter 7 case, conversion to Chapter 13 does not renew the lost opportunity."); cf. *In re Weinstock*, 1999 WL 260960 (Bankr. E.D. Pa. April 27, 1999) (No. 96-31147DWS) (debtor cannot re-reject executory contract in his superseding Chapter 13 case so as to transform nondebtor party's claim for postpetition payments to prepetition, unsecured status).

81. *Sheard* at *3; *Westgate Village Apts. v. Sims (In re Sims)*, 213 B.R. 641, 643 (Bankr. W.D. Pa. 1997); *In re Touloumis*, 170 B.R. 825, 828 (Bankr. S.D.N.Y. 1994) (residential lease, while theoretically asset of estate, is not one that Chapter 7 trustee will generally assume and assign; therefore, lessor is entitled to stay relief to continue eviction proceedings because such proceeding usually has no discernible impact on bankruptcy case). The *Sheard* court found some consolation in knowing that a debtor can control the situation and seek Chapter 13 relief if he or she wants to retain a contract or lease (and is properly advised).

82. 213 B.R. 641 (Bankr. W.D. Pa. 1997).

83. *Id.* at 642. "\$2.00 a month" is not a typo. The lease was subsidized and based on income.

deemed rejected insofar as this Chapter 7 bankruptcy estate is concerned.⁸⁴ The debtor received her discharge on October 4, 1996. A few months later, in April of 1997, a state court proceeding resulted in an order in favor of the landlord. Eviction was scheduled for May 15, 1997. The debtor filed a Chapter 13 petition on May 12, 1997.

The landlord maintained that it was entitled to relief from the stay because the prior court order in the Chapter 7 case had terminated the debtor's interest in the lease. According to the court, the landlord was quite mistaken. Granting a lessor relief from the stay does not *terminate* a debtor's interest in a lease nor does rejection, whether it occurs by motion or operation of law. Rejection constitutes breach, entitling the nondebtor party to damages. Turning to the Code, the court noted that a debtor has until plan confirmation to assume or reject a lease of residential real estate according to § 365(d)(2). Section 1322(b)(7) permits its assumption in the plan unless it was previously rejected under § 365. The lease had not been rejected in the Chapter 13 case because the court had not confirmed a plan or authorized rejection outside of it. The only remaining question was "whether under 11 U.S.C. § 1322(b)(7), Debtor may assume the lease inasmuch as it was rejected in her prior Chapter 7."⁸⁵

The court began its analysis of this question by looking at practice under the Bankruptcy Act, concluding that it "would establish that, once the lease was rejected in the Chapter VII, it could not be assumed later in the same case. The Bankruptcy Code of 1978 did not change this. Thus, we conclude that rejection is final for purposes of § 1322(b)(7) *only with respect to the particular case in which the contract was rejected.*"⁸⁶ But, explained the court, here the Chapter 7 case was

prosecuted to conclusion, a discharge entered and the case was closed. Because the lease was rejected by the estate in the [C]hapter 7, it reverted to Debtor. When she later filed this [C]hapter 13 case, her property and possessory interests in the lease became property of this [C]hapter 13 estate. The rejection in the [C]hapter 7 did not affect Debtor's ability to assume or reject the lease under § 1322(b)(7) in the second case. The date of filing of the [C]hapter 13 is the relevant date by which to measure what

84. *Id.* at 643.

85. *Id.* at 643.

86. *Id.* at 644.

constitutes property of this estate. The lease remained viable on the filing date, despite [the lessor's] assertion to the contrary and, therefore is property of the estate.⁸⁷

The court concluded the debtor could assume the lease in her Chapter 13 case if she could cure her defaults.⁸⁸ The court was not troubled by its conclusion, given that the relevant state law permitted lessees to cure their defaults and remain in possession until the very moment of actual eviction.⁸⁹

The *Sims*' debtor's Chapter 20⁹⁰ protected her right to assume her lease. The court's reasoning would also serve to "preserve" the right to assume if the debtor were able to obtain dismissal of the Chapter 7 case and refile under Chapter 13. Debtors who find themselves on the other side of the 60-day period with a lease they forgot to mention should try either a Chapter 20 or request dismissal of the Chapter 7 case and file a Chapter 13 petition.

Judge Lundin observes:

The most common executory contract for a Chapter 13 debtor is an apartment lease. Sometimes the debtor's apartment lease is a major asset of the estate—especially when the debtor is living in government-subsidized housing and has a very favorable lease. All too often, debtors' counsel do not think of an apartment lease as a necessary part of the Chapter 13 plan.⁹¹

Even more fundamentally, apartment leases are apparently not on some debtor's counsel's radar screens at all. If the lease is important to the debtor, valuable, *e.g.*, it is a subsidized lease, the debtor will almost surely lose it in a Chapter 7 case. A Chapter 7 debtor's only hope to retain it is a reaffirmation agreement and that requires the lessor's consent. The case law suggests lessors would rather eat ground glass. The debtor should seek Chapter 13 relief. Assumption does *not* require

87. *Id.*

88. *Id.* at 644 n.7.

89. *Id.* at 643, n.6. Because the debtor had failed to timely recertify her eligibility for the rent subsidy, it was possible that she would have had to pay the market rate of rent for the period during which she was not certified. If so, she conceded cure was not feasible. The court refused to speculate on the future, presumably because "sufficient unto the day is the evil thereof." *Id.* at 645.

90. A decision to file a Chapter 7, followed immediately thereafter by a Chapter 13.

91. LUNDIN, *supra* note 36, § 4-87, at 4-189.

the nondebtor party's consent and in a Chapter 13, unlike a Chapter 7, the debtor *can* assume.

B. FROM CHAPTER 13 TO CHAPTER 7

The situation going in reverse is not nearly as complicated. The 60-day period starts anew as of the time the case is converted from a Chapter 13 to a Chapter 7 unless the debtor has rejected or assumed the contract or lease in the Chapter 13 (or Chapter 11). Because assumption is unlikely to occur before confirmation, and most cases convert because a plan cannot be confirmed, the Chapter 7 trustee will have a 60-day period to decide in most cases.⁹² As one court explained, "the unexpired lease must be assumed within 60 days of the *order for relief* [W]hen a case under one chapter is converted to a case under another chapter, the conversion of the case constitutes an order for relief."⁹³

VI. NONDEBTOR'S RIGHTS

A. DURING POSTPETITION, PRE-REJECTION, PRE-ASSUMPTION PERIOD

Every school child knows that rejection of an unassumed executory contract or unexpired lease relegates the nondebtor party to a prepetition claim for damages.⁹⁴ Usually, that prepetition claim is unsecured. What is the nondebtor party's situation during the time that the debtor has to decide whether to assume or reject?

It all depends on who the nondebtor party is. Lessors of commercial (nonresidential) real estate are entitled to timely performance of all postpetition obligations.⁹⁵ No hearing is necessary to authorize payment of their administrative expense claim.⁹⁶ In addition, commercial lessors hold a claim "measured by the rent set forth in the lease rather than the

92. The exception concerns commercial leases in which the debtor is the lessee. Section 365(d)(4) requires action within 60 days after the petition in any relief chapter or the lease is deemed rejected.

93. *Carrico v. Tompkins (In re Tompkins)*, 95 B.R. 722, 723 (9th Cir. B.A.P. 1989) (emphasis added).

94. 11 U.S.C. §§ 365(g)(1), 502(g) (1998).

95. *Id.* § 365(d)(3).

96. *In re Brewer*, 233 B.R. 825, 829 (Bankr. E.D. Ark. 1999) (majority view is commercial lessor is entitled to allowance of administrative claim for rent without § 503 demonstration of benefit to estate); *In re Brennick*, 178 B.R. 305, 307 (Bankr. D. Mass. 1995).

property's fair market value,⁹⁷ or the value of the benefit conferred on the estate by its use.

The one source of disagreement lies in whether § 365(d)(3)'s timely performance requires immediate payment even if that would create a de facto priority for the commercial lessor at the expense of other administrative claimants.⁹⁸ In 1994, Congress gave comparable rights and protection to lessors of personal property "*other than personal property leased to an individual for personal, family or household purposes.*"⁹⁹

Where does that leave nondebtor lessors of consumer goods and residential real estate? From their perspective, in the Dark Ages. A hearing is necessary to establish they hold an administrative expense claim. The amount of their administrative claim, if any, will reflect the value of the benefit the estate derived from using their property. So, for example, what value would a Chapter 7 estate derive from a debtor's residential lease? Not much and that would translate into an administrative claim in favor of the lessor equal to "not much."

What about the nondebtor residential real property lessor in a Chapter 13 case? One court explained:

There is an apparent scarcity of case law discussing administrative expense priority for post-petition rent of residential premises in a Chapter 13 case (other than where an unexpired lease was first assumed and later rejected). This lack of authority is not surprising. In a Chapter 13 case, the amount of unpaid post-petition rent is typically so small that the parties either reach a compromise or abandon the claim, thereby avoiding litigation over the issue.

97. *Brennick*, 178 B.R. at 307.

98. See, e.g., *In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992) (declining to order payment if that would create priority); *In re Virginia Packaging Supply Co., Inc.*, 122 B.R. 491 (Bankr. E.D. Va. 1990) (same); *In re Almac's, Inc.*, 167 B.R. 4 (Bankr. D.R.I. 1994) (payment ordered subject to disgorgement to extent necessary to provide same dividend to other administrative claimants of equal rank); *In re Buyer's Club Mkts., Inc.*, 115 B.R. 700 (Bankr. D. Colo. 1990) (same); *In re Flugel*, 197 B.R. 92, 95 (Bankr. S.D. Cal. 1996) (statute requiring debtor to perform all obligations of unexpired, nonresidential lease while deciding to assume or reject is designed to insure payment of rent during decision period) (Chapter 13) (dictum); *In re Brennick*, 178 B.R. 305, 308 (Bankr. D. Mass. 1995) (statutory command to timely perform "must be obeyed even though to do so grants a priority as a practical matter"); *In re Telesphere Communications, Inc.*, 148 B.R. 525, 529-31 (Bankr. N.D. Ill. 1992) (it would be strange if commercial lessors, the object of Congressional concern, received less favorable treatment than postpetition suppliers who routinely receive full payment).

99. 11 U.S.C. § 365(d)(10) (1998) (emphasis added).

Although the Bankruptcy Code does not expressly prevent allowance of a claim for post-petition rent of residential property in a Chapter 13 case as an administrative expense, it is difficult to envision a situation where such a rental expense would qualify as an actual and necessary cost of preserving the bankruptcy estate as required by Section 503(b)(1)(A).¹⁰⁰

Presumably the court's reasoning would extend to personal property leases as well and it would not recognize an administrative expense claim for the lessor of the Chapter 13 debtor's refrigerator or sofa.

It is easy to understand why postpetition, postrejection rental payments on a debtor's refrigerator would not qualify for administrative expense status in Chapter 7. The expense is not an actual or necessary cost to preserve the bankruptcy estate. Indeed, postrejection, leased property is no longer part of the estate and hence its retention and use (by the debtor) can hardly be seen to benefit the *estate* and the debtor's creditors.

But in Chapter 13, there is no sharp line between the debtor and the bankruptcy estate. In many instances, what is good for the debtor is good for the estate. The benefit to the debtor *benefits* the debtor's creditors as well. For instance, the debtor's ability to use (lease) a car enables the debtor to get to work. The debtor's ability to work provides a source of income from which the debtor can pay all his or her creditors. Some Chapter 13 postpetition expenses will increase the return to all creditors. If so, shouldn't such expenses, if reasonable, be entitled to administrative expense status? We doubt the last word has been written on this issue.

Regardless, the limbo period is relatively short for lessors of residential real property and consumer goods. In a Chapter 7, *all* executory contracts and leases of whatever religious denomination are deemed rejected 60 days after the petition unless the court, for cause, extends the period to decide.¹⁰¹ In a Chapter 13, the time to propose a plan is relatively short.¹⁰² Resolution (confirmation or not) typically occurs within months, not years, thereby limiting (although not eliminating) the nondebtor party's exposure to loss.

100. *In re Scott*, 209 B.R. 777, 783 (Bankr. S.D. Ga. 1997).

101. 11 U.S.C. § 365(d)(1), (d)(4).

102. FED. R. BANKR. P. 3015(b) (if plan not filed with petition, it must be filed within 15 days thereafter "and such time may not be further extended except for cause shown and on notice as the court may direct.").

B. WHEN ASSUMED AGREEMENT IS BREACHED

After much wailing and gnashing of teeth, most courts now seem to agree that a nondebtor's claim for damages resulting from breach ("rejection") of an *assumed* lease or executory contract is entitled to administrative expense status.¹⁰³

The court in *Case Credit Corp. v. Baldwin Rental Centers, Inc. (In re Baldwin Rental Centers, Inc.)*¹⁰⁴ provides a sensitive, thoughtful discussion of the issue. The debtor in *Baldwin* entered into 14 equipment lease agreements with the lessor. The debtor's business plan was to sublease the equipment to its customers at a higher price so it could meet its rental obligations and still make a profit. The debtor was unable to generate sufficient income to stay current on its lease payments and it petitioned for Chapter 11 relief on August 20, 1997. On January 7, 1998, the court entered a consent order allowing the Debtor in Possession (DIP) to assume 5 of the 14 leases and to reject the others. A little over a year later, the DIP rejected the assumed leases.

The lessor requested the court to give its damages claim—future rent owed under the breached, assumed leases—administrative expense status. The debtor opposed the request, arguing that the future rents did not confer any benefit on the estate and, therefore, they could not qualify for administrative expense priority.

The court saw no way out of the conclusion that sections 365(g)(1), (g)(2) and 502(g) establish Congress' intent to treat damages arising from breach of an assumed lease differently from damages arising from rejection of an unassumed lease. Whereas § 365(g)(1) deems breach of an unassumed lease to occur immediately before the filing, § 365(g)(2) deems breach of an assumed lease to occur at the time of rejection, *i.e.*,

103. See, e.g., *Nostas Assocs. v. Costich (In re Klein Sleep Prods., Inc.)*, 78 F.3d 18 (2d Cir. 1996); *In re Monica Scott, Inc.*, 123 B.R. 990 (Bankr. D. Minn. 1991); *In re Pearson*, 90 B.R. 638, 645 (Bankr. D.N.J. 1988) (section 365, in particular, § 365(g)(2), applies to Chapter 13 proceedings and debtor's rejection of previously assumed lease gives rise to administrative claim in lessor for full amount of damages caused by breach); *Samore v. Boswell (In re Multech Corp.)*, 47 B.R. 747, 750-51 (Bankr. N.D. Iowa 1985) (filing of petition creates DIP, a new juridical entity distinct from prepetition debtor: DIP's assumption of executory contract is an act of administration creating an estate obligation. It presupposes a direct transaction with DIP and DIP's subsequent rejection causes legally cognizable injuries entitled to administrative expense priority). *But see In re Johnston*, 164 B.R. 551, 555 (Bankr. E.D. Tex. 1994) (awarding administrative expense claim for loss of future rents would contradict § 503(b)'s intent by unjustly enriching lessor and possibly eliminating any distribution to unsecured creditors).

104. 228 B.R. 504 (Bankr. S.D. Ga. 1998).

postpetition. Section 502(g) treats claims based on rejection of unassumed leases as prepetition claims. It says nothing about claims based on rejection of an assumed lease. The court interpreted § 502(g)'s silence as a manifestation of Congress' intent to treat claims arising from rejection of assumed leases as administrative expenses.

In response to the debtor's assertion that claims for future rents do not confer a benefit on the estate and giving them administrative expense priority might undermine reorganization attempts, the court almost seemed to sigh. It acknowledged that Congress probably "never contemplated the hardship that such damages inflict."¹⁰⁵ It went on to articulate the Second Circuit's reasoning in *Klein Sleep*. Essentially, the Second Circuit found the benefit to the estate in the act of assumption itself. With assumption, "[b]oth the debtor and the court have determined that the entire lease, complete with any burdens it may pose, benefits the estate. The DIP cannot then seek to avoid those burdens when 'the deal turn[s] sour.'"¹⁰⁶ Moreover, the promise of administrative expense status encourages creditors to deal with debtors during their reorganization attempts. And a successful reorganization maximizes "the value of the estate for the benefit of all creditors."¹⁰⁷

The court, very reluctantly, joined ranks with the clear majority view because the Code's plain language "require[s] all liabilities flowing from the rejection of an assumed lease to be accorded administrative expense priority."¹⁰⁸

VII. WHAT CONSTITUTES PROMPT CURE

Debtors who want to retain favorable executory contracts and leases have the opportunity to assume them in a Chapter 13. Assumption, according to § 365(b)(1)(A), requires cure of prepetition monetary defaults or adequate assurance of *prompt* cure. Section 1322(b)(5) says a Chapter 13 plan can "provide for the curing of any default *within a reasonable time . . .*" In the context of mortgage arrearages, courts have allowed debtors to cure over the life of their plans. Do debtors have the life of their plan to cure prepetition arrearages owed under a personal property lease or lease of residential real estate? Most courts, struggling

105. *Id.* at 511.

106. *Id.* at 512 (quoting *Klein Sleep*, 78 F.3d at 26).

107. *Id.* at 511.

108. *Id.* at 512.

with the interplay between §§ 365(b)(1)(A) and 1322(b)(5), have concluded that "prompt cure" means something significantly shorter than the three-to-five year life of the plan.¹⁰⁹

In *In re Reed*,¹¹⁰ the debtors' plan proposed to cure the prepetition arrearages on their car lease over an 18-month period. They argued this was "reasonable under the circumstances," given the practice in the Kentucky bankruptcy court of allowing up to 24 months to cure.¹¹¹ The court rejected the argument, distinguishing between cure of arrearages on long-term debt and that required for a personal property lease. It announced five considerations it would use in the future to evaluate the reasonableness of the proposed cure period: 1) the nature of the property; 2) the terms of the lease; 3) the amount of arrearages; 4) the remaining length of the lease term; and 5) how the debtors proposed to cure the lease. For consumer car leases, it announced a rebuttable presumption of a maximum six month cure period.¹¹²

Courts apply similar restrictions when considering what constitutes a "prompt" cure of arrearages under real estate leases. Thus, one court held that, absent unusual circumstances, six months was the maximum permissible cure period.¹¹³

A proposal to cure within six months or less is perfectly reasonable for car leases whose term can extend as long as four years and realty leases whose duration is generally one year or longer. What about rent-to-own (RTO) agreements under which the renter can choose every month (or even every week) whether or not to renew.¹¹⁴ As a matter of logic, one would think courts would impose a shorter time, perhaps requiring cure within the first month of the plan. But an Alabama court, in *In re Trusty*, concluded a 12-month cure period "is most certainly prompt" in

109. If the default is *postpetition*, the debtor must cure the default in one lump sum at the time of assumption. *In re Hall*, 202 B.R. 929 (Bankr. W.D. Tenn. 1996).

110. 226 B.R. 1 (Bankr. W.D. Ky. 1998).

111. *Id.* at 2.

112. *Id.* Cf. *In re French*, 131 B.R. 138, 140 (Bankr. E.D. Mo. 1991) (plan provision to cure default in 6 months presumptively prompt); *Bajardi v. Daugherty (In re Daugherty)*, 102 B.R. 167 (Bankr. E.D. Mo. 1989) (one year to cure arrearages under car lease too long); *General Motors Acceptance Corp. v. Lawrence*, 11 B.R. 44 (Bankr. N.D. Ga. 1981) (same).

113. *In re Morgan*, 181 B.R. 579, 587-88 (Bankr. N.D. Ala. 1994); cf. *In re DiCamillo*, 206 B.R. 64, 72 (Bankr. D.N.J. 1997) (cure over 4-year period not prompt); *In re Flugel*, 197 B.R. 92, 97 (Bankr. S.D. Cal. 1996) (cure over 10-year period not prompt!); *In re Yasin*, 179 B.R. 43 (Bankr. S.D.N.Y. 1995) (cure over 6 month period reasonable); *In re Liggins*, 145 B.R. 227, 231 (Bankr. E.D. Va. 1992) (cure over 4-year period not prompt).

114. For a discussion of RTOs, see *infra* Part VIII.

connection with an RTO.¹¹⁵ To further confuse matters, only a year before, the same judge had ruled that 6 months was the presumptive limit for cure in a Chapter 13.¹¹⁶

In reaching this surprising conclusion, the *Trusty* court opined that because “[p]rompt” is not defined in the Bankruptcy Code . . . a court is not required to define it in terms of . . . the length of the past or expected relationship of the parties.”¹¹⁷ The next paragraph of the opinion revealed what was really driving the court’s decision:

If [C]hapter 13 is to provide an effective means for debtors to reorganize, it must provide for the temporary retention by the debtors of personal property to aid in that reorganization. Section 365 was created to fulfill that fundamental requirement. While some items subject to rent-to-own agreements may not be necessary for the ultimate reorganization of a debtor, the opportunity to maintain the status quo, even on a temporary basis, may give a financially troubled debtor the break needed to succeed with a [C]hapter 13 plan. While a debtor may not maintain a “renter’s” relationship with a merchant for the entire 12 month cure period, the bankruptcy relationship that exists for this period is necessary for a successful reorganization.¹¹⁸

The imprecise nature of the term “prompt” permitted the court to strike a blow in favor of helping debtors succeed in their Chapter 13 plans. The court’s expansive view of “prompt” gave debtors in RTO relationships the opportunity to keep property in the short term without paying all prepetition arrearages owed.

*Prudential Investments Co. v. Physique Forum Gym, Inc. (In re Physique Forum Gym, Inc.)*¹¹⁹ stakes out a lonely position, holding that § 365 must “be read in conjunction with” § 108(b).¹²⁰ As a consequence,

115. 189 B.R. 977, 984 (Bankr. N.D. Ala. 1995).

116. *In re Morgan*, 181 B.R. 579, 587-88 (Bankr. N.D. Ala. 1994).

117. *Trusty*, 189 B.R. at 984 n.17.

118. *Id.*

119. 27 B.R. 691 (Bankr. D. Md. 1982).

120. Section 108(b) provides:

(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

(continued...)

a debtor must cure defaults no later than 60 days after commencement of the case or the period of cure in the contract, whichever is longer.¹²¹ Most courts do not read § 108(b) in that manner:

To the extent that the provisions of § 108(b) overlap with § 365 in the area of executory contracts, I find no conflict. Both sections operate independently and serve different functions. Section 108(b) has the very limited function of extending statutory and contractual term periods. Section 365, on the other hand, determines the rights and obligations of parties for assumption and rejection of executory contracts. The mere extension of time under § 108(b) does not, in any way, alter either the trustee's or creditor's rights under § 365 Most situations where § 108(b) extends time periods involve mortgage foreclosure and contract for deed cancellations. The detriment to the creditor resulting from the § 108(b) cure period in contract for deed cancellations, for example, is relatively minor if the trustee is unable to or elects not to cure the default.¹²²

Indeed, like most courts, the above court understands § 108(b) to expand rather than limit the trustee's rights under § 365.

Both *Trusty* and *Physique Forum* are anomalies. Generally, the case law establishes six months or less as a reasonable period of time to cure prepetition arrearages under a car or real estate lease.

Often, cure regarding a residential lease will involve significant amounts of money. In *In re Liggins*, it was over \$8,000.¹²³ The debtor's plan proposed payment of most lease arrearages as well as full payment of an unsecured educational loan. All other unsecured creditors would receive a 1% pay out. The Chapter 13 trustee objected to confirmation, arguing that the plan unfairly discriminated. The court sustained the objection. Although it was willing to recognize that a debtor could treat

120. (...continued)

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.

11 U.S.C. § 108(b) (1994).

121. *Physique Forum*, 27 B.R. at 693.

122. *Econo-Therm Energy Sys. Corp. v. Prudential Insur. Co.* (*In re Econo-Therm Energy Sys. Corp.*), 80 B.R. 137, 140-41 (Bankr. D. Minn. 1987).

123. 145 B.R. 227 (Bankr. E.D. Va. 1992).

her landlord's claim differently because a debtor needs a home for herself and her family, the court wanted the debtor to make some evidentiary showing "of the necessity . . . to pay the claim in full so that she may continue to occupy this particular apartment. The critical question will be whether there is such necessity that justifies a mere token payment of other unsecured debt."¹²⁴

VIII. RENT-TO-OWN CONTRACTS

Almost unknown 30 years ago, rent-to-own transactions (RTOs), sometimes called lease-purchase agreements, have become a major way to obtain goods—household furniture, appliances and electronic goods—for those unable to buy them because of their low income, poor credit or both. By 1997, RTOs had become a \$4.5 billion industry, with over 7,500 stores engaged primarily in RTO transactions serving 3.5 million customers.¹²⁵

Characterization of RTO agreements in bankruptcy is important. Assume Consumer goes into a store and sees a large screen TV he likes. Eager to watch the entire ACC basketball season at home rather than in a sports bar, he makes an RTO agreement with Store and takes the TV home. If Consumer, now Debtor, seeks bankruptcy relief, the court's characterization of the RTO agreement will affect the terms upon which he can retain the TV.

If the agreement is a "true lease" or an executory contract, he can keep it only if he cures all defaults (pays all arrearages) and assumes the contract. Essentially, he is bound by the bargain he struck. He is not so bound if his contract constitutes a security agreement. First, unless the TV is worth more than \$425, it is potentially exempt under the federal exemption scheme.¹²⁶ Even if Consumer's state has opted out, his state exemption statute will probably recognize an exemption right in the TV. If Store's security interest is avoidable, Debtor can keep the TV without more. Even if Store's security interest is valid, in a Chapter 7, Debtor can keep the TV by paying Store its value.¹²⁷ In a Chapter 13, he can keep the

124. *Id.* at 231.

125. Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates v. The Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L.J. 385, 385 & n.2 (1997).

126. See 11 U.S.C. § 522(d)(3) (1998).

127. See *id.* §§ 506(a) (allowed secured claim) & 722 (redemption).

TV by paying the creditor the amount of its secured claim plus interest over the life of the plan.¹²⁸

The true lease-security lease distinction is important outside of bankruptcy as well. Lessors enjoy greater rights than secured creditors in the event of lessee default. Lessors are not required to dispose of repossessed leased goods. They do not have to give the lessee notice of anything. They can sell leased goods and retain whatever profit they make. They are also not subject to the Truth in Lending Act or state usury statutes.¹²⁹

Although many variations exist, an RTO transaction goes something like this. Consumer rents a television for \$166.95 a month. According to the agreement, at the end of each month, she has the option of either renewing the agreement by paying another \$166.95, or returning the television to the store. If she faithfully pays for 18 months, she will become the proud owner of a television, paying a total of \$3005.10 for something probably worth less than \$1000.¹³⁰ The following is a typical RTO contract:

RENTAL PURCHASE AGREEMENT

Date: 12/28/95

RENTAL PURCHASE DISCLOSURES

1. RENTAL TERM: MONTHLY. . . .

Rental payments are due at the beginning of each term that you choose to rent the property. There are no refunds if you choose to return the property before the end of the term.

2. DESCRIPTION OF PROPERTY AND RENTAL RATES:

Category/Description	Mo. Rent
LR Suite/Ashley	59.00

128. See § 1325(a)(5)(b).

129. See Scott J. Burnham, *The Regulation of Rent-to-Own Transactions*, 3 LOY. CONSUMER L. REP. 40, 40-41 (1991).

130. These figures, except for the guesstimate about the value of the television, are taken from *In re Stellman*, 237 B.R. 759 (Bankr. D. Idaho 1999). Two of the debtor's other debts illustrate her place in the financial food chain: a 4-month loan for \$200 with an interest rate of 132.96% year, and a two week loan for \$200 with an interest rate of 533% per year. *Id.* at 763 n.10.

3. INITIAL RENTAL PAYMENT:

Your initial rental payment will include the following charges:

Rent	Delivery Charge	Total
59.00	5.00	64.00

....

5. COST OF LEASE:

If you choose to rent to own you must renew this lease for the following number of months or weeks:

15 Months \$59/mo. for a total cost of \$885.00

6. OUR ESTIMATED FAIR MARKET VALUE FOR THIS PROPERTY IS \$395.00

7. COST OF LEASE SERVICES:

If you renew this lease for the number of terms necessary to acquire ownership the cost of lease services will be \$490.

8. EARLY PURCHASE OPTION:

If you wish to purchase the rental property you may do so at any time by the payment of 55% of the remaining Cost of Lease calculated at that time.

....

TYPE OF TRANSACTION: THIS IS A RENTAL TRANSACTION.

You may use the property for the term of this lease. At your option, you may renew this lease. To do this, you must make a rental payment in advance for each term you wish to rent the property. The rental rates are shown above. Time is of the essence in this lease. There are no grace periods.

TERMINATION: You may voluntarily terminate this lease at the end of any term with no penalty. To do so, you must return the property and pay all rental payments and other charges due through the date of return.

....

TITLE, MAINTENANCE AND TAXES: We retain title to the property at all times and will pay any taxes which might be levied on the property.

You do not own the property unless you buy it or acquire ownership as provided by the terms of this lease. We will maintain the property in good working order as long as you rent it.

....

INTENT: You agree that by signing this lease your intent is to rent rather than purchase the property.

....

BY SIGNING THIS LEASE, YOU ADMIT THAT YOU HAVE READ IT, THAT YOU UNDERSTAND IT AND THAT YOU HAVE RECEIVED A SIGNED COPY OF IT. YOU ALSO ADMIT THAT YOU RECEIVED THE PROPERTY IN SATISFACTORY CONDITION.

WITNESS: /s/ Conger
LESSOR: Mr C's

RENTER: Lilla Lipton
CO-RENTER: Johnnie B. Jarrell¹³¹

Much litigation, both in and outside of bankruptcy, has focused on characterizing the true nature of a RTO transaction. Three lines of cases have emerged. One strand, a majority of courts, relies on § 1-201(37) of the U.C.C. to hold that RTO transactions are leases, not secured transactions. Another, relying on state RTO statutes, holds that RTO transactions are neither secured transactions nor leases. These courts treat RTO transactions as a species of executory contract. As a consequence, their conclusion offers little comfort to debtors because the debtor still has to assume the contract to retain the goods. Finally, a few courts, in and out of bankruptcy, have characterized RTO transactions as secured transactions.

*In re Frady*¹³² is representative of the cases holding an RTO transaction to be a true lease under U.C.C. § 1-201(37). In *Frady*, the debtors entered into two RTO agreements with the creditor. The first was for a VCR, the second for a washer. The agreement for the VCR called for 70 weekly payments of \$9.99, with the right at that time to buy the VCR for a purchase price of no more than \$89.91. The agreement for the washer called for 81 weekly payments of \$18.99, with the right to buy the

131. Mr. C's Rent To Own v. Jarrells (*In re Jarrells*), 205 B.R. 994, 995 (M.D. Ga. 1997).

132. 141 B.R. 600 (Bankr. W.D.N.C. 1991).

washer for a purchase price of no more than \$116.91. In both cases, the debtors could terminate the agreement at the end of any weekly term and have no obligations other than paying any back rent they might owe.

The debtors listed the creditor as a secured creditor and proposed a five year plan under which they would pay \$5.56 per month for the VCR and \$11.13 for the washer. Not surprisingly, the creditor objected to confirmation, arguing the RTO agreements were leases subject to assumption or rejection. The debtors countered that the agreements were "disguised sales."

The court made short shrift of the debtors' contentions. It announced a *per se* rule that an RTO agreement is a true lease. The court began by noting that § 1-201(37) defines "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation." Because the debtors had the right to terminate the RTO agreements at any time without further obligation, by definition, the agreements could not create a security interest, and had to be true leases.

The debtors also argued that the North Carolina Retail Installment Sales Act makes a terminable lease a sale if the lessee has an option to buy for nominal consideration. The court was, if anything, even less impressed with this argument. It noted that the statute defined "nominal consideration" as no more than 10% of the cash price of the goods at the time of the contract. In this case, the option purchase price for the VCR was \$89.91, and the cash price \$467.53. Similarly, the option purchase price for the washer was \$116.91, and the cash price \$709.25. Because the purchase price in both cases was greater than 10% of the cash price, the purchase price was not "nominal consideration," and neither agreement was a sale under the Retail Installment Sales Act.

The court therefore not only ordered the debtors to assume or reject the RTO agreements, but gave the creditor an administrative expense claim for unpaid postpetition rental payments.¹³³

Similarly, in *Powers v. Royce, Inc. (In re Powers)*,¹³⁴ the debtor entered into three RTO agreements for new and used household goods. The agreements provided for an initial two-week rental period. The debtor had no obligation to renew, but could choose to do so for additional two-week periods. The debtor could buy the goods in one of four ways: (1) immediately for cash; (2) anytime within 90 days for cash; (3) at a

133. *Id.* at 603.

134. 983 F.2d 88 (7th Cir. 1993).

sliding scale after the initial 90 days; or (4) for no additional consideration at the end of the contracts (the opinion did not state the total length of the contracts).

The debtor's Chapter 13 plan listed the creditor as secured, with a secured claim of \$1,000 (the value of the goods), and an unsecured claim of \$2,041. The creditor objected to confirmation, arguing the RTO agreements were leases which the debtor had to assume or reject. The bankruptcy court agreed with the debtor's characterization of the agreements as disguised installment sales. The district court, agreeing with the creditor, reversed. The Seventh Circuit affirmed the district court.

Like the court in *Frady*, the Seventh Circuit relied on § 1-201(37) of the U.C.C. to conclude that the debtor's power to terminate the RTO agreements at any time was enough to make the agreements true leases. Like *Frady*, it saw no need for further analysis.

Other courts have been uncomfortable with a *per se* approach to deciding whether an RTO agreement is a true lease rather than a security agreement. In *Mr. C's Rent To Own v. Jarrells (In re Jarrells)*,¹³⁵ the court found provisions common in both true leases and secured credit sales. The court noted that, after she made the last payment, the customer would own the property outright. In addition, both the store's name and the title of the contract, "rental-purchase agreement," supported the debtor's contention that the transaction was a disguised security interest.

On the other hand, at least as many factors suggested a "true lease." The debtor could return the property at the end of any rental period, giving her the right to terminate almost at will. Moreover, the lessor was responsible for maintaining the property, and paying any taxes due on it. Finally, the agreement itself expressly provided that the transaction was a lease rather than a purchase. Balancing these various factors, the court concluded that the agreements were true leases.

Several states have passed statutes specifically governing RTOs. In such situations, the RTO statute, not the U.C.C., governs. Such enactments may represent a legislative response to case law characterizing RTO agreements as disguised security agreements. For instance, in *In re Goin*,¹³⁶ a bankruptcy court in Idaho, relying on U.C.C. § 1-201(37), held an RTO transaction was a secured transaction because the lessees bore

135. 205 B.R. 994 (M.D. Ga. 1997).

136. 141 B.R. 730, 731 (Bankr. D. Idaho 1992).

the risk of loss, were responsible for paying the sales tax, were the beneficiaries of warranty provisions, and became the owners of the goods at the end of the agreement.

Seven years later, another Idaho bankruptcy court revisited the issue. The RTO in *In re Stellman*¹³⁷ was essentially identical to the one in *Goin*. The court felt compelled to conclude that the Idaho legislature had overturned *Goin* by passing the "Idaho Lease-Purchase Agreement Act."¹³⁸ According to the statute, "lease-purchase agreement"

means an agreement by a lessor and a consumer for the use of personal property by a consumer primarily for personal, family or household purposes, for an initial period of four (4) months or less that is automatically renewable with each payment after the initial period, but does not obligate or require the consumer to continue leasing or using the property beyond the initial period, and that permits the consumer to become the owner of the property.¹³⁹

The statute also expressly provided that § 1-201(37) of the Idaho U.C.C. did not apply to lease-purchase agreements¹⁴⁰. Based on this statutory command, the court concluded the debtor could not treat her RTO agreement as a secured transaction. Consequently, the court could not confirm her proposed plan, but the debtor was free to amend it once she decided whether to assume or reject the RTO agreement. The court was uncomfortable with the one-sidedness of RTO transactions, noting that the debtor had effectively paid annual interest of 132.96% on her obligation.¹⁴¹ Nevertheless, it declined to "hold that such agreements are *per se* unconscionable and unenforceable, or so unfair in genesis or impact that they must be judicially modified."¹⁴²

Alabama law underwent a similar transformation. In *In re Shelby*,¹⁴³ an Alabama bankruptcy court held that RTO transactions were disguised security agreements. The Alabama Legislature responded by enacting a statute rejecting the holding of *Shelby*. Under the statute, RTOs are neither true leases nor secured transactions. They are a kind of

137. 237 B.R. 759 (Bankr. D. Idaho 1999).

138. IDAHO CODE § 28-36-101 *et seq.* (1998).

139. *Id.* § 28-36-102(5).

140. *Id.* § 28-36-103(c).

141. *Stellman*, 237 B.R. at 763, n.10.

142. *Id.* at 764.

143. 127 B.R. 682 (Bankr. N.D. Ala. 1991).

hybrid beast, partaking of characteristics of both.¹⁴⁴ Even so, they are contracts and, as such, arguably subject to § 365. One court interpreting the Alabama RTO statute so held, concluding that RTO transactions were subject to assumption or rejection under § 365.¹⁴⁵ Like the Idaho court in *Stellman*, the court was uncomfortable with the result. It noted that it could not "say that the opinions different from the one this Court holds are not correct."¹⁴⁶ It also manifested its discomfort by allowing the debtors 12 months to cure any defaults if they chose to assume the contracts.¹⁴⁷

In states that have enacted legislation like that of Idaho and Alabama, RTOs do not fit within the traditional security interest/lease dichotomy. Still, they are contracts, and according to the case law, they are *executory* contracts, subject to assumption or rejection under § 365.¹⁴⁸ The courts seem to have reached that conclusion by a process of elimination rather than affirmative analysis: If an RTO is not a secured transaction or a lease, what else could it be but a contract? But *executory* contracts are a subset of the class of contracts. To say it is a contract is not to say it is an executory contract for bankruptcy purposes.

Is an RTO an *executory* contract? Does it meet the Countryman definition of a contract with material performance remaining on both sides at the time of the debtor's bankruptcy petition?¹⁴⁹ One reason courts hold a RTO transaction is not a secured transaction is the absence of any obligation on the debtor's part to renew the agreement. If the debtor has no continuing obligation to perform under an RTO, it is difficult to see how the agreement can qualify as an executory contract at least under the conventional definition.

If RTOs are not secured transactions, leases or executory contracts, what *are* they and what treatment should they receive? Each RTO agreement seems to represent a series of successive option contracts. The debtor has the right to keep the goods if he or she exercises the option to

144. *In re Trusty*, 189 B.R. 977, 981 (Bankr. N.D. Ala. 1995) ("bankruptcy courts in Northern District of Alabama recognize Alabama's rent-to-own statute exists in response to this court's opinion in *In re Shelby*, 127 B.R. 682 (Bankr. N.D. Ala. 1991)").

145. *Id.* at 980.

146. *Id.* at 981, n.7.

147. The normal period for cure of arrearages in personal property leases is six months. See discussion of cure, *supra* Part VII.

148. See, e.g., *Trusty*, 189 B.R. at 980.

149. Vern Countryman, *Executory Contracts in Bankruptcy*, Part 1, 57 MINN. L. REV. 439, 460 (1973) (executory contract is one "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other").

renew and thereby chooses to incur an obligation to pay for them for the next period of use. Some courts characterize option contracts as executory contracts.¹⁵⁰ Others view them as rights which pass to the estate and which the estate can exercise if it is in the estate's best interests to do so.¹⁵¹ The latter approach to RTOs would preclude debtors from retaining goods if they had missed prepetition payments. The failure to pay for past use would extinguish any future option to renew. Treated as executory contracts, they are assumable despite prior "defaults" so long as the Chapter 13 debtor cures those defaults within a reasonable period of time. Dodging or ignoring the "executoriness" bullet allows debtors to keep goods they otherwise would have to surrender. And that may assist the overall effort to help debtors rehabilitate financially. As one court observed, being able to "maintain the status quo, even on a temporary basis, may give a financially troubled debtor the break needed to succeed with a [C]hapter 13 plan."¹⁵²

A few courts have characterized RTO contracts as conditional sales contracts, giving rise to a security interest.¹⁵³ Although RTO statutes have overruled many of these cases, some remain good law. In general, these opinions are result-oriented in the extreme, with the courts intervening to protect consumers from over-reaching merchants (and themselves).

A good example is *In re Barnhill*,¹⁵⁴ involving a fairly standard RTO regarding a "home entertainment center." The original agreement provided for an initial term of one week, with the right to renew it for an additional 103 weeks. The debtor could terminate without penalty at any time by returning the system to the store. If the debtor made all 104 payments, she would own the center. She could also buy the center at any time by paying 55% of the remaining scheduled payments. She later entered into a similar agreement for a stereo set.

When the debtor petitioned for Chapter 13 relief, she listed the merchant as a secured creditor. The merchant objected to confirmation, arguing that the agreement was a true lease "regardless of the other aspects of the agreement" because a South Carolina statute governed

150. See, e.g., *In re A.J. Lane & Co.*, 107 B.R. 435 (Bankr. D. Mass. 1989); *Horton v. Rehbein* (*In re Rehbein*), 60 B.R. 436 (9th Cir. B.A.P. 1986).

151. See, e.g., *Unsecured Creditors' Comm. v. Southmark Corp.* (*In re Robert L. Helms Constr. & Dev. Co.*), 139 F.3d 702 (9th Cir. 1998) (en banc).

152. *In re Trusty*, 189 B.R. 977, 984 (Bankr. N.D. Ala. 1995).

153. UCC § 2-401(1).

154. 189 B.R. 611 (Bankr. D.S.C. 1992).

"consumer rental-purchase agreements." The court rejected the argument, concluding that § 1-201(37) governed the transaction because the rental-purchase statute did not expressly pre-empt the U.C.C.

In concluding the RTO agreement was a disguised security agreement, the court dismissed as inconsequential the debtor's right to terminate the agreement without penalty. It focused instead on: 1) the debtor's ability to buy the goods for no additional consideration; 2) the debtor's assumption of the risk of loss; and 3) the fact that the total payments significantly exceeded the value of the goods.

A few courts examining RTO agreements outside of bankruptcy have also held them to be disguised security agreements. In *Green v. Continental Rentals*,¹⁵⁵ the court concluded that RTO agreements were security agreements, as a matter of law, within the meaning of New Jersey's non-amended version of § 1-201(37). The court similarly concluded, as a matter of law, that the seller had violated the Truth in Lending Act as well as New Jersey's Retail Installment Sales Act and its Consumer Fraud Act.

Although litigation about the proper characterization of RTO agreements continues, the trend is clear. They are either leases or executory contracts, and hence subject to § 365, in the eyes of most courts. Only in those states that still have the pre-Article 2A version of § 1-201(37) or that lack a RTO statute, will a Chapter 13 debtor have a fighting chance to keep her goods by paying the RTO merchant their value plus interest over the life of a plan.

IX. ASSUMPTION OF RESIDENTIAL REAL ESTATE LEASES

In an era of plain meaning,¹⁵⁶ codifying the obvious can produce curious consequences. In 1984, at the prodding of the real estate lobby, Congress amended § 365 to preclude trustees from assuming leases of nonresidential real property that had "been terminated under applicable nonbankruptcy law prior to the order for relief . . ." ¹⁵⁷ At the same time, it amended § 541(b) to exclude from property of the estate any interest of a debtor-lessee under a nonresidential lease that had terminated

155. 678 A.2d 759, 765 (N.J. Super. Ct. Law Div. 1994).

156. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989).

157. 11 U.S.C. § 365(c)(3) (1998).

prepetition.¹⁵⁸ These amendments, along with others, were designed to protect commercial lessors.¹⁵⁹ These particular amendments were intended to stop courts from resurrecting dead leases, a miracle some courts had been accomplishing before breakfast. The amendments were successful in achieving their goal, but their goal was limited—to prevent courts from reviving *nonresidential* leases that had terminated prepetition. Section 365(c)(3) literally invites courts to perform mouth-to-mouth resuscitation on terminated *residential* leases. It is not surprising that some have accepted the invitation.

*In re Morgan*¹⁶⁰ is representative of the “toehold” theory of assumability. The debtor was the lessee of an apartment and behind on her rent. In her Chapter 13 plan, she proposed to assume the lease and pay the back rent. The lessor requested relief from the stay to bring an unlawful detainer action against the debtor at state law.

The court described (in painful detail) the Alabama procedures for terminating a lease and dispossessing the tenant. If a tenant refuses to leave following lease termination, the lessor must bring an unlawful detainer action, but cannot do so until 10 days after giving the tenant a notice to quit. The unlawful detainer complaint must be served on the tenant at least six days before trial. There are appeal periods if the court finds in favor of the lessor.

On June 30, 1994, after the tenant had missed her June rent, the lessor gave the tenant written notice of termination. On July 5, the lessor asked the tenant to surrender the premises within 10 days. (She did not pay the July rent.) The debtor petitioned for Chapter 13 relief on July 22. (She did not pay her August or September rent either.)

The lessor maintained the debtor could not assume the lease because it had been terminated prepetition at state law pursuant to its terms. The court explained that the lessor’s position was exactly right—for leases of *nonresidential* real property—but the lease in question was for residential real property. “The only qualification on the right of a Chapter 13 debtor to assume a residential real property lease, other than prompt cure and

158. *Id.* § 541(b)(2).

159. S. REP. NO. 65, 98th Cong., 1st Sess. 37 (1983); *In re Bernard*, 69 B.R. 13 (Bankr. D. Haw. 1986) (Congress amended § 365 in response to “heavy lobbying by . . . lessors . . . often frustrated by the long delay in regaining possession of their property.”).

160. 181 B.R. 579 (Bankr. N.D. Ala. 1994).

adequate assurance of future performance . . . is that the lease be '*unexpired*.'"¹⁶¹

The lessor maintained the lease *was* expired because "a lease expires once it has been terminated under state law."¹⁶² The court thought otherwise. If "expired" meant "terminated," § 365(c)(3) would be superfluous. A debtor can't assume an *expired* lease. The right to assume is limited to *unexpired* leases. Section 365 is captioned "Executory Contracts and *Unexpired* Leases." If "expired" and "terminated" are synonymous, then Congress did not need to enact §§ 365(c)(3) or 541(b)(2) because "by definition, a lease 'terminated under applicable nonbankruptcy law' could not be an 'unexpired lease.'"¹⁶³

According to the court, the terms have different meanings. "'Expire' means 'to come to an end,' while the word 'terminate' means 'to bring to an end.'"¹⁶⁴ "Expire" is an intransitive verb. "Terminate" is transitive. "Expire" in a contract or lease context means "termination by mere lapse of time, as the expiration date of a lease, insurance policy, statute, and the like."¹⁶⁵ The word "termination," on the other hand, in the same context, means,

an ending, usually before the end of the lease or contract, which termination may be by mutual agreement or may be by exercise of one party of one of his remedies due to the default of the other party [T]he word "expired" denotes the natural or inevitable end to a contract or lease by lapse of time, while the word "terminated" denotes the unnatural or premature end to a contract or lease as the result of breach or forfeiture. To hold that the two words are interchangeable would be to embellish the plain meanings of both words, in direct violation of the mandate of the Supreme Court . . . and to frustrate the purpose behind section 1322(b)(7)¹⁶⁶

161. *Id.* at 583 (emphasis added).

162. *Id.*

163. *Id.*

164. *Id.*

165. BLACK'S LAW DICTIONARY 579 (6th ed. 1990).

166. *Id.* at 584.

But, claimed the lessor, there was nothing left for the debtor to assume because "the lease was extinguished upon termination."¹⁶⁷ "Not so," replied the court, correcting the lessor's misperceptions regarding termination. Termination does not effect "some mystical disappearance of the lease which cannot be undone."¹⁶⁸ Until the state court enters a writ of restitution and no appeal is taken, reinstatement of the lease is not only possible but contemplated by the law. In fact, the court pointed out, the terms of the lessor's own lease established that the lease had life after termination. The lease provided:

If the lease is terminated by the Lessor for non-payment of rent, and the Lessee pays the rent and other charges and thus makes himself current, and remains or continues to be in possession of the leased premises or any part thereof, with the Lessor's consent, *this lease will be considered reinstated, and will have effect as though it had not been terminated.*¹⁶⁹

So, a lease that has terminated has not necessarily expired. Moreover, termination of a lease does not extinguish it. Consequently, a terminated lease remains assumable.

Did the court recognize any point in time beyond which a debtor could *not* assume a residential lease? The court noted two limitations: 1) the right does not extend beyond the lease term; and 2) it "presupposes some possessory nexus or toehold in the property. Once that possessory toehold is lost, no 'interest' exists to form the basis of an assumption under § 365."¹⁷⁰ A tenant loses its toehold when the writ of restitution is *executed*.

The court believed public policy was on its side. If consumer bankruptcy is to achieve its desired goal of giving debtors a fresh financial start, it must give them the ability to temporarily retain their dwellings. Congress enacted §§ 365 and 1322(b)(7) for that purpose. If the court were to adopt the lessor's position, those provisions would be of little use to most consumer debtors and that would substantially frustrate Chapter 13's ultimate aim. Moreover, an expansive reading of the right to assume residential leases provides "flexibility for those who rent to preserve their

167. *Id.*

168. *Id.* at 585.

169. *Id.* at 585 (emphasis added).

170. *Id.*

residences, the same as homeowners. Surely, Congress did not intend to protect homeowners while ignoring the plight of home renters."¹⁷¹ In addition, according to the court, between the requirement for prompt cure and adequate assurances of future performance, the Code provides lessors with ample protection.

But, recognizing a right to assume does not insure a debtor's ability to exercise it or the right to live happily ever-after. Actual assumption of an unexpired residential real estate lease

is an onerous proposition, which, at best, affords, the debtor only temporary housing. Be that as it may, sections 1322(b)(7) and 365 serve a Congressionally mandated purpose by providing assistance to many financially troubled debtors. To effectuate that purpose, however, the bankruptcy court must heed the plain language of the statutes so as to include within their operation those persons whose leases have been terminated under nonbankruptcy law. To construe the statutes in a manner that would exclude from their operation unexpired leases which have been terminated under nonbankruptcy law would be counter to the design of Chapter 13.¹⁷²

The Seventh Circuit takes a different position. Essentially, a lease is not assumable if the tenant's rights ended prepetition, whether that

171. *Id.* at 587.

172. *Id.* at 588. Other courts have reached similar conclusions. See, e.g., *Stoltz v. Brattleboro Housing Auth. (In re Stoltz)*, 233 B.R. 280, 284 (D. Vt. 1998) (bankruptcy court erred, as a matter of law, in denying tenant's motion to assume residential lease that had been terminated prepetition: under Vermont law, a debtor's lease, although terminated, is not expired for purposes of Chapter 13 until execution of writ of possession); *Ross v. Metropolitan Dade County (In re Ross)*, 142 B.R. 1013, 1014-15 (S.D. Fla. 1992) (until writ executed, debtor can assume unexpired lease of residential real estate), *aff'd mem.*, 987 F.2d 774 (11th Cir. 1993) (table); *In re Atkins*, 237 B.R. 816, 819 (Bankr. M.D. Fla. 1999) (Florida recognizes anti-forfeiture doctrine which permits tenant to avoid lease forfeiture by paying arrears with accrued interest: just as Chapter 13 debtor can cure default on mortgage of principal residence even when debt is accelerated and judgment of foreclosure entered but no foreclosure has taken place, Chapter 13 debtor-tenant can cure lease default after judgment of possession but prior to entry of writ of execution regardless of lease provisions); *In re Mims*, 195 B.R. 472, 474-75 (Bankr. W.D. Okla. 1996) (cases cited by debtor and lessor are not contradictory because each looks to governing authority to determine if lease was terminated prepetition: although no Oklahoma cases have considered when a residential lease expires, court holds that service of writ of assistance on debtor extinguishes debtor's rights for purposes of § 365 and because writ had not been served before debtor's bankruptcy, § 365 and 1322(b)(7) remain available to debtor); *In re Talley*, 69 B.R. 219, 223 (Bankr. M.D. Tenn. 1986) (if every default rendered lease "expired," provisions of § 365 permitting cure of defaults would be surplusage); see also *In re Yasin*, 179 B.R. 43, 49 (Bankr. S.D.N.Y. 1995) (rejection constitutes breach of lease: it does not terminate it).

ending occurred as a result of expiration of the lease term or lease termination as a result of default.¹⁷³

Robinson v. Chicago Housing Authority,¹⁷⁴ is the leading opinion. In *Robinson*, the debtor had trouble making her \$22.00 monthly rent payments during 1992. On January 7, 1993, the Chicago Housing Authority (CHA) served her with a Notice of Termination of Tenancy. At the time, she owed \$66.00. The notice stated that her failure to pay \$88 within 14 days would result in lease termination on the 15th day. When she did not meet that deadline, CHA filed a Forcible Entry and Detainer Action and obtained a judgment of possession. The court order noted that CHA could accept her rent if it chose to do so, but absent such acceptance, a writ of possession would issue 30 days later. CHA refused to accept the debtor's tender of all rent due and owing. On the day the writ of possession was to issue, the debtor petitioned for bankruptcy relief and proposed to assume the lease in her Chapter 13 plan.

The court rejected the debtor's argument that bankruptcy distinguishes between "terminated" and "expired," and hence, she could assume the terminated lease because it was unexpired. According to the court, neither the debtor nor the legislative history provides any authority to support the argument that Congress intended to give residential debtor-lessees greater rights under federal law than they enjoyed at state law. The 1984 amendments were intended to protect shopping center lessors from the long delays, uncertainty and hiatus in payments caused by a lessee's bankruptcy. Section 365(c) had "nothing to do with residential leases."¹⁷⁵ In addition,

Congress stated that "a distinction between residential and nonresidential leases is made here and in other provisions in this subtitle . . . to avoid depriving residential tenants of whatever consumer protections they may have under applicable non-bankruptcy law." . . . Therefore, rather than supporting [the debtor's] claim that Congress was suggesting enhanced federal protections for residential lessees, the legislative history here supports the established practice of looking to state law to determine whether a lease is unexpired.¹⁷⁶

173. *In re Finkley*, 203 B.R. 95, 99 (Bankr. N.D. Ill. 1996).

174. 54 F.3d 316 (7th Cir. 1995).

175. *Id.* at 319.

176. *Id.*

The court also rejected the debtor's argument on policy grounds, reasoning that recognizing a debtor's continuing interest in a terminated lease because it had not expired would subject landlords to continuing uncertainty. The court concluded:

federal bankruptcy law draws no meaningful distinction between "expired" and "terminated" residential leases and does not provide greater federal protection for lessees under residential leases, the stated terms of which have not run, even though they have been otherwise terminated. Instead the federal law allowing "unexpired" leases to be assumed calls for a determination whether a lease has ended under state law.¹⁷⁷

By equating termination with expiration, a lease that has been terminated at state law has also expired at state law according to the Seventh Circuit's view. It is therefore dead at state law and unassumable in bankruptcy. In the Seventh Circuit, then, a "possessory toehold" as of the commencement of the case is not enough. When it's over, it's over, and it's over when the lease has ended prepetition.

Needless to say, if a lease has expired prepetition, the debtor cannot assume it. So, too, if it will expire shortly after the filing, the debtor gains little from assumption. In *In re Watts*,¹⁷⁸ the lessor and lessee each had the right to terminate the year-to-year tenancy by giving at least 60 days written notice of termination. Prepetition, the lessor gave timely notice of its intention to terminate the lease.

In the debtor's subsequent bankruptcy, the debtor sought to assume the lease. The lessor requested relief from the stay. Absent lease renewal,

177. *Id.* at 320. See also *In re Williams*, 144 F.3d 544, 550 (7th Cir. 1998) (bankruptcy court did not err in modifying stay to allow state court proceeding to continue to determine if lease had ended: if it had, debtor could not assume it because an ended lease has no assignable value); *In re Bennett*, 165 F.3d 31 (7th Cir. 1998) (table) (companion case to *Williams*); *In re Finkley*, 203 B.R. 95 (Bankr. N.D. Ill. 1996) (abstaining from determining whether debtor's tenancy terminated prepetition in favor of allowing pending state court action to proceed); cf. *In re Stoltz*, 220 B.R. 552 (Bankr. D. Vt. 1998) (although lease was not terminated prepetition, it expired prepetition when landlord justifiably refused to renew it in light of tenant's material breach in failing to pay rent), *rev'd*, *Stoltz v. Brattleboro Housing Auth.* (*In re Stoltz*), 233 B.R. 280, 284 (D. Vt. 1998) (bankruptcy court erred, as a matter of law, in denying tenant's motion to assume residential lease that had been terminated prepetition: under Vermont law, a debtor's lease, although terminated, is not expired for purposes of Chapter 13 until execution of writ of possession); *Estep v. Fifth Third Bank* (*In re Estep*), 173 B.R. 126 (Bankr. N.D. Ohio 1994) (car lease terminated prepetition when debtor failed to cure within allotted time and therefore, Bank's postpetition sale of car did violate stay).

178. 181 B.R. 109 (Bankr. N.D. Ala. 1994).

the lease term had two weeks remaining. The court construed the lessor's notice as notice of its intent not to renew the lease. It observed that it knew "of no legal basis upon which [the lessor] can be required to renew the Debtor's lease once the lease term has expired . . ."¹⁷⁹ Given that only two weeks remained in the existing lease term, assumption would produce no real benefit to the debtor. The court granted the lessor relief from the stay.

X. CONCLUSION

Unless Congress does away with bankruptcy relief by enacting something that resembles H.R. 833, we can expect the next few years to bring a maturer understanding of Chapter 13 as courts and attorneys give it a hard look. Not least on the list of things in need of enlightenment is the interplay between § 365 and Chapter 13. We welcome what we hope is to come. In the meantime, attorneys need to remember that § 365 does exist in the consumer context and the list of issues to consider should include it.

179. *Id.* at 110.