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When Your Tenant Files for Bankruptcy

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Bankruptcy filings place a hold on evictions and all other debt collection activities. Under our Federal Bankruptcy laws, when a person files bankruptcy, no new notices or demands may be served and all state court procedures, including unlawful detainers, must immediately stop. This is referred to as an “automatic stay.” The automatic stay gives the Bankruptcy Court Trustee time to take control of the bankrupt estate’s assets, which includes the lease or rental agreement(s).

Unfortunately, some residents who file a bankruptcy action use it as a delay tactic because of the automatic stay. In fact, some residents file the bankruptcy on the day of trial in order to prevent it from moving forward. Even if a bankruptcy filing by a resident is incomplete, it may still temporarily delay a notice or eviction until the bankruptcy court dismisses the action for failure to file information or the bankruptcy court grants relief from the stay. This abuse of a federal right may circumvent the resident’s financial liability while the stay is in effect or if the bankruptcy filing is successful.

However, after a bankruptcy dismissal, the owner may pursue remedies in state court. If the court does not dismiss the bankruptcy, the plaintiff must go to the Bankruptcy Court and seek a motion for relief of the automatic stay. If granted, the relief tends to allow the plaintiff to seek possession of the property but likely will only permit possession only as the financial liability of rent and damages will remain with the bankruptcy court.

Eviction delay firms, sophisticated tenants and our legal system have allowed bankruptcy to cause major delays in the eviction process. Therefore, it is important to understand the process to minimize delays and maximize a landlord’s collections.

Types of Bankruptcy

Individual tenants file bankruptcy petitions under either Chapter 7 or Chapter 13.

1. A Chapter 7 bankruptcy is a liquidation bankruptcy. Generally, the debtor’s assets are sold and the proceeds disbursed to creditors.
2. A Chapter 13 filing, otherwise known as a “wage earners plan,” restructures the tenant’s debts to be paid off through an approved payment schedule.

Business entities file bankruptcy petitions under Chapter 7 or Chapter 11.

1. A Chapter 7 bankruptcy is a liquidation bankruptcy.
2. A Chapter 11 is like a Chapter 13. It reorganizes business debt through a payment plan. Some Chapter 11 cases fail in their goal to reorganize, resulting in conversion to a Chapter 7 and discharge.

Whether the bankruptcy filing was under Chapter 7, 11, or 13, the landlord is entitled to rent accrued after the filing. This rent is considered an “administrative expense” that must be given a high priority of payment. A landlord may also be entitled to recover rent or other amounts that became due before the bankruptcy was filed. However, landlords must file a timely claim with the Bankruptcy Court to ensure payment. We can assist landlords by filing claims with the

Bankruptcy Court and obtaining relief from stay to proceed with evictions if the post-petition rent is not paid.

It is also very important to serve a notice to pay rent or quit when it is legally correct to do so, as under bankruptcy law, a notice to pay rent or quit, electing forfeiture, that expires before the petition is filed terminates the lease, entitling the landlord to quick relief from stay.

A trustee's right to assume or reject a commercial lease must be exercised within 120 days from the date the bankruptcy petition is filed, or upon confirmation of a reorganization plan, whichever occurs first. The 120-day period can be extended for cause by the court for an additional 90 days. Any further extension requires the landlord's consent.

A Chapter 7 debtor has 60 days from filing to assume or reject a residential lease.

The trustee must perform non-monetary covenants required under the lease unless the covenant by its nature is impossible to perform (such as a "go dark" provision), in which event the landlord is entitled to damages caused by the breach.

It can also result in a requirement that rent paid by the tenant be disgorged and paid to a trustee ("preference"). The law on preference payments continues to evolve. If the tenant/debtor is insolvent when the payment is made to a creditor (such as the landlord), bankruptcy law may allow the trustee to demand that the creditor return that payment in certain situations. Current law allows the landlord to retain the payment (rent) if the payment:

1. Was made to satisfy a debt incurred in the ordinary course of business between the landlord and tenant/debtor,
2. Was made in the ordinary course of the debtor and landlord's business or
3. Was made according to ordinary business terms between the parties. Before the last round of revisions to the bankruptcy code, the law used to require expert testimony regarding what was a business standard for payment of rental. Now the issue seems to be what ordinary business between the parties is. For example, if the rent is due on the first, but ordinarily not paid by the tenant until the 20th, that might not be in line with the industry standard. But if it is the customary business practice between the parties, the landlord may be able to retain the payment.

Proofs of claim must be filed in a timely manner (i.e. generally either 70 days after a voluntary Chapter 7, 12 or 13 case is filed, or 90 days after the date first set for the §341(a) meeting of creditors for all other cases). A proof of claim should always be filed to protect the landlord's claim as a secured creditor, otherwise the security deposit may be "clawed back" by the court-appointed trustee.

Unfortunately, many tenants who use the bankruptcy action as a delaying tactic dismiss their bankruptcy action as soon as the time delay has occurred. This abuse of a federal right may circumvent the tenant's financial liability, which is its desired purpose. However, after a bankruptcy dismissal, the landlord may pursue remedies in the state court.

Automatic Stay Exception: Filing After Unlawful Detainer Judgment

A bankruptcy filed by a *residential tenant* generally will not stop the eviction if judgment for unlawful detainer has been entered for more than thirty days unless the resident files a "right to cure" certificate stating there are circumstances that permit him to pay the "entire monetary default" due the landlord. (Note, however, that in post-foreclosure eviction cases, the Sheriff's Department in several jurisdictions will not conduct a lockout unless the landlord has obtained an Order for Relief from Stay from the Bankruptcy Court.)

If the resident files the “certificate of right to cure,” the landlord may object to the certification if he wants to continue with the eviction, and if so, the Bankruptcy Court is required to hold a hearing within ten days to determine if the certification is true.

In the case of a pending eviction for endangerment to the property (waste) or illegal use of controlled substances, the stay will not apply if the landlord files with the court a certification that the resident has endangered the property or illegally used or allowed to be used a controlled substance on the property.

Motion for Relief from Automatic Stay

Court permission is required to continue an eviction after a bankruptcy has been filed. A “Motion for Relief from Automatic Stay” must be filed with the Federal Bankruptcy Court. The time it takes to receive an Order granting relief from the automatic stay varies from judge to judge and from court to court - anywhere from a few days to six weeks.

In some cases, tenants will file multiple bankruptcy actions in the same case to cause further delays. In these cases, some bankruptcy court judges grant an Order to be effective for six months to prevent future filings from delaying the eviction process.

Bankruptcy law is complex. When a tenant files for bankruptcy, seek legal advice.

If you have questions regarding this article, please call our Business Real Estate Group at (800) 574-5587.

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