

# Landlords Beware: Lease Rejection Does Not Mean Lease Termination

by

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Landlords and their counsel often assume that an order authorizing the rejection of a real property lease pursuant to 11 U.S.C. §365 effectively terminates the lease. Although practitioners and, to a lesser degree, courts may appear, as a matter of shorthand, to treat lease rejection as a termination in many circumstances, it is generally, though not universally, recognized that the rejection of a lease under §365 does not, in and of itself, terminate the debtor's interest in the lease. *In re Palace Quality Servs. Indus., Inc.*, 283 B.R. 868 (Bankr. E.D. Mich. 2002). Since lease rejection may require that parties take additional steps to assure termination of a lease in a bankruptcy case, a landlord should consult with bankruptcy counsel when a debtor-tenant rejects a lease. Furthermore, because the law on these issues varies from circuit to circuit and from bankruptcy court to bankruptcy court, the landlord should take care not to violate the automatic stay when it exercises its contractual right to evict a debtor-tenant upon breach.

Throughout §365 of the Bankruptcy Code, the terms “rejection,” “breach” and “termination” are used differently, but not consistently or interchangeably. *In re Austin Dev. Co.*, 19 F.3d 1077, 1082 (5<sup>th</sup> Cir. 1994). “Rejection” refers specifically to the debtor-in-possession's or trustee's decision not to assume a burdensome lease. If a lease is rejected, then the lease never becomes an asset of the bankruptcy estate. *Stoltz v. Brattleboro Hous. Auth.*, 259 B.R. 255 (D. Vt. 2001). The rejection of the lease, whether by the debtor in possession or the trustee or by operation of law,<sup>1</sup> is deemed to be a breach of the lease on the day preceding the bankruptcy filing. *In re Lavigne*, 114 F.3d 379 (2d Cir. 1997);<sup>2</sup> however, the lease is not deemed to be terminated on that date.

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<sup>1</sup> When a debtor-tenant files chapter 11, §365(d)(4) of the Bankruptcy Code requires that all nonresidential real property leases be assumed or rejected within 60 days of the filing of the bankruptcy, unless the court extends the time to assume or reject. If the debtor-tenant does nothing, the leases are deemed rejected by operation of law, and the debtor in possession/trustee must turn over possession of the property to the landlord. *In re Locke*, 180 B.R. 245 (Bankr. C.D. Cal. 1995).

<sup>2</sup> Before the lease is rejected, the debtor-in-possession or trustee is required to pay for “use and occupation” of the property as an administrative claim during the period before the lease is rejected or deemed rejected. *In re Macomb Occupational Health Care, LLC*, 300 B.R. 270 (Bankr. E.D. Mich. 2003). Upon rejection, the landlord becomes entitled to file a pre-petition

Generally, landlords should look to the terms of the lease and state law to determine how to effect the actual termination of the lease after rejection. *In re SKA! Design, Inc.*, 308 B.R. 777, 781 (Bankr. N.D. Tex. 2004); *Norritech v. Geonex Corp.*, 204 B.R. 684 (D. Md. 1997). Case law, however, does support alternatives to the state law/contract requirements for terminating a lease rejected in a bankruptcy case. Although the cases are typically fact-driven, two (and possibly three) distinct lines of authority emerge. One line of cases has held that the debtor's rejection of the lease—whether by operation of law pursuant to §365(d)(4) or by affirmative action—terminates the lease if there is a concurrent obligation (by law or by contract) to surrender possession of the property upon breach by. *See, e.g., SKA! Design*, 308 B.R. at 781; *In re Kmart Corp.*, 2003 WL 23147948 (N.D. Ill. 2003); *Cromwell Field Associates, LLP v. May Dept. Stores Co.*, 5 Fed. Appx. 186 (4<sup>th</sup> Cir. 2001) (unpublished); *In re Port Angeles Waterfront Assoc.*, 134 B.R. 377 (9<sup>th</sup> Cir. BAP 1991); *In re Henderson*, 245 B.R. 449 (Bankr. S.D.N.Y. 2000). Equating “rejection plus surrender” to termination, however, arguably extinguishes the rights of nondebtor third parties to the lease, including holders of security interests in the lease and subleases. The better view, articulated in a competing line of cases, recognizes that rejection (with or without surrender) does not equate to termination, in part because the rights of nondebtor third parties to the lease, as determined by state law, should be preserved despite the rejection. *See In re Stoltz*, 315 F.3d 80 (2d Cir. 2002); *In re Austin Development Co.*, 19 F.3d 1077 (5<sup>th</sup> Cir. 1994); *In re Teleglobe Communications Corp.*, 304 B.R. 79 (D. Del. 2004); *In re Park*, 275 B.R. 253 (Bankr. E.D. Va. 2002). In what may be called a third line of cases, a few courts have merged these conclusions by holding that rejection under §365 effectively terminates a debtor's right of possession, notwithstanding the retention of any state law possessory rights after breach, but also preserves certain other rights including third-party, i.e., mortgagee or sublessee, rights against the landlord/borrower in accordance with related transaction documents. *See, e.g., In re Locke*, 180 B.R. 245 (Bankr. C.D. Cal. 1995) and cases cited therein.

The split in authority described above—and the fact-specific nature of many of these decisions—means that the landlord cannot assume that bankruptcy rejection will terminate the lease and return possession of the property. As a practice rule, after rejection a landlord should take all steps necessary to effect termination of the lease under contract and state law, unless a bankruptcy court order providing for rejection of a lease also expressly provides for termination under the contract and applicable law. While it is in the landlord's best interest to receive such an order, it can come at some cost, particularly where the lease is rejected, the debtor-tenant has vacated, and the landlord has a buyer for the property. In some cases, title companies refuse to issue a “clean” title opinion without an express court order finding that the lease is terminated. In our experience, in recent retail cases debtors are extracting some consideration from landlords in order to agree to orders providing that rejected leases are also terminated leases.

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claim for damages for breach of the lease, the amount of which may be limited by §502(b) of the Bankruptcy Code. *Id.* If a lease is assumed by the debtor-in-possession or trustee, it can later be rejected; however, the claims for damages arising from breach of the lease are post-petition claims that are given administrative priority over all pre-petition claims and are not limited by §502. *In re Klein Sleep Prods.*, 78 F.3d 18, 30 (2d. Cir. 1996).

Absent an existing order or the debtor's agreement granting the landlord possession, a landlord faced with a squatter debtor-tenant post-rejection should seek relief from the automatic stay imposed by 11 U.S.C. §362 in order to pursue eviction, because the debtor-tenant may have a possessory interest in the property even though the estate of the debtor-tenant no longer has any interest in the lease. *In re Park*, 275 B.R. 253 (Bankr. E.D. Va. 2002); *In re Couture*, 225 B.R. 58 (D. Vt. 1998). In the alternative, a landlord may seek to recover possession of its property through a turnover action filed in the bankruptcy court. If the debtor-tenant has already vacated the property, then a state court eviction proceeding should not be necessary. *In re Kmart Corp.*, 290 B.R. 601 (Bankr. N.D. Ill. 2002).

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