

Bankruptcy Law for Property Managers

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At the end of every seven years thou shalt make a release. And this is the manner of the release: Every creditor that lendeth ought unto his neighbor shall release it; he shall not exact it of his neighbor or his brother; because it is called the Lord's release. Of a foreigner thou mayest exact it again; but that which is thine with thy brother thine hand shall release; save when there shall be no poor among you;....¹

I. INTRODUCTION

Bankruptcy is a legally declared inability or impairment of ability of an individual or organizations to pay their creditors. The primary purpose of bankruptcy is: (1) to give an honest debtor a "fresh start" in life by relieving the debtor of most debts, and (2) to repay creditors in an orderly manner to the extent that the debtor has the means available for payment. Bankruptcy allows debtors to be discharged from the legal obligation to pay most debts by submitting their non-exempt assets, if any, to the jurisdiction of the bankruptcy court for eventual distribution among their creditors.

Bankruptcy laws in the United States date back to 1800. Current federal bankruptcy law was enacted through the 1978 Bankruptcy Code (the "Bankruptcy Code") and later amendments, the most significant of which was the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments.").

II. TYPES OF BANKRUPTCY

A bankruptcy case is generally commenced by the debtor's filing of a petition for relief with the bankruptcy court. The debtor petition will designate which chapter it is filing under. The three most common types of bankruptcies are the Chapter 7 liquidation, the Chapter 11 reorganization and the Chapter 13 wage earner reorganization.

A. Chapter 7 Liquidation (Individual or Business Entity)

In a Chapter 7 liquidation, all nonexempt assets are liquidated by a trustee and the proceeds are distributed to creditors in accordance with certain statutory priorities. All debts, except those expressly excepted by statutory language, are discharged.² The goal is to give an individual a fresh start. In the case of a corporate debtor, there are no exempt assets, and the debtor gets no discharge.³ The case typically culminates in the court approval of the trustee's final report and proposed distribution (where there are assets to be distributed).⁴ A Chapter 7 bankruptcy case cannot be filed if, during the preceding 180 days, a prior bankruptcy was (i) dismissed due to the debtor's willful failure to appear or comply with a court order; or (ii) voluntarily dismissed after creditors sought relief to recover secured property. Individuals must receive credit counseling within 180 days of filing and must satisfy the "means" test.⁵

B. Chapter 11 Reorganization (Individual or Business Entity)

In a Chapter 11 reorganization, the debtor remains in possession and control of the business, albeit subject to court control, and, in certain cases, subject to oversight by a creditors' committee.⁶ Utilizing various tools provided by the Bankruptcy Code, including the right to

¹ *Deuteronomy* 15:1-4 (King James Version).

² 11 U.S.C. § 523; see Swedberg, Amy J., Maslon, Edelman, Borman & Brand, LLP, "When the Tenant Files Bankruptcy and the Effect of the Bankruptcy Reform Act on Landlords and Tenants." August 8, 2007, p. 1.

³ 11 U.S.C. § 727(a)(1); see Swedberg, *supra* at p. 1.

⁴ 11 U.S.C. § 707(b)(1); see Swedberg, *supra* at p. 1.

⁵ See 11 U.S.C. § 707(b)(2); see Swedberg, *supra* at p. 1.

⁶ Swedberg, *supra*. at pp. 1-2

reject burdensome contracts, abandon burdensome property (subject to certain limitations), and modify the terms of secured and unsecured obligations, the debtor seeks to rehabilitate its business and/or reorganize its capital structure.⁷ If successful, the case will culminate in court approval of a reorganization plan.⁸ If the case is not successful, it will end in a dismissal, or conversion to a Chapter 7 liquidation.⁹ A successful Chapter 11 plan of reorganization must satisfy all of the criteria in 11 U.S.C. § 1129 to be confirmed.¹⁰

C. Chapter 13 Wage Earner Reorganization (Individuals Only)

Like Chapter 11, the debtor remains in possession and control of his assets, subject to court control, and oversight by a standing Chapter 13 trustee.¹¹ Like Chapter 11, there are various tools available to allow the wage earner to reorganize his obligations.¹² If successful, the case will culminate in court approval of a Chapter 13 plan and complete consummation of the plan.¹³ If not successful, the case will end in a dismissal, conversion to Chapter 7, or a hardship discharge.¹⁴ Chapter 13 is ordinarily reserved for individuals with regular incomes who are presently unable to pay their debts or individuals who wanted to file for Chapter 7 but did not satisfy the “means” test.¹⁵ To be eligible for Chapter 13, an individual, or an individual and a spouse, must owe less than \$307,675 in unsecured debts and less than \$922,975 in secured debts.¹⁶ Debtors are allowed to repay creditors, in full or in part, over a period of time during which creditors are prohibited from continuing collection efforts.¹⁷ Chapter 13 debtors are

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ Swedberg, *supra* at p. 2

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ 11 U.S.C. § 101(12); 11 U.S.C. § 109(e).

¹⁷ Swedberg, *supra* at p. 2

restricted to monthly living allowances mandated by the Internal Revenue Service – all “disposable income” must be dedicated to the repayment of unsecured creditors.¹⁸ The period during which these payments must be made is calibrated based on the amount owed and the debtor’s income.¹⁹ In no case, however, may the plan last than five years.²⁰

III. THE AUTOMATIC STAY

The filing of a voluntary petition, a joint petition, or an involuntary petition under any chapter of the Bankruptcy Code immediately and automatically imposes a stay, applicable to all entities, of most actions that otherwise could have been taken against the debtor or the property of the estate²¹. The purpose of the automatic stay is to give the debtor “a breathing spell from his creditors” in which the debtor may “attempt a repayment or reorganization plan.”²² The automatic stay also protects creditors by averting a scramble for the debtor’s assets and promoting instead “an orderly liquidation procedure under which all creditors are treated equally.”²³

The automatic stay prohibits the commencement or continuation of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the filing of the petition for the bankruptcy case.²⁴ The petition operates as a stay as to claims against the debtor that arose before the commencement of the bankruptcy case.²⁵ The scope of protection is broad.²⁶ The automatic stay creates a restraint and injunction

¹⁸ 11 U.S.C. § 1325(b)(1)(A).

¹⁹ *See* 11 U.S.C. § 1322.

²⁰ *Id.*

²¹ Ralph V. Mitchell, *Real Estate in Bankruptcy*, Minnesota Practice – Real Estate Law (2008), at §7.06, *citing* 11 U.S.C. § 362(a).

²² *Id.*, *citing* H.R. Rep. No. 95-595, at 340 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5963, 6296, and 6297..

²³ *Id.*, *citing* H.R. Rep. No. 95-595 at 340(1997), reprinted in 1978 U.S.C.C.A.N. 5787, 6297; *Farley v. Henson*, 2 F.3d 273, 274 (8th Cir. 1993)

²⁴ *Id.* at §7.07., *citing* 11 U.S.C. 362 (a)(1).

²⁵ *Id.*, *citing* 11 U.S.C. 362 (a)(1).

against any judicial proceeding against a debtor in bankruptcy.²⁷ In addition, the automatic stay prohibits the enforcement against the debtor or against property of the estate of (i) a judgment obtained before the commencement of a bankruptcy;²⁸ (ii) any act to obtain possession of property of or from the estate or to exercise control over property of the estate;²⁹ (iii) any act to create perfect, or enforce any lien against property of the estate;³⁰ and (iv) any act to create, perfect, or enforce against any property of the debtor any lien to the extent that the lien secures a claim that arose before the commencement of the bankruptcy case.³¹ Moreover, the automatic stay prohibits (i) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the bankruptcy case;³² (ii) the setoff of any debt owing to the debtor that arose before the commencement of the bankruptcy case;³³ and (iii) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.³⁴

With respect to Minnesota real estate that is property of the debtor's estate in a bankruptcy case, the automatic stay prohibits, among other things, the commencement or continuation of any action or proceeding to foreclose a mortgage by action or advertisement, to cancel a contract for deed, to obtain appointment of a receiver, to evict a tenant, to execute a judgment, or to create or perfect a lien³⁵.

Even though the automatic stay is broad, it is not without limits.³⁶ Statutory exceptions to the automatic stay are found in Section 362(b) of the Bankruptcy Code.³⁷ Many of these

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*, citing 11 U.S.C. § 362 (a)(2).

²⁹ *Id.*, citing 11 U.S.C. § 362 (a)(3).

³⁰ *Id.*, citing 11 U.S.C. § 362 (a)(4).

³¹ *Id.*, citing 11 U.S.C. § 362 (a)(5).

³² *Id.*, citing 11 U.S.C. § 362 (a)(6).

³³ *Id.*, citing 11 U.S.C. § 362 (a)(7).

³⁴ *Id.*, citing 11 U.S.C. § 362 (a)(8).

exceptions are beyond the scope of these materials. Two (2) exceptions added by the 2005 Amendments directly impact residential landlords. New Section 362(b)(22) protects residential landlords against the effect of the automatic stay on certain tenant evictions.³⁸ It provides that if the landlord has obtained a state court order for possession before the debtor-tenant files bankruptcy, then the automatic stay does not affect the continued eviction of the debtor-tenant.³⁹ Section 362(b) does not apply, however, if, when the bankruptcy petition is filed, the debtor-tenant certifies to the court under penalty of perjury that (1) applicable non-bankruptcy law would allow the lease default to be cured even after the order for possession was entered, and (2) any rent due within the next 30 days has been deposited with the court.⁴⁰ Within 30 days after filing the bankruptcy petition, the debtor-tenant must further certify that all pre-petition monetary defaults have been cured.⁴¹ A landlord who objects to the original or subsequent filing is entitled to a hearing before the court.⁴²

A second exception added by the 2005 Amendments of note is Section 362(b)(23), which protects residential landlords from tenants who endanger their leaseholds or illegally use controlled substances there.⁴³ Section 362(b)(23) provides that the automatic stay does not apply (as opposed to being terminated, annulled, or modified) if the landlord certifies to the court under penalty of perjury (1) that the landlord has filed an eviction action in state court against the debtor-tenant alleging endangerment of the property or illegal use of controlled substances there,

³⁵ *Id.*, citing *New York Life Ins. Co. v. Bremer Towers*, 714 F.Supp. 414, 419; *In re Anderson*, 62 B.R. 448, 452 (Bankr.D.Minn. 1986); *In re Re-Trac Corp.*, 59 B.R. 251, 259 (Bankr.D.Minn. 1986); *In re Artishon*, 39 B.R. 890, 894 (Bankr.D.Minn. 1984); *Lanesboro State Bank v. Hennessey*, 317 N.W.2d 49, 52 (Minn. 1982).

³⁶ Mitchell, *supra* at § 7.08.

³⁷ *Id.*, citing 11 U.S.C. § 362(b)(1)

³⁸ See Mitchell at §7.08(h).

³⁹ *Id.*, citing 11 U.S.C. § 362 (b)(22)

⁴⁰ *Id.*, citing 11 U.S.C. § 362(l)(1).

⁴¹ *Id.*, citing 11 U.S.C. § 362(l)(2).

⁴² *Id.*, citing 11 U.S.C. § 362 (l)(3).

⁴³ Mitchell, *supra* at §7.08(i).

or (2) if no such state court proceeding has been filed, that within the 30-day period preceding landlord's certification the debtor-tenant has endangered the property, or engaged in or allowed the illegal use of a controlled substance there⁴⁴. The debtor-tenant has 15 days to object to the landlord's certification, and the bankruptcy court must hold a hearing within ten days of any such objection.⁴⁵ If the debtor-tenant persuades the bankruptcy court that the circumstances to which the landlord certified did not exist or have been remedied, then the stay remains in effect⁴⁶. If the debtor-tenant fails to persuade the court that the debtor-tenant's objection is valid, then the court will enter an order "upholding the [landlord's] certification" and the landlord will be free to proceed with the eviction⁴⁷.

The automatic stay of acts against the property of the estate continues until the property is no longer property of the estate.⁴⁸ The stay of all other acts under § 362(a) of the Bankruptcy Code continues until the earlier of (1) the date the case is closed or dismissed, or (2) the date a discharge is granted or denied.⁴⁹

The 2005 Amendments modified the duration of the automatic stay under certain circumstances.⁵⁰ For an individual debtor who had been a debtor in a dismissed bankruptcy case within the past year, the stay is limited to 30 days after the new petition is filed.⁵¹ If the new

⁴⁴ See Mitchell at §7.08, citing 11 U.S.C. §§ 362(m)(2)(D), 362(b)(23). At least until §§ 362(m)(2)(D) and 362(b)(23) have become a well-established part of bankruptcy practice, it would be prudent for the landlord to include in the proposed order accompanying the certification an affirmative statement that either (1) the automatic stay does not apply, or (2) if it applies, that cause exists for modifying the stay to permit the eviction.

⁴⁵ *Id.*, citing 11 U.S.C. § 362 (m)(1) to (m)(2).

⁴⁶ *Id.*, citing 11 U.S.C. § 362(m)(2)(C).

⁴⁷ *Id.*, citing 11 U.S.C. § 362(m)(2)(D). The 2005 Amendments are silent on the effect of the order "upholding the [landlord's] certification"; i.e., does it simply mean that the landlord has made a *prima facie* case for eviction, or does it constitute a determination that the tenant in fact was using controlled substances. Mitchell at § 7.08, FN 41 .

⁴⁸ Mitchell, *supra* at § 7.10, citing 11 U.S.C. § 362 (c)(1).

⁴⁹ *Id.*, citing 11 U.S.C. 362 (c)(1). See *In re Midland Marina, Inc.*, 259 B.R. 683, 687 (B.A.P. 8th Cir. 2001); *Olive St. Inv., Inc. v. Howard Sav. Bank (In re Olive St. Inv. Inc.)*, 972 F.2d 214, 216 (8th Cir. 1992); *Spaude v. State Bank (In re Spaude)*, 112 B.R. 304, 306 (Bankr.D.Minn. 1990).

⁵⁰ *Id.*

⁵¹ *Id.*, citing 11 U.S.C. § 362 (c)(3)(A).

petition was filed in good faith, however, the court may extent the automatic stay as to one or more creditors on the motion of the debtor or other party in interest.⁵²

Even though § 362(a) of the Bankruptcy Code provides the automatic stay of a broad range of actions, a party in interest may seek relief from the stay.⁵³ A request for relief must be made by written motion and conform to the requirements of the Local Rules of the bankruptcy district.⁵⁴ The court may grant *ex parte* relief when irreparable damage will occur.⁵⁵ After notice and a hearing, the court must grant relief from the stay for cause, including lack of adequate protection.⁵⁶ The court also must grant relief from the stay when the debtor has no equity in the property and the property is not necessary to an effective reorganization.⁵⁷ The party moving for relief from the stay has the burden of proof as to the debtor's equity in the property.⁵⁸ The party opposing the motion, typically the debtor, has the burden of proof on all other issues.⁵⁹

IV. EFFECT ON RESIDENTIAL REAL ESTATE LEASES

Under Section 365 of the Bankruptcy Code, a trustee or debtor in possession may, subject to the court's approval, assume or reject any executory contract or unexpired lease of the debtor.⁶⁰

Determining whether the lease is unexpired within the meaning of Section 365 involves reading the lease to find the expiration date.⁶¹ A lease that has been terminated under state law

⁵² *Id.*, citing 11 U.S.C. § 362 (c)(3)(B).

⁵³ Mitchell, *supra* at § 7.11, citing 11 U.S.C. § 362 (d); *See Anderson v. Farm Credit Bank (In re Anderson)*, 913 F.2d 530, 531 (8th Cir. 1990).

⁵⁴ *Id.*, citing Bankr.D.Minn. L.R. 9013-1 (motion practice); 9013-2(motion papers); 9013-3 (entities served) (available at <http://www.mnb.uscourts.gov>), authorized under Fed.R.Bankr.P. 4001(a), 9013, 9014.

⁵⁵ *Id.*, citing 11 U.S.C. § 362 (f); Fed.R.Bankr.P. 4001(a)(2).

⁵⁶ *Id.*, citing 11 U.S.C. §§ 102(1), 361, 362(d)(1); *See United Sav.Ass'n v. Timbers of Inwood Forest Assoc.*, 484 U.S. 365, 382, 108 S.Ct. 626, 636, 98 L.Ed.2d 740, 755 (1988).

⁵⁷ *Id.*, citing 11 U.S.C. § 362(d)(2).

⁵⁸ *Id.*, citing 11 U.S.C. § 362 (g)(1).

⁵⁹ *Id.*, citing 11 U.S.C. § 362 (g)(2).

prior to bankruptcy may not be assumed under Section 365.⁶² In Minnesota, a lease may be terminated by express agreement or by operation of law.⁶³

In the case of a residential real property under Chapter 7, the trustee must assume the unexpired lease of the residential real property within sixty (60) days after the order for relief or within any additional time as the court, for cause, may allow.⁶⁴ Under all other bankruptcy chapters, the trustee may assume the unexpired lease of residential real property anytime before the confirmation of a plan unless the court orders the trustee to determine a specified period of time.⁶⁵

In order for a trustee or debtor in possession to assume an unexpired lease, the trustee or debtor in possession must (1) cure or provide adequate assurance of a prompt cure of all defaults; (2) compensate or provide adequate assurance of prompt compensation to the other party of any actual pecuniary loss resulting from any defaults; and (3) provide adequate assurance of future performance.⁶⁶ The court generally uses a business judgment test to decide whether to approve the proposal to assume or reject.⁶⁷ The test requires a determination that the transaction is in the best interest of the estate.⁶⁸ The cure contemplated in Section 365(b)(1)(A) allows for something other than immediate cash payment.⁶⁹

⁶⁰ Mitchell, *supra* at § 7.12, *citing* 11 U.S.C. § 365(a).

⁶¹ *Id.*, at § 7.14.

⁶² *Id.*, *citing In Re Jeurissen*, 85 B.R. 531, 536 (Bankr.D.Minn. 1988).

⁶³ *Id.*, *citing Trimble v. Lake Superior & Puget Sound Co.*, 99 Minn. 11, 13, 108 N.W. 867, 868 (1906); *Provident Mut. Life Ins. Co. v. Tachtronic Instruments, Inc.*, 394 N.W.2d 161, 164-65 (Minn.Ct.App. 1986).

⁶⁴ Mitchell, *supra* at § 7.16, *citing* 11 U.S.C. § 365 (d)(1).

⁶⁵ *Id.*, *citing* 11 U.S.C. § 365 (d)(2).

⁶⁶ *Id.*, *citing* 11 U.S.C. § 365(b)(1)(A) to (C).

⁶⁷ *Id.*, *citing In re Audra-John Corp.*, 140 B.R. 752, 752 (Bankr.D.Minn. 1992).

⁶⁸ *Id.*, *citing Four B. Corp. v. Food Barn Stores, Inc. (In re Food Barn Stores, Inc.)*, 107 F.2d 558, 567 (8th Cir. 1997).

⁶⁹ *Id.*, *citing In re Carlisle Homes, Inc.*, 103 B.R. 524, 538 (Bankr.D.N.J. 1988).

In the Minnesota district, a decision to assume an unexpired lease has the effect of giving administrative priority to the expenses and liabilities incurred under the lease.⁷⁰

The rejection of an unexpired lease during the bankruptcy case generally gives rise to a pre-petition claim for breach of lease as if such lease had been breached immediately before the date of filing of the petition.⁷¹ State law governs the parties' rights in consequence of a deemed breach under Section 365(g).⁷²

V. TRUSTEE'S AVOIDANCE POWERS

Congress has endowed a bankruptcy trustee, or a debtor in possession, with statutory "avoiding powers."⁷³ Among these are the power to avoid certain transfers that could be avoided by a bona fide purchaser of real property, certain statutory liens, certain preferential transfers, certain fraudulent transfers and obligations, and certain unauthorized post-petition transactions.⁷⁴ To invoke the avoiding powers, the trustee must commence an adversary proceeding, i.e., a separate lawsuit, within the bankruptcy case.⁷⁵ Avoidance actions are not discretionary because the trustee, as a fiduciary, has an obligation to exercise the avoiding powers for the benefit of the estate.⁷⁶ Many of the avoidance powers are beyond the scope of these materials. However, a brief discussion of the avoidance of preferential transfers is warranted.

Under Section 547(b) of the Bankruptcy Code, the trustee may avoid preferential transactions made by a debtor within 90 days before the bankruptcy filing, or within one year

⁷⁰ *Id.*, citing *In re Monica Scott, Inc.* 123 B.R. 990, 992 (Bankr.D.Minn. 1991).

⁷¹ *Id.*, citing 11 U.S.C. § 365 (g)(1); *Arctic Enters., Inc. v. Tousley Sport Ctr. (In re Arctic Enters., Inc.)*, 15 B.R. 512, 513 (Bankr.D.Minn. 1981).

⁷² *Id.*, citing *In re Audra-John Corp.*, 140 B.R. 752, 757 (Bankr.D.Minn. 1992).

⁷³ Mitchell, *supra* at § 7.17, citing 11 U.S.C. §§ 1107, 1203.

⁷⁴ *Id.*, citing 11 U.S.C. §§ 544(a)(3), 545, 547, 548, 549.

⁷⁵ *Id.*, citing Fed.R.Bankr.P. 7001.

⁷⁶ *Id.*, citing *Edward Pirsig Farms, Inc. v. John Deere Co. (In re Pirsig Farms, Inc.)*, 46 B.R. 237, 241 (D.Minn. 1985).

before the bankruptcy filing if the transfer is to insiders.⁷⁷ A preference is a transfer that enables a creditor to receive payment of a greater percentage of the creditor's claim against the debtor than the creditor would have received if the transfer had not been made and the creditor participated in the distribution of the assets of the bankruptcy estate.⁷⁸ The purpose of the preference section is to discourage creditors from racing to the courthouse to "dismember the debtor during his slide into bankruptcy" and "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."⁷⁹

Section 547(c) of the Bankruptcy Code provides that certain transfers that otherwise qualify as avoidable preferences may not be avoided by the trustee.⁸⁰ Among these are (1) transfers deemed to be a contemporaneous exchange for new value; (2) payments made in the ordinary course of business; (3) so-called enabling loans; and (4) payments made to certain creditors who give subsequent new value to the debtor.⁸¹ These and other exceptions are intended to protect creditors who continue to do business with distressed entities.⁸²

⁷⁷ Mitchell, *supra* at § 7.21, *citing* 11 U.S.C. § 547(b)(4)(A) to (B).

⁷⁸ *Id.*, *citing* *Union Bank v. Wolas*, 502 U.S. 151, 160, 112 S.Ct. 527, 533, 116 L.Ed.2d 514, 524 (1991).

⁷⁹ *Id.*, *citing* *Union Bank v. Wolas*, 502 U.S. 151, 160, 112 S.Ct. 527, 533, 116 L.Ed.2d 514, 524 (1991)(quoting H.R. Rep. No. 95-595, at 177 to 178 (1977), *reprinted* in 1978 U.S.C.C.A.N. 5963, 6137, to 6138).

⁸⁰ Mitchell, *supra* at § 7.22.

⁸¹ *Id.*, *citing* 11 U.S.C. §§ 547(c)(1)(A) to (B), 547(c)(2)(A) to (B), 547(c)(3)(A) to (B), 547(c)(4)(A) to (B).

⁸² *Id.*, *citing* *Iannacone v. Klement Sausage Co. (In re Hancock-Nelson Mercantile, Co.)* 122 B.R. 1006, 1010 (Bankr.D.Minn. 1911).

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Mr. O'Brien attended the University of St. Thomas in St. Paul, Minnesota, and graduated with honors in 1997 with a Bachelor of Science. He received his J.D. with honors from William Mitchell College of Law in St. Paul, Minnesota and is admitted to practice in the States of Minnesota and Wisconsin and in the United States District Court for the District of Minnesota. He frequently lectures on a variety of topics including real estate lending and loan documentation, asset protection planning and partnerships, choice of entity, commercial leasing, residential landlord-tenant law and general real estate topics. He is a member of the Minnesota Multi Housing Association (MHA) and CIC Midwest.

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