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Adam K. Lau

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**A Sublessee's Rights in the Face of A Debtor-Sublessor's Rejection of an Unexpired Lease
Under Chapter 11**

Adam K. Lau, J.D. Candidate 2017

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Introduction

Whether or not rejection of a lease constitutes termination is of great concern to interested parties in a chapter 11 bankruptcy proceeding. This determination can alter the remedies available for injured parties. Section 365 of the Bankruptcy Code establishes the general rule that rejection does not constitute termination, and sets forth the circumstances where exceptions to the general rule apply.¹

In *In re Overseas Shipholding Group, Inc.*,² a Delaware Bankruptcy Court held that the rejection of a lease constitutes a prepetition breach of the lease under section 365(g) of the Bankruptcy Code. The court determined the amount of damages a lessee facing rejection of its lease could claim could not be more than what it could claim outside of bankruptcy and that the lessee is subject to underlying agreements and applicable state statutes.³ The debtor-lessor

¹ See 11 U.S.C. § 365 (2012).

² *In re Overseas Shipholding Group, Inc.*, 2015 WL 3475727, at *1 (Bankr. D. Del. June 1, 2015).

³ *Id.* at 3.

argued that the case was similar to *Chatlos Systems, Inc. v. Kaplan*⁴, where a Delaware bankruptcy court found that rejection of a lease constituted termination of the lease.⁵ The underlying lease contained a provision that stated that the debtor would not incur any liability to the lessee if the lease were terminated prematurely, therefore, precluding the lessee from bringing a claim for damages against the debtor.⁶ However, the *Overseas* court found the facts in the *Chatlos* case were dissimilar because in *Overseas*, the lessee vacated and relinquished possession of the premises, whereas in the *Chatlos* case the lessee remained in possession.⁷ This important distinction changes the lessee's available remedies in a rejection case.

Part I of this article details the background and purpose of section 365. Part II and Part III narrow the discussion to the relevant case law where rejection of a lease does not constitute termination under section 365(g), and the available options and remedies to lessees. Part IV then explores the exceptions in section 365 where rejection of the lease constitutes termination of a lease. This article concludes that a court will look at the actions of the lessee to determine whether rejection of a lease is termination of the lease or a prepetition breach, which in turn, determines the available remedies.

I. Background and History of Section 365

Section 365 of the Bankruptcy Code allows a debtor to assume or reject certain executory contracts and unexpired leases. The purpose of section 365 is to “allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same

⁴ *Chatlos Systems, Inc. v. Kaplan*, 147 B.R. 96 (Bankr. D. Del. 1992).

⁵ *Id.* at 98.

⁶ *In re Overseas Shipholding Group, Inc.*, 2015 WL 3475727, at *2.

⁷ *Id.* at *3.

time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.”⁸

The “assume or reject” concept currently embodied in section 365 was first conceived in an English case, *Copeland v. Stephens*.⁹ In *Copeland*, the court rejected a debtor’s argument that he had no liability on a lease because of the assignment of his lease obligation onto his bankruptcy assignees. However, the *Copeland* court held the bankruptcy assignees were protected from assuming the lease obligations because the assignees did not consent to the assignment.¹⁰ Problems arose after *Copeland*, in cases where a non-debtor party to a lease or unexpired contract not assumed by the trustee had no claim against the estate and could not share in any distribution of estate assets.¹¹ From the debtors’ perspective, debtors found that they could not receive a discharge on future obligations under the non-assumed lease or contract because the discharge only applied to those obligations that could be asserted against the estate.¹² The United States Supreme Court addressed these issues in *Central Trust Company of Illinois v. Chicago Auditorium Association*,¹³ holding:

It is the purpose of the Bankruptcy Act, generally speaking, to permit all creditors to share in the distribution of the assets of the bankrupt, and to leave the honest debtor thereafter free from liability upon previous obligations . . . it would lead to most unfortunate results if, by interpreting the act in a narrow sense, persons entitled to performance of such agreements on the part of bankrupts were excluded from participation in bankrupt estates, while the bankrupts themselves . . . were left still subject to action for non-performance in the future, although without the property or credit often necessary to enable them to perform.

¹⁴

⁸ WILLIAM L. NORTON, NORTON BANKRUPTCY LAW AND PRACTICE 3d ¶ 46:2 (3d ed. January 2016 Update), available at WL, 2 Norton Bankr. L. & Prac. 3d § 46:2.

⁹ *Copeland v. Stephens*, 1818 WL 2322 (K.B. 1818).

¹⁰ *Id.*; see also NORTON BANKRUPTCY LAW AND PRACTICE 3d ¶ 46:2.

¹¹ See NORTON BANKRUPTCY LAW AND PRACTICE 3d ¶ 46:2.

¹² *Id.*

¹³ *Central Trust Co. of Illinois v. Chicago Auditorium Association*, 240 U.S. 581 (1916).

¹⁴ *Id.* at 591.

Congress adopted this ability to assume or reject these agreements and set out the procedure and requirements in section 70b of the United States Bankruptcy Act in 1938 (the “Bankruptcy Act”), expanding its application to include unexpired leases.¹⁵ Section 365 of the Bankruptcy Code is the successor to section 70b of the Bankruptcy Act and the “assume or reject” option for debtors has been a part of the Bankruptcy Code since its inception in the late 1970s.¹⁶

II. Non-Debtor Lessee’s First Option when Rejection Does Not Constitute Termination

Despite section 365’s codification, courts still face the question of when rejection of a lease or executory contract constitutes termination. Ultimately, this determination depends on the facts of each case, specifically, the actions of a lessee after a lessor rejects a lease.

The Bankruptcy Code explicitly uses the terms “rejection,” “breach” and “termination” differently under section 365(g)¹⁷ and states that, in general, rejection of an executory contract or unexpired lease constitutes a breach, not a termination.¹⁸ Section 365(h) provides options for a lessee facing a rejection of its lease.¹⁹ In cases where a chapter 11 debtor is a lessor and rejects an unexpired lease, the lessee has two options: (1) surrender possession of the premises, or (2) retain his or her rights under the lease.²⁰ Where a lessee chooses the first option and does not terminate the lease, the lessee may seek damages as a general unsecured claim.²¹ The tenant also has the discretionary authority to consider the lease terminated, which will be further discussed

¹⁵ See NORTON BANKRUPTCY LAW AND PRACTICE 3d ¶ 46:2.

¹⁶ *Id.*

¹⁷ See *Eastover Bank for Savings v. Sowashee Venture (In re Austin Development Co.)*, 19 F.3d 1077, 1082 (5th Cir. 1994); see, e.g., *In re Giles Associates, Ltd.*, 92 B.R. 695, 698 (Bankr. W.D. Tex. 1988).

¹⁸ See 11 U.S.C. § 365(g).

¹⁹ See 11 U.S.C. § 365(h).

²⁰ *In re Overseas Shipholding Group, Inc.*, 2015 WL 3475727 at 4.

²¹ *Id.*

in Part IV below. In this context, rejection of a contract acts as a debtor's determination not to perform its obligations under the contract.²² And while rejection of a contract or unexpired lease constitutes a breach, it does not terminate the contract or lease except in narrow situations.²³

In *Overseas*, a sublessee brought action against a chapter 11 debtor-sublessor for damages relating to the debtor's rejection of its lease.²⁴ In this case, the sublessee surrendered the premises and brought action to recover its security deposit.²⁵ The sublessee amended its complaint to add damages accounting for moving expenses, legal fees and increased utility expenses after moving to a new location.²⁶ The debtor argued that the rejection of the lease constituted termination of the lease and it was not liable for damages due to a provision in the lease that absolved the debtor's liability in the event of termination.²⁷ The court stated that, under Section 365 generally, rejection of a lease constitutes a prepetition breach of the lease and does not terminate the lease.²⁸

Therefore, in the case of *Overseas*, where the rejection of the lease constituted a prepetition breach, the remedies available to the sublessee would be the equivalent to a nonbankruptcy breach. In this situation, parties must look to the underlying agreements and applicable state statutes to determine what remedies would be available to them. In *Overseas*, the underlying agreement, the sublease, contained a provision that stated the sublessee could not seek damages against the debtor in the event the debtor fails to perform. Therefore, because the

²² See *In re Scarborough–St. James Corporation*, 2015 WL 5672628, at *4 (Bankr. D. Del. Sept. 24, 2015); see also, *In re Hawker Beechcraft, Inc.*, 486 B.R. 264, 277 (Bankr. S.D.N.Y. 2013).

²³ See generally 11 U.S.C. § 365(h)–(i).

²⁴ *In re Overseas Shipholding Group, Inc.*, 2015 WL 3475727, at *1.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 3.

²⁸ *Id.* at 2.

underlying agreement barred the sublessee from seeking damages against the debtor, the only remedy the sublessee could obtain was simply the return of its security deposit.

III. Non-Debtor Lessee's Second Option when Rejection Does Not Constitute Termination

Overseas also mentioned another concept: the potential of additional rights for lessees who decide to remain in possession after rejection of their lease. As stated above, where a chapter 11 debtor is a lessor and rejects an unexpired lease, the tenant has two options: (1) the tenant can surrender possession of the premises, or (2) the tenant can retain his rights under the lease.²⁹

Under section 365(h), a lessee may retain its rights under a lease for the remainder of the lease and for any renewal or extensions of these rights to the extent that these rights are enforceable under applicable nonbankruptcy law.³⁰ The remedy available to a lessee who remains in possession is an offset against the rent for the balance of the term after the date of the rejection of the lease, and for the term of any renewal or extension of the lease, the value of any damage caused by the nonperformance of the debtor after the date of rejection.³¹ The offset of rent does not entitle the lessee or lessor to modify the rent obligation under a rejected lease, other than such offset.³² Also the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

For example, in *In re Upland/Euclid, LTD.*, the Ninth Circuit affirmed a denial of a debtor-lessor's motion to reject a lease under Section 365 because the debtor was moving to

²⁹ See supra note 18.

³⁰ See 11 U.S.C. § 365(h).

³¹ *In re Upland/Euclid, Ltd.*, 56 B.R. 250, 252 (B.A.P. 9th Cir. 1985).

³² *Id.*

reject in order to set a reasonable future rent for the premises.³³ The court noted that under section 365(h), a debtor-lessor may reject a lease, provide no more services to the lessee, and stop the flow of funds benefitting the lessee but cannot deprive the lessee of its possessory property interest in the leased premises.³⁴ To protect the lessee under this scenario, section 365(h)(2) allows the lessee to recover damages from the loss of services as an offset against the rent under the rejected lease.³⁵ The issue in this case was whether section 365(h)(2) allows the bankruptcy court to change the rent set by the rejected lease if the debtor/lessor rejects an unexpired lease of real property and the lessee elects to remain in possession.³⁶ The court noted “the statute's phrase ‘offset against the rent reserved’ implies that the rent under the lease continues.”³⁷ The court reasoned that if the offset would be against a modified rent, the section should state the offset is against “‘the rent that would otherwise be due,’ ‘the reasonable rental value of the property,’ or simply ‘the rent,’ not ‘the rent reserved under such lease.’”³⁸

Similarly, in *In re Friarton Estates Corp.*,³⁹ a New York Southern District bankruptcy court, recognized a rent-controlled tenant’s ability to remain on the premises for the term of their lease when facing a landlord’s attempt to reject their lease under section 365.⁴⁰ However, in this case, the court held that the debtor-lessor could not eliminate essential services to the tenant, whereas in *Upland/Euclid*, the lessor could terminate services but damages caused would result in abatement in rent.⁴¹ In *Friarton*, while the lessee is entitled to offsets in rent for damages

³³ *Id.* at 255.

³⁴ *In re Upland/Euclid, Ltd.*, 56 B.R. at 252.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *In re Friarton Estates Corp.*, 65 B.R. 586 (Bankr. S.D.N.Y. 1986)

⁴⁰ *Id.* at 593.

⁴¹ *In re Friarton Estates Corp.*, 65 B.R. at 593.

caused by the debtor-lessor's failure to perform, the New York bankruptcy court held that essential services must still be provided.⁴² The court's rationale revolved around using New York state law in considering the nature of the rights of the rent-controlled tenants.⁴³ The court determined that the observance of state law in a bankruptcy case would provide New York City rent controlled tenants with certainty and uniformity.⁴⁴

In summary, lessees facing a rejection of their lease have options other than vacating the premises. The law has protections for lessees who have fulfilled their obligations under their leases and affords them the right to continue their lease for the full term of the agreement, while awarding abatements in rent for any damages suffered by the lessee due to a debtor-lessor's failure to perform its obligations. State laws also play an important role. Specifically, New York law grants lessees additional protection, as it may in certain situations require debtor-lessors to continue providing essential services to lessees.⁴⁵

IV. The Exceptions: When Rejection Does Constitute Termination

While the general rule under section 365 is that a debtor's rejection of an executory contract or unexpired lease does not result in termination, there are a number of exceptions within Section 365.

Section 365(h)(1)(A)(i) states, "if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms . . . or any agreement made by the lessee, then the lessee . . . may treat such lease as terminated by the rejection."⁴⁶ A similar provision is found under section 365(i) in regards to interest in timeshares.

⁴² *Id.* at 594.

⁴³ *Id.* at 593–94.

⁴⁴ *Id.* at 594.

⁴⁵ *Id.*

⁴⁶ 11 U.S.C. § 365(h)(1)(A)(i).

Section 365(i)(1) states “If the trustee rejects an executory contract of the debtor for the sale of real property or for the sale of a timeshare interest under a timeshare plan, under which the purchaser is in possession, such purchaser may treat such contract as terminated, or . . . may remain in possession of such real property or timeshare interest.”⁴⁷ Also, many courts consider the language of section 365(d)(4) to equate to termination of unexpired leases after rejection. Section 365(d)(4) states, “an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor.”⁴⁸

With these exceptions, one must be mindful that the power to terminate lies solely with the lessee or purchaser, and not with the lessor or seller. The statute’s language states plainly that, in these exceptions, the lessee or purchaser *may* treat the lease or agreement as terminated. For example, in *In re 6177 Realty Associates, Inc.*⁴⁹, the court agreed that rejection does not always equal termination of executory contracts or leases, but that the majority of cases hold that rejection does equal termination of non-residential real property leases in which the debtor or trustee is the lessee.⁵⁰ The *6177 Realty* court reasoned that the surrender language in section 365(d)(4) “renders rejection of a non-residential real property lease different from other executory contracts in which rejection may not equal termination.”⁵¹

In *Overseas*, the debtor-sublessor argued that since rejection of the sublease terminated the lease, it was not liable for damages due to a provision in the underlying agreement.⁵²

However, in rejecting this argument, the court in *Overseas* noted this applies in the context

⁴⁷ 11 U.S.C. § 365(i)(1).

⁴⁸ 11 U.S.C. § 365(d)(4).

⁴⁹ *In re 6177 Realty Associates, Inc.*, 142 B.R. 1017 (Bankr. S.D. Fla. 1992).

⁵⁰ *Id.* at 1019.

⁵¹ *Id.*

⁵² *In re Overseas Shipholding Group, Inc.*, 2015 WL 3475727, at *1.

where a sublessee remains in possession of the premises.⁵³ In *Overseas*, the sublessee did not elect to remain in possession of the premises.⁵⁴ The court in *Overseas* also noted that the debtor's argument failed to recognize additional rights a lessee may have under section 365(h).⁵⁵

So while there are exceptions that allow rejection of executory contracts and unexpired leases to constitute termination, the applicability of these exceptions is limited. These provisions give the power to terminate after rejection in cases where the debtor is the lessee in the agreement. These provisions grant lessees the ability to either continue to perform their obligations under their lease, or, discontinue their obligations and deem a lease terminated. This essentially allows debtor-lessees to terminate unproductive or troublesome leases, while having the option to continue beneficial or profitable leases.

Conclusion

The Bankruptcy Code provides generally that rejection of an unexpired lease is not termination and instead should be treated as a prepetition breach. The Bankruptcy Code also gives lessees numerous options when facing a rejection of their leases, whether it is surrendering the premises and bringing action as if it were a prepetition breach, or remaining in possession of the premises for the full term of the agreement. In addition, the Bankruptcy Code gives authority to a lessee, when faced with rejection of its lease, to treat the lease as terminated. The exceptions discussed above allow rejection of leases to terminate a lease and give that discretionary authority to the debtor-lessee. The determination of whether rejection of an unexpired lease constitutes termination is fact specific and courts must often look at the actions of the lessee. Lessees should be mindful that any remedies available to them or claims that may arise under

⁵³ *Id.* at 3.

⁵⁴ *Id.*

⁵⁵ *Id.* at 4.

section 365, are treated as prepetition claims subject to any underlying agreements made between the parties and applicable state laws.