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\*24 TIMING IS EVERYTHING WHEN REJECTING THE COMMERCIAL REAL ESTATE LEASE

Lisa S. Gretchko

Pepper Hamilton LLP gretchkol@pepperlaw.com

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A debtor's right to reject leases is a mainstay of the reorganization process. Often, the business debtor needs to "shed" unprofitable locations by rejecting some of its commercial real estate leases. The debtor's right to reject can be the bane of the commercial landlord's existence. Rejection often results in "dark stores," a disruption of the landlord's income stream and an inability to plan. This inherent tension between debtors and landlords has generated substantial case law, including the recent decision by the U.S. Court of Appeals for the Sixth Circuit in *Koenig Sporting Goods Inc. v. Morse Road Co.*, 203 F.3d 986 (6th Cir. 2000). *Koenig* is the first circuit court decision to conclude that a debtor/tenant *must* pay *all* of the rent that *becomes due* during the post-petition pre-rejection period under a lease of non-residential real property, even when possession of the property is relinquished mid-month. At issue was §365(d)(3) of the Bankruptcy Code, which states, in pertinent part:

The trustee shall timely perform all the obligations of the debtor ... arising from and after the order for relief under any unexpired lease of non-residential real property, until such lease is assumed or rejected, notwithstanding §503(b)(1) of this title ...

In *Koenig*, the tenant was a party to a 10-year lease of non-residential real property under which the tenant was to pay monthly rent of \$8,500 on the *first* day of each month. On Aug. 18, 1997, the tenant filed its chapter 11 petition. Thereafter, the debtor obtained court authority to conduct going out of business (GOB) sales at its retail stores. Next, the debtor filed a motion seeking an extension of the 60-day lease rejection deadline embodied in 11 USC §364(d)(4). In that motion, the debtor/tenant sought court authority to reject the leases of the stores at which the GOB sales were being held by giving just seven days' notice of rejection to the landlord of those stores. Morse Road Co., the landlord at issue in the case, received the motion but did not object to it. The motion was granted on Nov. 6, 1997. On Nov. 25, 1997, the debtor/tenant notified its landlord, Morse Road Co., that it was rejecting the lease effective Dec. 2, 1997, and the debtor actually vacated the premises on Dec. 2.

On Jan. 29, 1998, the landlord filed a motion with the bankruptcy court seeking payment of rent for the entire month of December 1997. The debtor/tenant objected, arguing that the landlord was only entitled to rent for Dec. 1st and 2nd, which totaled \$516.13. The bankruptcy court granted the landlord's motion. The debtor/tenant appealed to the Bankruptcy Appellate Panel for the Sixth Circuit, which affirmed. The debtor/tenant then appealed to the Sixth Circuit Court of Appeals.

In a well-reasoned opinion, the Sixth Circuit became the first circuit court to address an issue that has thus far split lower courts. One line of cases supported the debtor/tenant's position that the landlord was only entitled to a *pro-rata* share of the December rent for the two days the debtor/tenant actually occupied the leased premises. *See, e.g., In re McCrory Corp.*, 210 B.R. 934 (S.D.N.Y. 1997). Another line of cases supported the landlord's position that it was entitled to the full month's rent if the rent payment was due on the first of the month and the debtor/tenant occupied the non-residential real property for *any* portion of a month. *See, e.g., In re Krystal Co.*, 194 B.R. 161 (Bankr. E.D. Tenn 1996).

The Sixth Circuit rejected the debtor/tenant's argument that 11 U.S.C. §365(d)(3) was ambiguous in the context of this case. The lease clearly stated that rent was due on the *first* day of the month. Dec. 1, 1997, occurred during the post-petition pre-rejection period, and therefore, 11 U.S.C. §365(d)(3) unambiguously required the debtor/tenant to pay December rent *in full* even though the lease rejection was effective on Dec. 2, 1997, and the debtor actually vacated the premises on that day.

The court rejected the debtor/tenant's argument that “equity” and “common sense” mandated that the December rent be prorated so that the debtor/tenant would only pay rent for the two days that it occupied the leased premises. In so ruling, the court noted that the debtor/tenant *chose* Dec. 2, 1997, as the date to reject the lease and vacate. If the debtor/tenant had chosen to reject the lease and vacate just two days earlier—on Nov. 30, 1997—it would never have become obligated to pay the December 1997 rent. Because the debtor/tenant had control over the dates on which it rejected the lease and vacated, the court reasoned that it would be inequitable to deny the landlord the full December rent.

In its ruling, the court seemed to focus on the debtor's complete control over the lease-rejection process. The bankruptcy court had approved all of the debtor's requests regarding its store leases, including the debtor's motions to conduct GOB sales and to reject store leases on seven days' notice to the affected landlord. In light of these granted enhancements to the debtor's already powerful right to reject the lease, the court was patently unwilling to grant the debtor yet another indulgence.

*Koenig* seems harsh to debtor's lawyers because they are accustomed to 11 U.S.C. §503(b)(2), which provides that administrative expenses are to be paid *only* for actual and necessary costs to preserve the estate. Consequently, debtors' lawyers object to any debtor having to pay rent for any period after it has rejected the commercial lease and vacated the premises. In reality, however, the perceived harshness of *Koenig* is mandated by the language of 11 U.S.C. §365(d)(3), which *requires* the debtor to timely perform all post-petition pre-rejection obligations under a commercial lease and expressly exempts those obligations (such as rent) from the rigors of 11 U.S.C. §503(b)(2). Based on the language of 11 U.S.C. §365(d)(3), *Koenig* is a well-written decision that clearly defines the debtor/tenant's rent obligation if a lease of non-residential real property is rejected mid-month. The decision brings a much-needed certainty to the application of 11 U.S.C. §365(d)(3) for both landlords and tenants, and confirms that timing is everything, even in the context of lease rejection.

19-SEP AMBKRIJ 24

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