

Can You Handle Rejection?

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In a case that arose from the bursting of the Internet bubble, the court was faced with the issue of whether to approve a retroactive rejection of the dot-com debtor's lease. *Pacific Shores Development v. At Home Corporation (In re: At Home Corporation)*, 9th Circuit, Dec. 28, 2004, 392 F3rd 1064. The Ninth Circuit approved a retroactive rejection of the lease and related it back to the date of the debtor's motion, even though that date was *before* the landlord re-took possession of the premises. The panel relied heavily on *Thinking Machines v. Mellon Fin. Servs. Corp. (In re Thinking Machines)*, 67 F. 3rd 1021 (1st Cir. 1995).

The debtor had leased two buildings from the landlord and deposited \$20,000,000 in escrow for finish-out. Although the renovations were substantially completed, the debtor sought relief under Chapter 11 and did not occupy the buildings. On the date of the bankruptcy filing, the landlord held \$1,000,000 in escrow. The tenant did not "surrender" the space to the landlord prior to filing because, for some reason, it was fearful that the landlord would convert the escrowed funds to "rent." On the date of filing, the debtor sought, among the usual "first day motions," to reject the lease *nunc pro tunc* to the date of filing of the motion. While the landlord did not object to the rejection, it did object to the retroactive nature of the request; if the relief were granted, it could not "retain" the \$1,000,000 escrow monies as post-petition rent.

The landlord argued that it was improper to allow a retroactive rejection to be effective as of a date that was prior to the landlord's re-taking possession of the premises. It also argued that the court's reliance on the following factors was in error: (i) the debtor moved to reject the lease immediately upon filing the bankruptcy; (ii) the debtor immediately sought a hearing; (iii) the debtor was not in possession of the premises; and (iv) the landlord's sole interest was in "running the administrative rent."

The court went into a lengthy discussion of the "Shopping Center Amendments" to § 365 of the Bankruptcy Code and concluded that such amendments to § 365(d) cured the two significant problems faced by commercial landlords in a bankruptcy proceeding. The court recited that the amendments ensured a landlord that (1) it would receive its contractual rent until the lease was rejected and (2) the debtor could not tie up the space for the entire bankruptcy proceeding. The court then addressed the litigation that followed the passage of the amendments relating to the effective date of a rejection. It discussed the "majority view" that the rejection does not become effective until such time as an order is entered. This view regards court approval as a condition precedent to the rejection of a lease. See *Paul Harris Stores, Inc v. Salter Realty Trust* 148 B.R. 808, 815 (S.D. Ohio 1991). Under the "minority view," a rejection is effective upon the filing of the motion. Under this view, the court order is merely a stamp of approval of the business judgment exercised by the debtor or trustee. See *Joseph C. Spiess* 145 B. R. 597, 601 (Bankr. N.D. Ill. 1992).

In reviewing the ability of the bankruptcy court to order a retroactive rejection, the court noted that § 365 is silent on this issue. It then went on to find that a bankruptcy court had the equitable power to order a retroactive rejection when such an order was necessary or appropriate to carry out the provisions of § 365(d). This power flows from § 105(a), which is the equivalent of the "all writs" act for bankruptcy courts.

After finding that the court had the power to issue the retroactive order, the court explored whether the landlord's possession of the premises was required before such an order could be entered. The panel believed that possession was not necessary.

Finally, after deciding the bankruptcy judge had the statutory power to order retroactive rejection and that a surrender of possession by the tenant (or possession by the landlord) was not required, the court addressed whether the bankruptcy court's action was an abuse of discretion. It noted that retroactive rejection should be ordered only in exceptional cases, citing *O'Neil Theatres*, 257 B.R. 806, 808 (Bankr. E. D. La. 2000). The court would not limit the factors that a bankruptcy court could consider in determining whether to order a retroactive rejection. The landlord pointed out that in virtually every case where retroactive rejection was approved, the debtor was not occupying the premises. It argued that the automatic stay under § 362 in effect created a *de facto* occupancy. In finding that the bankruptcy court did not abuse its discretion, the panel commented on the fact that the court focused on the practical effect, rather than the legal significance of the lack of occupancy. It found that the lack of actual occupancy made it easier for the landlord to re-let the premises.

It appears that this panel of the Ninth Circuit was motivated to affirm in some part by the landlord's seemingly greedy motives to retain the \$1,000,000 in rent. It made a point of reiterating the language from the bankruptcy court that the landlord's sole interest was in "running the administrative rent." In that regard, this may be a case of bad facts making bad law. In short, debtors will be seeking retroactive rejection whenever they can allege any facts that would enable them to argue that it would be "inequitable" for the landlord to be paid administrative rent for the period subsequent to the relation-back date. Acceptance of this argument would make it almost impossible for a landlord to obtain compensation for the period when it was barred by the automatic stay from taking possession of the premises.

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