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### A Bankruptcy Court May Temporarily Suspend Rent Obligation

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**A Bankruptcy Court May Temporarily Suspend Rent Obligation**

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**Introduction**

Section 365(d)(3) of title 11 of the United States Code (the “Bankruptcy Code”) authorizes a court to “extend, for cause, the time for performance of any [rent] obligation[‘s] [on unexpired leases of nonresidential real property] that arise[] within 60 days after the date of the order for relief[.]”<sup>1</sup> Historically, courts have recognized that under § 365(d)(3), there is a statutory obligation on debtors to pay rent on unexpired leases.<sup>2</sup> Courts have also recognized that if a debtor’s rent obligation is deferred, lessors are entitled to adequate protection.<sup>3</sup> However, courts are divided on the exact timing of when a debtor’s statutory obligation to pay rent arises, what circumstances permit courts to defer a debtor’s rent obligation, and the subsequent

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<sup>1</sup> 11 U.S.C. § 365(d)(3) (2018). Section 365(d)(3) of the Bankruptcy Code provides that a debtor in possession “shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.” *Id.*

<sup>2</sup> See *In re Circuit City Stores, Inc.*, 447 B.R. 475, 506 (Bankr. E.D. Va. 2009) (recognizing debtors’ obligation under § 365(d)(3) to pay rent).

<sup>3</sup> See *In re Pier 1 Imports, Inc.*, 615 B.R. 196, 202 (Bankr. E.D. Va. 2020).

treatment of lessors' claims.<sup>4</sup> Consequently, the Covid-19 pandemic has created challenges that have further complicated the already unclear applicability of § 365(d)(3).<sup>5</sup>

This memorandum analyzes a court's ability to defer a debtor's statutory rent obligations on unexpired leases. Part I discusses the majority and minority positions regarding § 365(d)(3) rent deferral issues that were prevalent in jurisprudence prior to the Covid-19 pandemic. Part II addresses how the Bankruptcy Court for the Eastern District of Virginia, one of the first courts to address the issue of rent deferral during a pandemic, approached these unparalleled circumstances. Part III analyzes how courts have since dealt with these issues throughout the pandemic.

### **I. Courts are Split on the Issue of Delaying Rent Obligations under § 365(d)(3).**

Historically, the majority of courts have taken the view that § 365(d)(3) is ambiguous as to the timing of exactly when the statute requires the payment of rent that accrues post-petition on unexpired leases.<sup>6</sup> Accordingly, the majority of courts have adopted the accrual method to deal with § 365(d)(3) related issues.<sup>7</sup> In contrast, the minority of courts have applied the billing method to analyze § 365(d)(3) issues.<sup>8</sup> The key difference between the two methods is how

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<sup>4</sup> See *In re McCrory Corp.*, 210 B.R. 934, 936–937 (Bankr. S.D.N.Y. 1997).

<sup>5</sup> See *In re Pier 1 Imports, Inc.*, 615 B.R. at 198.

<sup>6</sup> See *In re McCrory Corp.*, 210 B.R. at 937; see *In re Travel 2000, Inc.*, 264 B.R. 444, 450 (Bankr. W.D. Mich 2001) (“When applying 11 U.S.C. § 365(d)(3) to the circumstances of the case before us, ambiguity emanates from the words ‘arises’ and ‘obligation.’.”); see also *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986, 989 (6th Cir. 2000) (highlighting that there is a “split of authority within the district and bankruptcy courts as to the proper interpretation of this provision.”).

<sup>7</sup> See *In re McCrory Corp.*, 210 B.R. at 937.

<sup>8</sup> See *id.*

courts view the distinction between prepetition and post-petition obligations in relation to the petition date.<sup>9</sup>

**A. The Majority of Courts Allow Rent to be Deferred Under the Accrual Method.**

Under the accrual method, courts view anything that has accrued after the entry of the order for relief as “a post-petition charge that may be elevated to administrative priority under § 507(a).”<sup>10</sup> As such, the majority of courts have used this framework to defer post-petition rent and rent related obligations.<sup>11</sup> Furthermore, the majority approach uses the accrual method for the sake of differentiating prepetition obligations from post-petition with regard to when the obligation to pay rent under a lease arises.<sup>12</sup>

Additionally, the majority of courts treat lessors’ claims for post-petition rent as administrative expense claims “payable upon the effective date of any plan of reorganization in these cases,” instead of treating them as a superpriority that would require immediate payment.<sup>13</sup> For example, these courts have dealt with stub rent claims by allowing it to be prorated but have still deferred it as an administrative expense claim rather than treat it as a priority payment due immediately.<sup>14</sup>

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<sup>9</sup> See *In re Circuit City Stores, Inc.*, 447 B.R. 475, 507 (Bankr. E.D. Va. 2009) (noting that the discrepancy between the two analytical approaches was the treatment of the petition date).

<sup>10</sup> See *id.* at 508.

<sup>11</sup> See *id.* at 508–509.

<sup>12</sup> See *id.*; see also *In re McCrory Corp.*, 210 B.R. at 937.

<sup>13</sup> *In re Circuit City Stores, Inc.*, 447 B.R. at 511–512.

<sup>14</sup> See *id.* at 511 (“[T]he Debtors should not be ordered to pay the Stub Rent immediately. Stub Rent is not entitled to superpriority but only to administrative priority pursuant to § 507(a) of the Bankruptcy Code.”).

## **B. Courts That Have Taken the Minority Approach, Require Payment of Rent Obligations Immediately.**

A minority of courts utilize the billing method to address § 365(d)(3) timing issues.<sup>15</sup> Under the billing method, a debtor must pay its rent when due under the lease “during the post-petition, prerejection period, regardless of when those charges accrued.”<sup>16</sup> Further, under the billing method, unpaid postpetition rent is generally due for immediate payment (in accordance with the lease terms) regardless of the effect that requiring such payment would have on the assets of the estate.<sup>17</sup> Courts that adopt this approach typically refuse to grant a debtor’s request for rent deferral.<sup>18</sup> For example, if a debtor rejects a lease after the debtor’s monthly rent obligation has arisen for that month, the billing method rejects the notion of awarding lessors a deferred pro rata share of rent in favor of finding that lessors are entitled to immediate payment of that full month’s rent.<sup>19</sup>

The minority view is predicated on the congressional intent behind § 365(d)(3), which was to relieve the burden that rent related uncertainties place on nonresidential lessors during the intervening period between a debtor’s petition filing and the assumption or rejection of a lease.<sup>20</sup> And the minority of courts view the language of § 365(d)(3) as clear and unambiguous.<sup>21</sup> In support of the statute’s language being unambiguous, the Sixth Circuit, in *In re Koenig Sporting*

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<sup>15</sup> See *In re McCrory Corp.*, 210 B.R. at 937–938.

<sup>16</sup> See *id.*

<sup>17</sup> See *id.*

<sup>18</sup> See *In re Oreck Corp.*, 506 B.R. 500, 504 (Bankr. M.D. Tenn. 2014).

<sup>19</sup> See *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986, 989 (6th Cir. 2000) (“In this case, involving a month-to-month, payment-in-advance lease, where the debtor had complete control over the obligation, we believe that equity as well as the statute favors full payment to [landlord].”).

<sup>20</sup> See *id.* (quoting *In re Cannonsburg Envtl. Assocs.*, 72 F.3d 1260) (stating that the purpose of § 365(d)(3) is to “prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-a-vis the estate.”).

<sup>21</sup> See *id.*

*Goods, Inc.*, relied on the fact that because rent obligations are due in advance, generally on the first of each month, the lessors have an unpaid claim against the estate for failure to timely pay the rent obligation just “like anything else.”<sup>22</sup> The Sixth Circuit therefore held that the statute’s language supports this treatment of those claims.<sup>23</sup> And unlike the majority interpretation, their view is that the statute’s meaning is not actually predicated on reading the words “arise” and “obligation” as requiring an analysis of when in the petition process the rent was due because the debtor knew of the charges in advance of filing.<sup>24</sup> Thus, historically the court split has hinged on whether the language of § 365(d)(3) is ambiguous or not.<sup>25</sup>

## **II. The Bankruptcy Court for the Eastern District of Virginia Held That § 365(d)(3) Authorized the Court to Grant Debtor Relief.**

*In re Pier 1 Imports, Inc.*, was one of the first cases to address the impact of the pandemic on a debtor’s rent obligations.<sup>26</sup> With stay-at-home orders and mandatory closures of nonessential retail businesses affecting Pier 1’s ability to carry out its Chapter 11 reorganization, Pier 1 faced the challenge of satisfying their rent obligations and sought relief from the courts.<sup>27</sup>

In the early stages of the pandemic, the *Pier 1* court for the recognized that even though § 365(d)(3) had never been applied to anything like a global pandemic, past jurisprudence weighed in favor of permitting the court to defer rent obligations if doing so would be in the best

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<sup>22</sup> See *In re Oreck Corp.*, 506 B.R. at 504 (citing *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986).

<sup>23</sup> See *In re Koenig Sporting Goods, Inc.*, 203 F.3d. at 989.

<sup>24</sup> See *id.*

<sup>25</sup> See *In re McCrory Corp.*, 210 B.R. 934, 937–938 (Bankr. S.D.N.Y. 1997).

<sup>26</sup> See *In re Pier 1 Imports, Inc.*, 615 B.R. 196, 197–198 (Bankr. E.D. Va. 2020).

<sup>27</sup> See *id.* (noting that the impact of mandatory closures on the Chapter 11 debtor was that they saw go-forward stores’ sales fall approximately 65% compared to the prior year and that Pier 1 instituted remedial measures to preserve liquidity, ranging from furloughing employees, closing stores, decreasing salaries, and reaching out landlords to negotiate possible rent deferrals, that were unsuccessful in offsetting losses enough to allow Pier 1 to satisfy its rent duties).

interests of the estate.<sup>28</sup> Moreover, the court did not hold that the debtors were relieved of their duty to pay rent but instead held that in light of the present circumstances, the statute permitted the debtors to defer “such rent obligations as they accrue through the Limited Operations Period to be paid at a later date.”<sup>29</sup> Accordingly, the court determined that the lessors’ claims were to be treated as administrative expense claims instead of superpriority treatment because the court held that lessors were not entitled at this time to be paid before other “accrued but unpaid administrative expense claims.”<sup>30</sup>

In support of its approach, the court cited the fact that there was no other feasible alternative at this time to the relief sought.<sup>31</sup> The court reasoned that even if it were to read the statute in a way that forced the debtor to liquidate to meet their rent obligations, such liquidation is not possible since the debtor was forced to remain closed and could not generate the revenue necessary to pay rent.<sup>32</sup> Also, the court further supported this approach by addressing issues of lessors’ entitlement to adequate protection pursuant to § 361 and § 363 of the Bankruptcy code.<sup>33</sup> Section 361 defines adequate protection as compensating “non-debtor[s] to the extent any proposed lease” would cause a decrease in the value of that entity’s interest in the subject property.<sup>34</sup> But the court held that this did not require debtors provide lessors with

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<sup>28</sup> *See id.* at 204.

<sup>29</sup> *Id.* at 201.

<sup>30</sup> *Id.* at 202.

<sup>31</sup> *See id.* at 203.

<sup>32</sup> *See id.* at 203–204 (“The Debtors cannot effectively liquidate the inventory while their stores remain closed.”).

<sup>33</sup> *See id.* 202–203.

<sup>34</sup> 11 U.S.C. § 361 (2018).

immediate payment and that administrative expense claim treatment coupled with debtors' remedial measures and assurance of cure payment was sufficient.<sup>35</sup>

Therefore, the court determined that in light of the “unforeseen, and unforeseeable glitch in the administration of the Debtors' Bankruptcy Cases[,]” § 365(d)(3) was correctly read as authorizing courts to delay a debtor’s rent obligations under appropriate circumstances if delay is in the best interests of the estate.<sup>36</sup>

### **III. Other Courts Have Also Evaluated Covid-19’s Impact on Rent Obligations.**

Courts in other jurisdictions have addressed similar issues to that of *In re Pier 1 Imports, Inc.*, with some courts taking somewhat similar approaches to the Pier 1 court.<sup>37</sup> For instance, the Bankruptcy Court for the Southern District of Florida, in *In re Cinemax USA Real Estate Holdings, Inc.*, took an analytical approach that resembled the *In re Pier 1 Imports* court in some ways, but still had some notable differences.<sup>38</sup>

The *Cinemax USA* court applied the doctrines of force majeure and frustration of purpose in the context of § 365(d)(3) rent issues.<sup>39</sup> According to the court, the debtor was not required to

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<sup>35</sup> See *In re Pier 1 Imports, Inc.*, 615 B.R. at 203 (“The Court found that, to the extent adequate protection is required, the continued payment of the related non-rent payments and assurance of cure payment in July is sufficient to protect the Lessors against any perceived diminution in value.”).

<sup>36</sup> See *id.* at 203–204; see *In re Modell's Sporting Goods, Inc.*, No. 20-14179 (VFP), Docket No. 166 (Bankr. D. N.J. March 27, 2020) (holding that the pandemic warranted granting debtors an additional deferral of rent obligations beyond the initial 60-day period because doing so was in the best interests of the estate); see also *In re Hitz Rest. Grp.*, 616 B.R. 374, 378–79 (Bankr. N.D. Ill. 2020) (holding that § 365(d)(3) authorized the court to defer rent obligations).

<sup>37</sup> See *In re Modell's Sporting Goods, Inc.*, Docket No. 166 (granting debtor relief because relief was in the best interests of the estate); see *In re CraftWorks Parent, LLC.*, No. 20-10475 (BLS), Docket No. 217 (Bankr. D. Del. Mar. 30, 2020) (granting debtor a suspension of rent payments while bankruptcy proceedings were paused due to the pandemic); see also *In re Cinemax USA Real Estate Holdings, Inc.*, No. 20-14695-BKC-LMI, 2021 WL 564486 at \*1, \*5 (Bankr. S.D. Fla. Jan. 27, 2021) (approving relief for the debtor).

<sup>38</sup> See *In re Cinemax USA Real Estate Holdings, Inc.*, 2021 WL 564486 at \*5.

<sup>39</sup> See *id.*



pay rent for the time that their business was closed as a result of the pandemic because the “pandemic was completely unforeseeable.”<sup>40</sup> Further, this court determined that § 365(d)(3) by itself was not a sufficient basis for courts to defer rent obligations for cause due to pandemic related issues.<sup>41</sup> But this court also held that § 365(d)(3) did not bar the court from granting debtors relief.<sup>42</sup> The court instead found § 365(d)(3) impliedly allowed it to use the doctrines of force majeure and frustration of purpose to still grant debtor relief and extinguished the debtor’s obligation to pay rent for the intervening period that debtor remained closed from Covid-19 instead of deferring the rent and converting it to an administrative expense claim.<sup>43</sup>

However, at least one court has disagreed with the Pier 1 court and declined to read § 365(d)(3) as authorizing the court to grant debtor further relief.<sup>44</sup> The Bankruptcy Court for the Southern District of Texas, in *In re CEC Entertainment, Inc.*, declined to view § 365(d)(3) as giving the court the power to alter the debtor’s rent obligations.<sup>45</sup> This court evaluated whether it could grant debtor relief in the form of rent deferral or rent reduction at venues that the debtor operated in three states that were experiencing closures due to the pandemic and related government mandates.<sup>46</sup> However, the court held that the meaning of the statute was not only clear, but it required that a debtor, who is a commercial real property lessee, must continue to timely perform its lease obligations.<sup>47</sup>

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<sup>40</sup> *See id.*

<sup>41</sup> *See id.*

<sup>42</sup> *See id.*

<sup>43</sup> *See id.*

<sup>44</sup> *See In re CEC Entertainment, Inc.*, No. 20-33163, 2020 WL 7356380 at \*1, \*1 (Bankr. S.D. Tex. Dec. 14, 2020) (declining to provide relief to debtor).

<sup>45</sup> *See id.* at \*4.

<sup>46</sup> *See id.* at \*1.

<sup>47</sup> *See id.* at \*4 (“Section 365(d)(3) unambiguously requires that debtors timely perform obligations under commercial leases. The [c]ourt cannot override that statutory mandate.”).

## Conclusion

The Covid-19 pandemic has complicated an already divisive court split on the language and applicability of § 365(d)(3) of the Bankruptcy Code on rent obligations, with the majority of courts finding the section's language to be ambiguous.<sup>48</sup> During the pandemic, most courts have utilized some variation of the accrual method to ease the burden the pandemic and its related government mandates have placed on debtors.<sup>49</sup> A majority of courts that have issued written decisions on the rent deferral issue during the pandemic have determined that despite the statutory obligation to pay rent, a court may delay that obligation under appropriate circumstances if delay is in the best interests of the estate.<sup>50</sup> Still, one court has declined to interpret § 365(d)(3) as providing courts the authority to affect such a remedy and grant relief to debtors in the form of a rent deferral.<sup>51</sup> Thus, the pandemic has not changed the fact that courts remain split on the issue of rent deferrals under § 365(d)(3).<sup>52</sup>

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<sup>48</sup> *See In re CEC Entertainment, Inc.*, 2020 WL 7356380 at \*5–\*6; *see also In re McCrory Corp.*, 210 B.R. at 937.

<sup>49</sup> *See In re Pier 1 Imports, Inc.*, 615 B.R. 196, 203–204 (Bankr. E.D. Va. 2020).

<sup>50</sup> *See id.*

<sup>51</sup> *See In re CEC Entertainment, Inc.*, 2020 WL 7356380 at \*4.

<sup>52</sup> *See id.*