

Giant Eagle, Inc. v. Phar-Mor, Inc.

Courtney Pasquariello, J.D. Candidate 2010

QUESTION PRESENTED

Whether under bankruptcy law and Pennsylvania common law a lessee corporation that files for bankruptcy and rejects equipment leases is excused from liability for its breach when the lessor enters into a substitute lease with a mitigatory lessee that later rejects the substitute lease?

BRIEF ANSWERS

Although under Pennsylvania common law a lessor has a duty to mitigate damages and is unable to claim damages that could have been avoided, no legal proposition exists that an injured lessor who attempts mitigation of damages resulting from a lessee's misconduct must bear the consequences of a failed effort. Although the lessor received partial mitigation of a claim against a liable lessee, the lessee nonetheless remains liable for his previous breach.

STATEMENT OF FACTS

On May 1, 1995 Phar-Mor, Inc. (Phar-Mor) entered into leases scheduled to terminate on September 1, 2008 with Giant Eagle, Inc. and Value Eagle Associations (Giant Eagle) to rent warehouse equipment owned by each company respectively. On September 24, 2001, eight years shy of the lease expiration date, Phar-Mor entered a chapter 11 bankruptcy filing. Phar-Mor nevertheless continued to use the warehouse equipment in helping the company disassemble

over the next several months and continued to pay partial rent during that period. The bankruptcy court eventually ordered the sale of Phar-Mor's assets on July 18, 2002 leading to liquidation sales and final inventory counts.

Following Phar-Mor's demise, Giant Eagle entered a claim for administrative expenses resulting from the rents due from the leases during this time. Further, terms in the lease agreements included an express choice-of-law provision, requiring the use of Pennsylvania law, as well as another provision which required Phar-Mor to pay liquidated damages at a present future value rate. However, Giant Eagle, recognizing its duty to mitigate damages, entered into a substitute, but separate and independent, lease agreement with Snyder Drugstores, Inc. (Snyder) on October 31, 2002. The new lease terms were for the same equipment at an equal price as had previously been leased to Phar-Mor however, there was no assumption, release, assignment, waiver, or novation of Phar-Mor's leases. Additionally, Snyder's leases had a different end date of October 31, 2012.

On September 11, 2003, to Giant Eagle's dismay, Snyder filed bankruptcy followed by Snyder's formal rejection of the leases on November 30, 2003. After Snyder's rejection Giant Eagle was not able to make another substitute lease agreement and chose to scrap, sell, and reuse the equipment. Giant Eagle then filed claims in bankruptcy proceeding for Phar-Mor requesting: (1) rent owed from the period of September 24, 2001 until September 30, 2002 to cover administrative expenses; and (2) liquidated damages due for the monthly lease payments over the remaining period following September 30, 2002 not including the amount that had been mitigated by the lease with Snyder. Phar-Mor objected to the claims for the administrative expenses due for the period from July 18, 2002 until September 30, 2002, however this cost is not at issue. Phar-Mor also objected to the liquidated damages Giant Eagle was claiming for the

period after October 31, 2002 during which Giant Eagle had entered into a lease agreement with Snyder. Phar-Mor claimed that as a result of the substitute lease agreement Giant Eagle was not suffering from actual damages during this time.

DISCUSSION

A lessee corporation becomes liable for future rent payments when it files for bankruptcy and rejects an unexpired equipment lease. Here, Giant Eagle, a lessor, claimed that it was owed “(1) administrative expenses in the form of rents due from September 24, 2001, until September 20, 2002, less the amounts Phar-Mor had already paid; and (2) liquidated damages for monthly lease payments due for the lease term remaining after September 20, 2002, less the amount mitigated.” *Giant Eagle, Inc. v. Phar-Mor, Inc.*, 528 F.3d 455, 458 (6th Cir. 2008). Phar-Mor, on the other hand, argued that once Giant Eagle entered into a subsequent lease agreement with a third-party, Snyder on October 31, 2002, Giant Eagle had fully mitigated all damages caused by Phar-Mor and thus Phar-Mor was not liable for any damages occurring after the substitute lease was formed.

It is undisputed by the courts that Phar-Mor was liable for rent payments from July 18, 2002 until September 30, 2002 despite the fact that Phar-Mor contended that it continued to use the leased equipment for Giant Eagle’s benefit. Under 11 U.S.C. § 365(d)(5) a debtor must pay rent until he actually rejects a lease. However, the Sixth Circuit Court of Appeals disagreed with the bankruptcy and district courts’ decision favoring Phar-Mor, that in entering a subsequent lease with Snyder, Giant Eagle had fully mitigated all damages caused by Phar-Mor’s breach of lease agreement and thus Phar-Mor was not liable after Snyder rejected its lease.

This memorandum will: I. address the underlying statutory information which must be known in order to fully understand the case at hand; II. Discuss the arguments of each party and the lower court history of the case as it made its way up from the bankruptcy court to the district court to the Sixth Circuit Court of Appeals; and III. Explain the conclusion of the Sixth Circuit Court of Appeals on the issue of failed mitigation reviving dead claims.

I. Statutory Context

The case *Giant Eagle, Inc. v. Phar-Mor, Inc.* spawned from 11 U.S.C. § 502(g)(1) and 11 U.S.C. § 365(g). 528 F.3d 455, 461 (6th Cir. 2008). Under 11 U.S.C. § 365(g) an unexpired lease may be rejected by a bankruptcy trustee and may proceed as if the lease had been breached by the debtor immediately before the petition date. 11 U.S.C. § 365(g) (2006). The purpose of section 365(b) is to secure the title of a general unsecured creditor for the non-breaching party to a contract that has not been assumed. As a result, the non-breaching party (lessor) is prompted to file a proof of claim in order to recover damages according to 11 U.S.C. § 502(g)(1). Therefore, the result of a rejection is an existing breach of contract or lease agreement for which damages can be recovered. The substantive rights of parties' under the lease, including measure of damages, are not affected by the rejection. 3 COLLIER ON BANKRUPTCY, ¶365.09, at 365-81.

II. Arguments and Lower Court History

It is clear from *Giant Eagle* and *Phar-Mor*'s arguments addressing liability that both parties were approaching the idea of lease rejection and mitigation from two polar opposite and conflicting view points. While *Giant Eagle* argued that it was rightfully entitled to damages as a result of *Phar-Mor*'s lease rejection and should thus be named a general unsecured creditor for distribution purposes in *Phar-Mor*'s bankruptcy proceeding, *Phar-Mor* disagreed stating that it was excused from liability after the date of *Giant Eagle*'s new lease with *Snyder*. *Giant Eagle*,

528 F.3d at 461. Phar-Mor explained that when a lessor enters a subsequent lease agreement with another party which would have the effect of fully mitigating a prior lease rejection it is as if the prior breached lease had been assumed or had never existed. *Id.* Thus the bankruptcy court, district court, and Sixth Circuit Court of Appeals were left to answer the question of revival of potentially fully mitigated leases.

The bankruptcy court addressed the issue of damages post lease-rejection first when it found that Giant Eagle had mitigated all damages resulting from Phar-Mor's lease rejection through its replacement lease with Snyder. *Id.* at 459. The court turned to Pennsylvania state law to determine the method of calculating damages because the bankruptcy code did not address this issue. Although Pennsylvania law provided various options when calculating damages, the most fitting option appeared to be that provided under 13 Pa.C.S.A. § 2A523(a)(6), that a lessor is able to "pursue any other remedies provided they are in the lease contract". *Id.* However, the court clearly stated that the lessor is obligated to mitigate damages and could not claim reasonably avoidable damages. The court concluded that once the mitigation of damages by a lessor has been complete through a re-letting of equipment, the lessor can not later claim damages for the time period included in the new lease from the debtor if the new lessee breaches its obligations. *Giant Eagle*, 528 F.3d at 459–60. Reasoning that to do otherwise would require a forecasting of viability of all lessees who enter mitigating leases in order to determine if the mitigating lease will be successful, the court felt that this would be a revival of a debtor's duty which would result in four major problems including: (1) uncertainty as the breachor waited to for the end of the rejected lease term to find out if he would owe damages; (2) forced litigation by lessor in order to protect himself from the expiration of the statute of limitations in case of failed mitigation; (3) the creation of an unwanted guarantor or co-debtor relationship between the

breaching lessee and mitigating lessee; and (4) the lessor's unjust enrichment resulting from his being put in a better position than he would have been under the original lease. *Id.* at 460.

Dissatisfied with the bankruptcy court's ruling, Giant Eagle appealed this issue to the district court. *Id.* Affirming the bankruptcy court's decision, the district court stated that Giant Eagle failed to demonstrate that the lease obligations of Phar-Mor could be *revived* after mitigation and replaced by a new lease agreement with Snyder. However, the district court cited no other law or additional reasoning for its opinion. *Id.* at 461.

III. Sixth Circuit Court of Appeals Ruling

Upon its *de novo* review of the issue, the Sixth Circuit Court of Appeals held that the district court erred when it disallowed Giant Eagle's rightful claim for future-rent damages resulting from Phar-Mor's lease rejection based on the fact that the substitute lease with Snyder, if completed, would have provided mitigation for the claimed damages. Because this case presented a question of law, the circuit court recognized that the bankruptcy court's factual findings were not material to the disposition of the appeal. *Id.*

Accepting proper lease rejection under 11 U.S.C. § 365(a) this court was still left to determine "how to properly quantify such a claim—first 'as of the date of the filing of the petition' (i.e., benefit of the lease bargain), and then, 'except to the extent that such claim is unenforceable against the debtor' (i.e., actual damages)." *Id.* at 462. For this calculation the court relied on state law provided that it did not clash with bankruptcy law, and again decided, just as the bankruptcy court had, that the 13 Pa.C.S.A. § 2A523(a)(6) provided the most fitting method of calculation. *Id.* at 463. Additionally, finding support in, *In re Steiner*, the court concluded that Giant Eagle was only entitled to actual damages so as not to unjustly enrich the lessor who was returned his property, thus having it available for release, as a result of the prior lease rejection.

50 B.R. 181, 183 (Bankr. N.D. Ohio 1985); *Giant Eagle*, 528 F.3d at 462. In order to avoid unjust enrichment, the proper equation was to first determine the benefit of original lease as of the time of filing of the petition and then subtract the amount reasonably mitigated, here the amount mitigated through Snyder's one-year lease. *Giant Eagle*, 528 F.3d at 463.

The Sixth Circuit Court of Appeals reasoned that the four consequences that plagued the bankruptcy court were flawed from the beginning to the end starting with the fact that the court was working under the false assumption that obligations of the original lessee were terminated in the event of subsequent mitigation. Additionally, the bankruptcy court's argument that if allowed this so-called revival would leave behind an anxious debtor wondering if he would have to pay damages at some unpredictable future date was also erroneous in that this is a question of the duration of the statute of limitations and thus is left up to legislation. For under this scenario, the possible debtor would be waiting no longer to find out if he had to pay for his breach than if a lessor had taken his time in filing an original claim for damages. Furthermore, the problem of forced litigation by a lessor in order to ensure protection against failed mitigation is also a statute of limitations problem left up to the legislature. Finally, the court of appeals struck down the idea that by allowing the lessor to recover damages from two breaching parties, rather than a single party, the lessor would be in a better position than had had been under the original claim because it simply was not true. *Id.* at 464–65.

Moreover, although Phar-Mor argued that the bankruptcy court had to calculate the claim at the time of lease rejection, taking into consideration possible reasonable future re-let value rather than actual values, this case was very unique in the fact that both leases were rejected within a very short period of time making the actual re-let value available to the court during the time of calculations. *Id.* at 465. Considering both this unique set of circumstances as well as

Phar-Mor's reliance on *In re American Home Patient, Inc.*, a case that did not even address the possibility of mitigation the Sixth Circuit Court of Appeals found Phar-Mor's argument baseless. 414 F.3d 614, 618–19; *Giant Eagle*, 528 F.3d at 465–66. As a result, the court chose not to ignore the true re-let values. *Id.* at 465. Finally, the Sixth Circuit Court of Appeals struck down Phar-Mor's stand that Giant Eagle should "suffer the consequences of [its] mitigation efforts with Snyder" due to the claim's lack of support in law. *Id.* at 466.

CONCLUSION

As the result of the Sixth Circuit Court of Appeals' judgment in *Giant Eagle, Inc. v. Phar-Mor, Inc.*, a lessor who attempts to mitigate damages resulting from a prior lessee's breach of contract but suffers from failed mitigation is not required to bear the consequences of the failed mitigation. 528 F.3d 455, (6th Cir. 2008). Because the substitute lease entered into by the lessor and a third-party is not a novation of the original lessee's obligations, the failed mitigation does not result in a revival of a past claim against a debtor, but rather a renewal of a debt that has yet to expire under the clearly stated statute of limitations. To hold otherwise would require the creation of a new law, a power which has not been granted to the court, for "there is no proposition in law or equity that an injured party who attempts to mitigate the damage that results from another party's misconduct must 'suffer the consequences' of its attempting to mitigate". *Id.* Therefore, the Sixth Circuit Court of Appeals was correct in deciding this case for Giant Eagle and enforcing its claim of damages resulting from Phar-Mor's lease rejection.