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BANKRUPTCY LAW

Stub Rent Revisited

No entitlement to immediate payment

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The recent increase in retail bankruptcies has caused the bankruptcy courts and litigants to revisit a variety of legal issues, including the debtor's obligation to pay post-bankruptcy rent while it decides which leases to assume or reject. Recently, the United States Bankruptcy Court for the District of Delaware was asked to determine whether the debtor was required to pay stub rent in a case involving a retail chain with 350 locations. *In re Goody's Family Clothing, Inc.*, 392 B.R. 604 (Bankr. D. Del. 2008). The bankruptcy court held that the landlord was entitled to an order allowing the claim for stub rent, but was not entitled to immediate payment.

Goody's filed a petition under Chapter 11 of the United States Bankruptcy Code on June 9, 2008. Since virtually every real estate lease in the case called for rent to be paid on the first day of the month, Goody's did not pay the June 2008 rent, arguing it is a prebankruptcy obligation which does not have to be paid under Bankruptcy Code Section 365(d)(3) and existing case law, including *CenterPoint Properties v. Montgomery Ward Holding Corp.*,

268 F.3d 205 (3d Cir.2001). Under Section 365 of the Bankruptcy Code, a tenant under a nonresidential lease is only required to "timely perform all the obligations. . . arising" from and after the order for relief (i.e., the date the voluntary bankruptcy petition is filed). The Montgomery Ward court held that obligations only arise when a party becomes legally obligated to perform the obligation which, in this case, is when the rent is required to be paid under the lease. Since the June 2008 rent was due before the bankruptcy was filed on June 9, 2008, the obligation to pay June 2008 rent did not arise post-petition.

Several landlords (collectively landlord) demanded to be paid rent due from June 9, 2008 (the date the bankruptcy was filed) through the end of the first month of the case. This rent is commonly referred to as stub rent. The landlord argued that under Bankruptcy Code Section 503(b)(1), a landlord can file a motion seeking allowance of an administrative claim to the extent it can establish that the debtor's use of the property during the stub period gave rise to an expense which was an actual, necessary cost and expense of preserving the estate. Bankruptcy Code Section 503(b)(1) is available to all creditors, providing they can meet their burden of proof. Not to be outdone, Goody's countered that Bankruptcy Code Section 365(d)(3) pre-empts Bankruptcy Code

Section 503(b)(1) and awarding an administrative claim before a lease is rejected or assumed would conflict with Bankruptcy Code Sections 365(g)(1) and 365(b)(1)(A). Under Bankruptcy Code Section 365(g)(1), if Goody's rejects the lease, Goody's argued that the landlord's unpaid stub rent would be treated as prebankruptcy rent and paid as a general unsecured claim. However, if the lease is assumed, Bankruptcy Code Section 365(b)(1)(A) would require Goody's to pay the stub rent when it cures any monetary defaults (a condition for assuming a lease). The bankruptcy court addressed each argument in turn.

First, the bankruptcy court rejected the pre-emption argument, finding that Bankruptcy Code Section 365(d)(3) does not render Bankruptcy Code Section 503(b)(1) inapplicable. The decision focused on the language in Bankruptcy Code Section 365(d)(3) stating that the post-bankruptcy obligations must be timely performed notwithstanding Section 503(b)(1). In interpreting the notwithstanding language, the bankruptcy court stated that:

Put another way, section 365(d)(3) effectively reads: forget what §503(b) says when the issue is pre-rejection period obligations of a nonresidential real estate lease . . . and aside from administrative expenses

provided for in §503(b)(1), §365(d)(3) creates a new and different obligation—one that does not necessarily rest on the administrative expense concept. In short, section §365(d) (3) does not limit a landlord's remedies for payment of post-petition rent to that section, rather it expands those rights.

Next, the bankruptcy court rejected Goody's argument that Bankruptcy Code Sections 365 (b) (1)(A) and/or 365(g)(1) alters its determination that Bankruptcy Code Section 503(b)(1) is an available remedy to landlords. The bankruptcy court found that courts routinely allow administrative claims for post-bankruptcy use and occupancy of real property by a debtor even if the debtor has already rejected the lease. The fact that the lease is rejected is not controlling — it is whether the landlord can meet its burden of proving its claim under Bankruptcy Code Section 503(b) (1).

Having found that the landlord can look to Bankruptcy Code Section 503(b) (1) as authority for allowance of stub rent, the bankruptcy court turned its attention to the landlord's burden of proof. Under existing law, the landlord must prove that the stub rent is an actual, necessary expense of preserving the debtor's estate. The bankruptcy court found that (1) Goody's occupancy of the leased space establishes that payment of that use is an actual, necessary expense of preserving the estate, and (2) the amount of the claim is the fair market rental value for the use and occupancy which, without evidence to the contrary, is presumably the lease rate. The bankruptcy court ultimately awarded the landlord the full amount

of its stub rent claim.

The landlord won the battle, but the war was not over. The bankruptcy court turned to the last issue which is when Goody's must actually pay the stub rent — immediately or when Goody's emerges from the bankruptcy case. Under established case law, it is clear that the timing of payment of an administrative expense is within the sound discretion of the bankruptcy court. When exercising this discretion, the bankruptcy court noted that: "one of the chief factors courts consider is bankruptcy's goals of an orderly and equal distribution among creditors and the need to prevent a race to the debtor's assets. Thus, distributions prior to confirmation of a plan are usually disallowed when the estate may not be able to pay all administrative expenses in full. Other factors include the particular needs of each administrative claimant and the length and expense of the case's administration."

The bankruptcy court also held that the debtor's decision as to the timing of payment of claims is generally inside the ordinary course of the debtor's business. As such, the decision is entitled to "deference, i.e., the court will not entertain an objection to [a transaction made in the ordinary course of business], provided that the conduct involves a business judgment made in good faith upon a reasonable basis and within the scope of authority under the Bankruptcy Code."

Under this standard, the landlord argued that Goody's should not be able to pick and choose which administrative creditors it wants to pay (i.e., vendors for post-bankruptcy deliveries and professionals being paid during the case), while not paying the landlord its allowed stub rent. Finding this argument fundamentally

flawed, the court held that the Bankruptcy Code's policy of equal distribution among creditors does not require a simultaneous distribution. The landlord also argued that it is bearing the risk of administrative insolvency (i.e., there will not be enough money at the end of the case to pay all administrative claims). The bankruptcy court found there is virtually no risk of administrative insolvency in the Goody's case and, more important, Goody's filed its bankruptcy plan and was nearing the end of the case. Finally, the bankruptcy court noted that the landlord failed to offer any evidence of how it is being prejudiced, short of having to wait for its money like other creditors.

The Goody's Family Clothing case confirms how many retail bankruptcy cases are being handled by bankruptcy courts, at least in the Third Circuit. However, as more retail cases are filed, lawyers will continue to challenge older holdings by making creative arguments in the hope of shifting negotiating leverage their way. When it comes to stub rent, the decision to file a motion for allowance of stub rent often depends on the size of the claim and whether the debtor has given the landlord any indication of its intention to assume or reject the lease. If the stub rent is small or the debtor intends to assume the lease, it may be prudent to wait until the end of the case for allowance of the claim. However, if the claim is large and the debtor is going out of business, it may be worthwhile to file the motion early in the case to be in a position to negotiate payment of the stub rent as the case proceeds. ■

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