

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

Stub Rent and the Way Around *Montgomery Ward*

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The recent flood of retail bankruptcy filings brings to the forefront the divergent positions taken by various circuits, and even different courts within the same circuit, regarding payment of “stub rent.”¹ As courts continue to reach different conclusions on whether payment of stub rent² is an obligation that must be timely performed at the outset of a bankruptcy case, and debtors argue that stub rent should be treated as a general unsecured claim,³ a recent decision from the U.S. District Court for the District of Delaware provides a new twist on this recurring dispute.

In an opinion in *In re Goody's Family Clothing*,⁴ issued March 31, 2009, Hon. Renee Marie Bumb (D. N.J., sitting by designation), took the

¹ Stub rent is the unpaid rent due from the date of the bankruptcy filing through the end of that month under a lease that requires payment of rent on the first day of the month. Debtors typically file for bankruptcy without having paid rent for that month. The period between the bankruptcy filing and the end of that month is referred to as the stub rent period, and “stub rent” refers to the rent relating to the debtor’s use and occupancy of the premises during the stub rent period.

² Disparate treatment of stub rent is the result of a circuit split regarding treatment of various lease obligations with pre- and postpetition components, including rent, common-area maintenance charges and real estate taxes. See *In re Stone Barn Manhattan LLC (f/k/a Steve & Barry’s LLC)*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008). In “billing date” jurisdictions, courts look only at the date that the obligation becomes due and payable under the lease, not whether some portion of the obligation relates to the prepetition period. *Id.* Under the proration theory, the courts look at the underlying nature of the claim and when it accrues to determine whether it is an obligation that must be timely performed. *Id.* Typically, in a proration jurisdiction, if the claim contains both pre- and postpetition components, the court essentially divides the claim into two parts: Only the postpetition component is subject to the timely performance obligation and allowed as an administrative priority claim, while the remainder is treated as a prepetition claim. In billing-date jurisdictions, courts generally view stub rent as having arisen prepetition (on the first day of month), and in proration jurisdictions, courts generally view stub rent as having arisen on the petition date and each of the remaining days in that first month that the debtor occupies the premises. *Id.*

³ *In re Goody’s Family Clothing Inc.*, 401 B.R. 656, 665 (D. Del. 2009).

⁴ *Id.* at 656.

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opportunity to suggest that the Third Circuit’s decision in *Montgomery Ward*,⁵ in which the Third Circuit adopted the “billing date approach” for the treatment of lease obligations, should not be applied to stub rent because the result contradicts Congress’ intent in enacting §365(d)(3) of the Bankruptcy Code and, taken to the extreme, arguably renders §365(d)(3) meaningless with respect to almost all rent payments.⁶ The district court was not asked to directly address the applicability of §365(d)(3) to stub rent and affirmed the bankruptcy court’s ruling that stub rent was properly

the Bankruptcy Code in 1984, requires a debtor-in-possession (DIP) to “timely perform all the obligations...arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding §503(b)(1).”⁷ The purpose of §365(d)(3) was to save landlords the expense and burden of having to file motions for payment of rent and demonstrate under §503(b)(1) that such rent constitutes an actual, necessary expense of preserving the debtor’s estate.⁸ Under §365(d)(3), payment of rent at the contract rate is automatic and is the preferred avenue for recovering stub rent. In proration jurisdictions, stub rent is generally payable immediately under §365(d)(3).

In contrast, in billing date jurisdictions, courts generally require landlords to use §503(b)(1) to recover payment of stub rent. Section 503(b)(1) allows an administrative claim

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allowed as an administrative claim under §503(b)(1) of the Code. However, in a lengthy footnote, the district court provided three suggestions as to why §365(d)(3) could require payment of the full month’s rent for the month during which the case filed, not just the prorated portion of the stub rent period.

A Brief Primer on Recovery of Stub Rent

Landlords have two statutory means to seek payment of stub rent: §365(d)(3) and 503(b)(1). Whether a jurisdiction follows the billing-date approach or proration approach will inform how the landlord proceeds with respect to stub rent. Section 365(d)(3), added to

for “the actual, necessary costs and expenses of preserving the estate.” However, payment usually requires proving that the stub rent is an actual and necessary cost of preserving the estate. Rather than having its claim paid “timely” as required by §365(d)(3), §503(b)(1) claims are usually paid at the end of the case, alongside other administrative claims. Requests for immediate payment of administrative claims are generally denied, and by waiting until the end of the case, the landlord is also forced to bear the risk that the case will be administratively insolvent and that it will be paid less than 100 percent of its allowed claim.

⁵ *Centerpoint Properties v. Montgomery Ward Holding Corp.* (In re *Montgomery Ward Holding Corp.*), 268 F.3d 205 (3d. Cir. 2001).

⁶ 401 B.R. at 664, n. 8.

⁷ 11 U.S.C. §365(d)(3)

⁸ 401 B.R. at 664, n. 8.

Goody's: The Bankruptcy Court Opinion⁹

The facts of *Goody's* are fairly straightforward. The debtors filed for bankruptcy on June 9, 2008, after failing to pay June rent that was due June 1, 2008, for the debtors' retail stores.¹⁰ Several landlords subsequently moved for allowance of their June stub rent under §503(b)(1) and immediate payment of that stub rent under §365(d)(3). The debtors objected to both the allowance and the immediate payment of the stub rent, arguing that §365(d)(3) preempted §503(b)(1)¹¹ and thus, §365(d)(3) was the landlord's sole avenue for recovering stub rent. The debtors argued that because the Third Circuit is a billing date jurisdiction, the stub rent arose prepetition and could not be allowed as an administrative claim under §503(b)(1). Finally, the debtors argued that even if §365(d)(3) did not preempt §503(b)(1), there was no postpetition actual and necessary cost or expense due under the leases during the stub rent period, and thus, the stub rent could not be an allowed claim (much less paid) under §503(b)(1).¹²

The bankruptcy court, under Hon. **Christopher S. Sontchi** (D. Del.; Wilmington) agreed with the debtors that, pursuant to the "billing date" approach, the debtors' obligation to pay stub rent arose prepetition, on the first day of the month, and payment of the stub rent is not an obligation that must be timely performed pursuant to §365(d)(3).¹³ However, the bankruptcy court disagreed with the debtors' argument that §365(d)(3) preempted §503(b)(1), ruling that the "notwithstanding" in §365(d)(3) means "in spite of," not "to the exclusion of," as the debtors had argued at length.¹⁴

⁹ *In re Goody's Family Clothing Inc., et al.*, 392 B.R. 604 (Bankr. D. Del. 2008). As clarification for those readers unfamiliar with the saga of Goody's, the Goody's chain of retail stores has made two recent chapter 11 filings. The first filing, on June 9, 2008, was made by Goody's Family Clothing Inc. and its affiliates, and was assigned Case No. 08-11133 (CSS) (jointly administered). The proceedings and decisions discussed herein arise under the first chapter 11 case. Following confirmation of a plan of reorganization in the first case, the second filing, on Jan. 13, 2009, was made by Goody's LLC and its affiliates, and was assigned Case No. 09-10124 (CSS) (jointly administered).

¹⁰ *Id.* at 607.

¹¹ The debtors highlighted the phrase in §365(d)(3) "notwithstanding §503(b)(1)" as evidence of congressional intent to preempt §503(b)(1).

¹² In support of their final argument, the debtors cite the unpublished Sixth Circuit case, *BK Novi Project LLC v. Stevenson (In re Baby N' Kids Bedrooms Inc.)*, in which the debtor filed for bankruptcy on June 8, 2006, after failing to pay rent that was due on June 1, 2006. The landlord moved for payment of its stub-rent claim under §503(b)(1) and was denied by both the bankruptcy and district courts. The Sixth Circuit Court of Appeals held that because the obligation to pay stub rent "arose" before the petition date, it was not payable as an administrative expense. The court stated that the language in §503(b)(1), classifying as administrative expenses the "actual, necessary costs and expenses...for services rendered after the commencement of the case," dictated that a claim must arise after the petition date in order to receive administrative priority under §503(b)(1). Neither the authors nor the editors of *ABI Journal* express any viewpoint as to the propriety of citing to unpublished opinions.

¹³ 392 B.R. at 608-09.

¹⁴ *Id.* at 612.

The court stated that §365(d)(3) creates a "new and different" obligation from the administrative expenses provided for in §503(b)(1), one that does not require the landlord to file an administrative claim and seek immediate payment.¹⁵

Having found that §365(d)(3) does not preempt or prevent a landlord from moving for allowance and payment of stub rent under §503(b)(1), the bankruptcy court ruled that the debtors' postpetition use and occupancy of the leased premises were actual and necessary expenses of preserving the debtors' estates that gave rise to valid administrative claims under §503(b)(1) for the fair market value of the occupation period. With respect to the fair market value, the court ruled that absent evidence to the contrary, it would presume that the rental rate under the lease is the fair market value. The debtors presented no evidence to the contrary, and the claims for stub rent were allowed at the rental rate in the leases. However, the bankruptcy court refused to order immediate payment of the landlords' claims for stub rent under §503(b)(1), holding that such claims should be paid on the effective date of a plan of reorganization at the same time as other similar administrative claims.¹⁶

Goody's: The District Court Opinion¹⁷

On appeal, the debtors argued that the bankruptcy court erred in ruling that the landlords' claims for stub rent were entitled to administrative priority under §503(b)(1).¹⁸ The landlords did not appeal the bankruptcy court's ruling that the debtor was not required to pay the stub rent immediately under §365(d)(3).¹⁹

The district court's decision adopted the bankruptcy court's analysis of the meaning of "notwithstanding" and performed an analysis of the legislative history of §365(d)(3), concluding that "notwithstanding" merely carved rent obligations out of the requirements of §503 and did not preempt landlords from recovering under §503(b)(1) to the extent that payment under §365(d)(3) was not required.²⁰

Montgomery Ward and Footnote 8

The most interesting, and perhaps significant, aspect of the district court's

decision is that it took issue with the bankruptcy court's application of *Montgomery Ward*²¹ to rent payments. *Montgomery Ward* has long been accepted in the Third Circuit as the landmark case supporting the "billing date" approach to payment of lease obligations. In *Montgomery Ward*, a landlord moved for payment of taxes attributable to both the pre- and postpetition period that came due under a real property lease after the bankruptcy filing. The debtor contested the motion, seeking to pay only the prorated postpetition amount. The Third Circuit Court of Appeals held that the debtor-tenant was liable for payment of the entire tax bill, regardless of the time period to which those taxes were attributable, because the entire tax bill was an obligation arising under the lease after the bankruptcy filing that the debtor was required to timely perform. Applying the reasoning of *Montgomery Ward* to rent payments due on the first of the month, when a bankruptcy petition is filed after the first of the month, none of the rent for the month is an obligation that the debtor is required to timely perform under §365(d)(3).

Without disturbing the bankruptcy court's ruling, the district court noted that applying *Montgomery Ward* to monthly rent payments contradicts the expressed intent of §365(d)(3) to relieve landlords of the burden of filing administrative expense claims and moving for immediate payment of postpetition rent. In the lengthy footnote 8 of the decision, the district court noted that using the "billing date" approach allows debtors to strategically avoid significant postpetition rent obligations by filing petitions on the first few days of the month. The practical effects of *Montgomery Ward* can differ drastically, based on the way the lease is drafted. Using the example of a typical retail lease provision that the total rent obligation is due on the commencement of the lease with payment amortized in monthly installments, the district court noted that *Montgomery Ward* arguably strips §365(d)(3) of any practical effect because in that scenario the entire lease obligation arises prepetition. However, if under the lease rent is due each day, but is permitted to be paid monthly for the sake of convenience, the practical effect would be the same as the "proration" approach followed in other circuits. The district court continued,

¹⁵ *Id.* at 611.

¹⁶ *Id.* at 617-18.

¹⁷ 401 B.R. 656.

¹⁸ *Id.* at 660.

¹⁹ Although the landlords later suggested that the district court could revisit that issue, the court declined to formally do so. *Id.* at 664.

²⁰ *Id.* at 665-70.

²¹ 268 F.3d 205.

in the same footnote, to suggest three possible solutions to the seemingly inconsistent outcomes that result from use of the “billing date” approach.

First, the court suggested treating rent as a recurring obligation that arises daily, rather than at the beginning of the month or some other date designated in the lease, regardless of how a lease is drafted. In other words, the entire month’s rent would become due each day of the month. This approach not only eliminates the “billing date” problem for stub rent, but goes a step further than simple proration. A debtor filing for bankruptcy protection mid-month would be obligated to pay the entire month’s rent under §365(d)(3) because the obligation to pay the whole month’s rent would arise each day after the petition is filed.

Second, the district court suggested that landlords use grace periods to their benefit, treating the end of the applicable grace period as the date that the rent becomes due and treating the designated due date as simply the option to pay early. This approach would benefit landlords where debtors file for bankruptcy protection in the time between the due date and the end of any applicable grace period, but would not prevent “strategic” filings, as the debtor could simply wait until a day after the grace period to file for bankruptcy.

The final work-around suggested by the district court is to treat default clauses in leases as creating a new obligation upon an event of default, one that requires payment of all rent due plus the specified penalty. When the event of default occurs postpetition, all rent plus penalties would be payable under §365(d)(3). This approach would provide for payment of the whole month’s rent, rather than prorating rent due for the stub period.²²

While the district court’s criticism of the application of *Montgomery Ward* and its proposed solutions all appear as *dicta* in the *Goody’s* opinion, the district court’s well-reasoned probe of the widely-accepted application of *Montgomery Ward* to stub rent adds a new set of arguments for future motions to compel payment of stub rent.

Unless Congress intervenes in the interim and clarifies a debtor’s payment obligations with respect to stub rent, the inconsistent approaches to payment of stub rent are ripe for resolution by

the U.S. Supreme Court. The debtors in *Goody’s* have appealed the district court’s opinion to the Third Circuit, and an appeal to the Supreme Court is possible.²³ Stay tuned. ■

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²³ As discussed in greater detail by Joel H. Levitin and Richard A. Stieglitz Jr. in “The Ticket to Solving the Stub Rent Dilemma,” (*ABI Journal*, February 2009, p. 26), the U.S. Bankruptcy Court for the Southern District of New York in *In re Stone Barn (W/a Steve & Barry’s)* issued a memorandum opinion, holding that stub rent should be prorated and paid at the outset of the case pursuant to §365(d)(3). 398 B.R. 359. After acknowledging the existing circuit split and undertaking a thorough analysis of the cases for both the billing-date approach and proration, the court ruled that the goals of the Bankruptcy Code were best achieved through the proration approach and allowed payment of stub rent under §365(d)(3). The court stated that the proration approach was fair and equitable to all parties and removed the incentive for debtors to a file bankruptcy case on the second day of the month in order to circumvent the payment of rent under the “billing date” approach. Finally, in light of the existing circuit split and divergent decisions even within the Second Circuit, the court *sua sponte* stayed the effectiveness of its own ruling to allow the parties the appeal and stated that if the parties so desired, the court would certify its decision for appeal directly to the Second Circuit. Since the parties settled before an order was entered and no appeal was taken, the issue remains unresolved in the Second Circuit.

²² 401 B.R. at 664, n. 8.